Achieve More Precise Portfolio Structures with Strategic Beta: Part 1 of 3

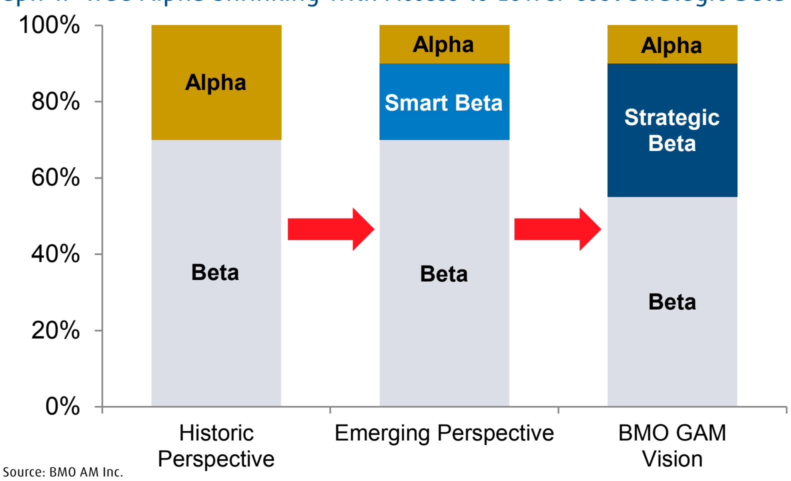
Strategic Beta allows investors to target exposures efficiently in order to generate specific results in their portfolios. As institutional funds move towards outcome-oriented benchmarks and more targeted risk exposures, Strategic Betas are likely to prove integral to their investment approach. The uses of Strategic Beta have been covered in some depth over the last few years mostly with a view to enhancing return, although they can also be used to reduce risk or as a precise way to deliver an intended outcome. In this series, we summarize some of that discussion and point Canadian investors to certain solutions that we believe enhance portfolio efficiency. This first article starts with an overview of the current state of the market regarding Strategic Beta.

Strategic versus Traditional Beta

Traditionally, "beta" has referred to capitalization weighted indices that reflect the universe of securities in a market. This serves us well as a way of representing how a broad market performs. Passive management, of course, is the replication of these capitalization-weighted indices. While there are variations in how investors think about Strategic or Smart Beta, relative to traditional beta, most of us think of it as a way of capturing a particular outcome.

By definition, Strategic Betas are active management since they are not capitalization-weighted strategies. They usually focus on specific outcomes, behavioural anomalies or structural inefficiencies that can be captured in a transparent rules-based approach and may be found in stocks, bonds and other asset classes. Often, they can be accessed in a lower cost way than traditional active management. Strategic Betas are available in a variety of rules-based and fundamental strategies accessible through vehicles such as ETFs and institutional pools. They are not to be confused with quantitative fund management which normally aims to capture an alpha.

Graph 1: True Alpha Shrinking with Access to Lower Cost Strategic Beta[1]



Source: BMO AM Inc.

Historically, some return premia obtained from systematic risk factors, such as value and small capitalization, were considered "alpha". Because of our recent ability to access these returns through rules-based strategies, many of these types of return premia are no longer considered alpha: this concept is illustrated in Graph 1. Research indicates that the magnitude of the return from these factors, or what we now call Strategic Beta, may be larger than the remaining alpha, meaning that historically Strategic Betas have likely accounted for more than half of active manager outperformance[1].

Much of the research on Strategic Betas is focused on finding sources of return that outperform broad markets, such as value, low volatility or small capitalization stocks. There are varying opinions as to which ones are likely to deliver the highest long-term return. However, what we do know and expect to be true going forward is that Strategic Betas' performance relative to broad markets will vary over time.[2] *Over the long run, we believe that investors will fare better if they use these betas to target specific risk exposures for their portfolios, not because they might outperform broad benchmarks but because those portfolios will be more precisely positioned to deliver the investors' desired outcomes.*

Key to targeting specific risk exposures is ensuring the purity of the beta, because unintended or residual exposures to other factors exist in most securities. In order to ensure a desired portfolio outcome, it is most important to have a good understanding of the nature of the benchmark for the target beta, particularly how it behaves in different market conditions and relative to other holdings in the portfolio.

