

Enhance Total Fund Efficiency with Strategic Beta: Part 3 of 3

Strategic Beta allows investors to target exposures efficiently in order to generate specific results in their portfolios. As institutions move towards outcome-oriented benchmarks and more targeted risk exposures, Strategic Betas are likely to prove integral. In this series, we discuss how institutions are using Strategic Beta and point to key solutions that we believe enhance Canadian portfolio efficiency or generate specific useful outcomes. In our first two articles, we provided an overview of the current state of the market regarding Strategic Beta and discussed how to enhance portfolio efficiency using low volatility Strategic Beta. This third article addresses other Strategic Betas with a view to combining them in a portfolio.

Targeting Specific Outcomes

Strategic Betas have the highest impact when investors are clear about their purpose in the portfolio. Much of the research on Strategic Betas is focused on their potential to outperform broad markets, with varying findings as to whether that is a reasonable expectation. *We believe that investors will fare better if they use Strategic Betas to target specific risk exposures, not because they might outperform broad benchmarks but because their portfolios will be more precisely positioned to deliver their desired outcomes.*

Prioritizing desired portfolio outcomes helps articulate the trade-offs that lead to the best solution. Keeping in mind that all Strategic Beta solutions are not created equal, investors benefit from considering the strategies' behaviours and correlations in normal and extreme markets and how their exposures compare to the fund's needs and gaps, both among Strategic Beta and across providers in the market. As well, investors require a definition of success and a way to measure it.

Table 1 provides a useful framework for thinking about each Beta and the outcomes it contributes. For example, reducing volatility can be achieved in different ways. By choosing a High Quality strategy to deliver that outcome, other outcomes might also be expected, such as outperforming the broad market over a cycle and enhancing a liability hedge. The key is to develop a conviction about the importance of each outcome that will help identify the best solution.

TABLE 1: PRIORITIZING OUTCOMES

Effect on Total Stock Outcomes	Strategic Betas (Stocks)						Bonds GDP-Weighted Emerging Markets [^]
	Direct Real Estate	Infra- structure	Equal Weight ⁺	Low Volatility	High Quality	Small Cap	
1. Enhance liability hedge through lower volatility factor exposure	✓	✓		✓			
2. Outperform broad market over a cycle [*]				✓	✓	✓	✓
3. Reduce volatility	✓	✓		✓	✓		✓
4. Reduce gaps in exposures	✓	✓	✓	✓		✓	✓

Source: BMO Global Asset Management ✓ = High potential to achieve outcome

^{*} Some studies show these betas may outperform markets over long periods of time. We are uncomfortable approaching a Strategic Beta with a view to outperforming a market because results can vary significantly through a cycle. As well, risk characteristics may not imply a sufficient difference to justify a higher return.

[^] We expect GDP-weighted debt to be less volatile than cap-weighted strategies with higher exposure to more indebted countries.

⁺ Equal weighting ensures a holistic exposure to a sector by reducing the impact of the larger stocks and thereby allowing you to truly extract the equity risk premia of that sector.

Next, we examine two Strategic Betas – Global Infrastructure and Quality – to demonstrate the importance of clarifying desired outcomes before committing to a strategy. For the purposes of this examination, we use publicly listed ETFs to illustrate our points. It’s important to note that our comments reflect the strategies themselves and not the ETF, which is simply a vehicle used to deliver the strategy.

Global Infrastructure

Infrastructure is attractive because stable cash flows are expected to contribute to lower volatility. Possible objectives for global infrastructure investments include:

- reducing the cyclicity of returns,
- reducing volatility, and
- hedging liabilities.

It can be accessed in two ways, either of which may entail the use of leverage that magnifies the volatility of the assets:

1. Directly by acquiring an interest in each project through pooled funds or direct holdings. Returns are based on infrequently appraised values that do not reflect interim market fluctuations and thus understate the volatility of the assets.
2. Through publicly traded infrastructure stocks. While the stocks exhibit volatility more consistent with broad market movements, investors may prefer them for their liquidity. As well, investors who have committed to direct investment in infrastructure can use the stocks to minimize policy mismatch until the allocation has been invested.

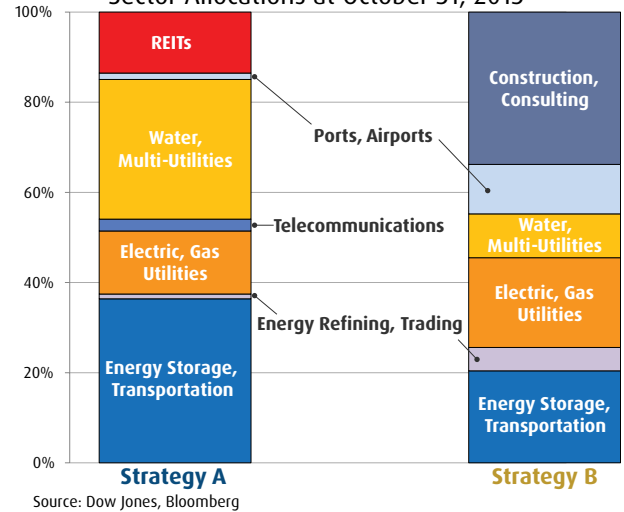
To demonstrate the range of potential outcomes from infrastructure strategies, we examined the characteristics of two Canadian-listed global infrastructure ETFs, Strategies A and B, starting with their sector exposures, shown in **Graph 1**. The sector allocations of the two ETFs differ considerably, with Strategy B having a substantial exposure to the more cyclical Consulting and Construction sector. This outcome is visible in **Graph 2**, where, as expected, we see the volatility of Strategy A is significantly lower than both the MSCI World Index and Strategy B.