What Strategic Beta Delivers

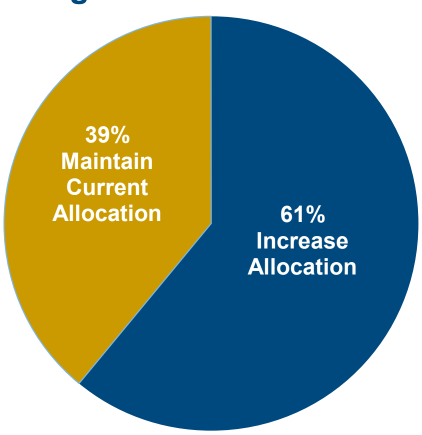
Investors can access specific risk exposures through some rules-based strategies that are based on non-capitalization-size weights, such as equal, value or risk weightings. For example, equal-weighted strategies may be driven by a philosophy that market capitalization indices are less efficient because they emphasize larger capitalization and/or higher-priced stocks, which may not be optimal. Alternatively, investors could take the view that equal weighting provides a more holistic exposure to the sector and allows you to more effectively capture the risk premia being sought, rather than being dominated by the larger cap securities. Other strategies choose stocks with particular characteristics, such as smaller capitalization, higher quality or lower volatility.

Investors target specific outcomes for a variety of reasons, particularly the following:

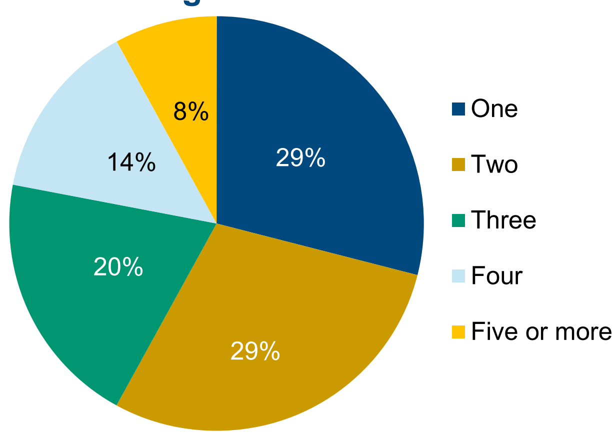
- Certain Strategic Betas, such as small cap and value, have been shown by many different studies to generate a return above the broad market over long periods of time;
- Others, such as low volatility, work to reduce risk, either alone or in combination with other holdings; and,
- Strategic Beta return premiums can be less correlated to broad markets, which makes them useful for creating certain portfolio outcomes, particularly absolute returns. They are created from the return generated by a particular factor relative to the broad market. The value premium, for example, is the *difference* in return between value stocks and the broad market and has a low correlation to the broad market itself. For example, for the ten years to December 31, 2014, the BARRA global value factor had a correlation of only 0.3 with the MSCI World index (sources: BARRA and Bloomberg).

New strategies designed to extract an alpha from the active management of multiple Strategic Beta exposures are increasingly becoming available. These may involve actively managing the weights of specific Strategic Beta exposures often using ETFs.

Outlook for Smart Beta[3] Usage in next 18 months



Number of Smart Beta[3] Strategies Used

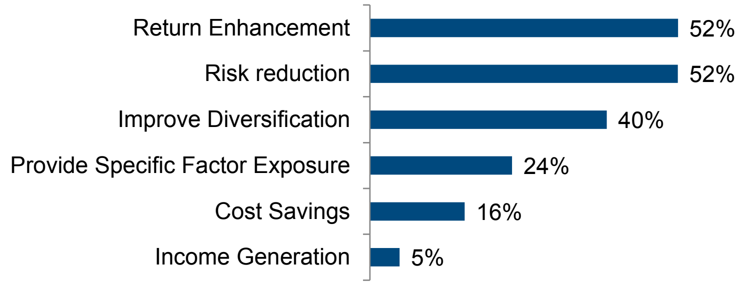


How Investors Use Strategic Beta[3]

In a recent survey on the uses of Strategic Beta by global institutions, one consultant found that 21% of North American institutions are already invested with another 34% evaluating or expecting to evaluate Strategic Beta soon. On average, investors are evaluating four different strategies with only 6% intending to hold a single strategy: of those using Strategic Beta, 70% use more than one strategy. Another 33% are using or evaluating Strategic Beta for tactical purposes. Conscious adoption of Strategic Beta is greatest among the largest asset owners, but smaller ones are quickly following.

Key uses of Strategic Beta are the following:

Reasons to investigate smart beta strategies[3]



1. **Return enhancement:** an impetus for considering Strategic Beta for 52% of institutions[3]

   Much of the existing research aims to identify fundamental market drivers and to weight portfolios according to their potential outperformance of broad markets, volatility and correlations with other assets. One recent article[4] was based on the largest stocks in equity markets in countries such as the US, as well as in a global index. Consistent with other studies, the main drivers of return were found to be small capitalization and value stocks so that portfolios emphasizing those factors were expected to outperform broad markets over long periods of time. Equal-weighted and random portfolios were found to outperform because they favour one or both of small cap and value relative to the broad markets. Other factors that have been found to outperform broad markets include stocks with one or more of the following characteristics relative to the market: higher yield, lower volatility, less liquidity and higher quality. Definitions of these factors, especially value and quality, vary widely.

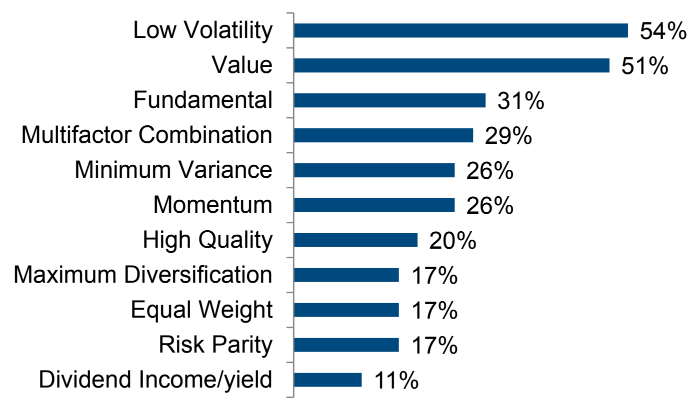
   When choosing a provider of rules-based Strategic Betas, investors should be especially conscious of the thought the provider has put into exactly which factors are being measured and how. The factors must have sufficient liquidity to be implementable.

2. **Risk reduction:** 52% of institutions seek to reduce risk, 40% to improve diversification[3]

   Investors who define risk as volatility of surplus may invest in rules-based strategies that help hedge against their liabilities, such as individual or a combination of fixed income ETFs that meet the desired credit and duration objectives.

   Investors who define risk as total portfolio volatility (standard deviation) can use Strategic Beta to reduce risk.

Current Smart Beta Usage[3]



   There are two key ways to do this:

   Hold Strategic Betas with low correlations to other portfolio assets: Considerable research is focused on defining many sources of uncorrelated beta, from areas such as renewable energy, real estate catering to students and commercial long-lease real estate. Most of these are illiquid and demand specialized active management.

   Invest in strategies with lower volatility: Alternatively, volatility can be reduced by investing in stocks with below-market volatility. These are available globally as fundamental, quantitative, or rules-based strategies designed to generate less volatility.

   Investors who define risk as tracking error relative to a policy mix may wish to close gaps in key asset classes, sectors or risk factors over short or long periods of time. These gaps can be potentially closed by investing in one or more of market-cap-based passive index strategies, traditional actively managed strategies or rules-based Strategic Beta strategies. The choice comes down to investor beliefs and preferences.

For example:

- Your fund may have committed to infrastructure exposure that is going to take several years to implement. During that period, you may decide to minimize your mismatch relative to your policy by holding publicly traded infrastructure stocks.
- Canadian investors tend to have a home-country bias in stocks, which implies an underweighting in health care and technology among other things, relative to US and global markets. You may wish to access those specific missing or reduced exposures.
- Upon reviewing all your managers' exposures, you may conclude that your aggregate holdings are underweighted in a factor you believe is important, such as small cap or value stocks.

3. Thematic investing

Strategic Beta can also be useful in implementing thematic investing to take advantage of global or local transformational trends. An example would be Environmental, Social and Governance (ESG) or Socially Responsible (SRI) investing: There is a wealth of research demonstrating the value that ESG/SRI brings to investors and to broader social values. Ways to access that value include active strategies in global stock and bond markets, as well as passive, as more ESG indices emerge.

What's Next

In summary, Strategic Beta represents a way of capturing rules-based, transparent and more precise exposure to a desired investment outcome. These range across specific needs regarding income, total return or risk. Potential pitfalls include ensuring exposures are pure and having a deep understanding of factor behaviour and construction.

The next articles in this series address key Strategic Beta strategies:

- Integrating lower volatility returns through active and passive Canadian and global stock strategies, and
- Strategic Beta strategies that enhance total fund efficiency.

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Footnotes

1. Adapted from "Can Alpha be Captured by Risk Premia", by Jennifer Bender, Brett Hammond and William Mok, Winter 2014, Volume 40 Number 2, The Journal of Portfolio Management
2. From Nomura Global Markets Research, Jan 26, 2015, Global Quantitative Research Monthly
3. From "Smart beta: 2015 global survey findings from asset owners" by Rolf Agather, CFA, Managing Director of Research, North America and Peter Gunthorp, Managing Director, Research & Analytics, FTSE Russell. Based on a survey undertaken in February 2015. The 214 asset owners representing more than US$2 trillion were drawn from Europe (26%) and North America (61%). Roughly 23% work in private businesses, 14% in non-profits or universities, 13% in union/industry wide plans and 22% in governments. 65% manage defined benefit plans, 38% defined contribution plans and 17% endowments/foundations. By AUM, 29% manage assets less than $1 billion in size, 33% manage assets between $1 and $10 billion and 38% in excess of $10 billion.
4. The Surprising Alpha from Malkiel's Monkey and Upside-Down Strategies, by Robert Arnott, Jason Hsu, Vitali Kalesnik and Phil Tindall, The Journal of Portfolio Management, Summer 2013