Finally, **Table 2** shows the correlations of the two strategies with key benchmarks.

- Perhaps most important to Canadian investors, Strategy A has a higher correlation with long Canadas, making it the better liability hedge.
- Strategy A is less correlated with the MSCI World Index, making it a better diversifier within a global stock portfolio.

Note:
 Strategy A = Dow Jones Brookfield Global Infrastructure North American Listed Index
 Strategy B = Manulife Asset Management Global Infrastructure Index

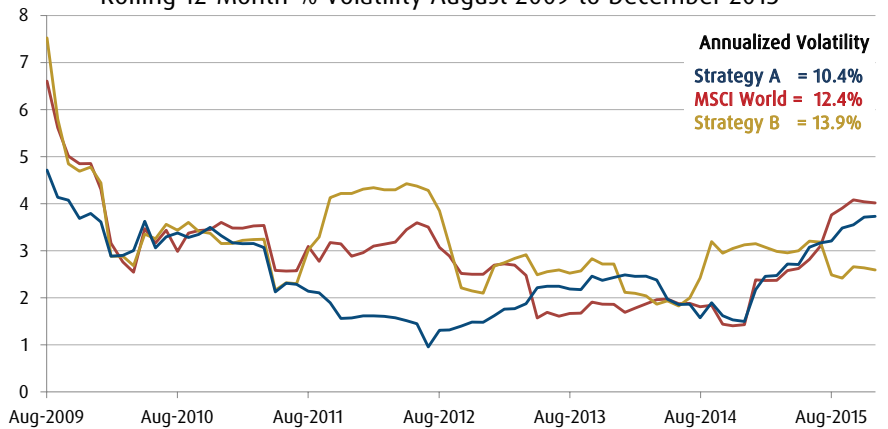
GRAPH 1: STRATEGY B MORE CYCLICAL
Sector Allocations at October 31, 2015



Source: Dow Jones, Bloomberg

GRAPH 2: STRATEGY A LESS VOLATILE

Rolling 12-Month % Volatility August 2009 to December 2015



Source: Bloomberg

TABLE 2: STRATEGY A – THE BEST LIABILITY HEDGE

Correlations		
from August 2009 to December 2015		
	Strategy A	Strategy B
MSCI World Index	0.68	0.82
FTSE TMX Long Federal Bonds	0.39	0.14

Source: Bloomberg, PC Bond

Quality

A typical definition of a quality stock is a market-leading company with a durable business model and sustainable competitive advantage. Investors may choose to access quality stocks for the following reasons:

- enhance total portfolio diversification by sectors or factors,
- generate a stable earnings stream, leading to below-market volatility, and/or
- generate above-market returns over the long run.

To demonstrate the range of outcomes available, we again compare two US stock Quality ETFs listed in Canada, starting with their sector allocations in **Graph 3**. Both are based on MSCI Indices, and seek a combination of:

- high return on equity,
- stable earnings growth, and
- low leverage.

The difference is that Strategy D's sector allocations are neutral to the broad market, providing no sector diversification by design, whereas Strategy C's securities are weighted based on the product of their weight in the broad market and their Quality score, with a cap of 5% per security. Which approach is more appropriate varies by investor, depending on the desire to diversify against existing exposures or to enhance exposure to a specific factor.

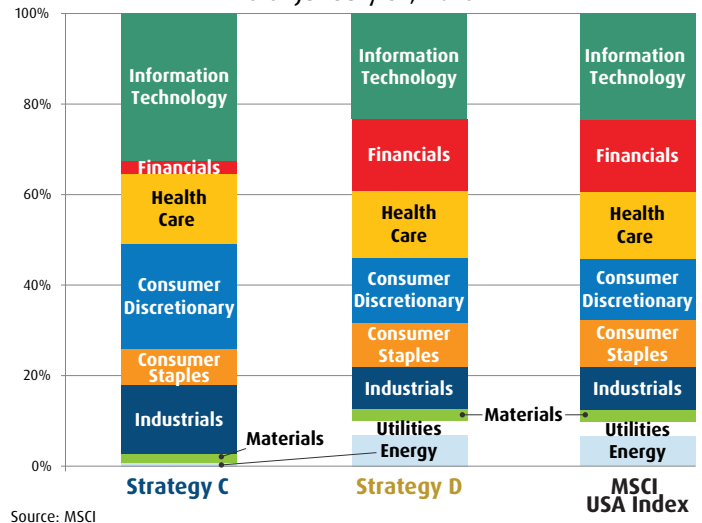
The variation in sector exposures naturally generates different factor exposures over the long run, as shown in **Graph 4**, which shows it over the last 10 years. Once again, the right choice is a function of each investor's targeted outcomes.

To understand which strategy best captures the stability of earnings and the long-term returns, we turn to **Graph 5**. The two strategies experienced similar returns over the long run above the broad market, with Strategy C having a slightly better risk profile.

In conclusion, prioritizing all desired outcomes will lead investors to the best solution for any target Strategic Beta. Global Infrastructure and Quality represent two potential desirable exposures and choosing the right strategy is a matter of knowing which risks are best for a particular portfolio overall.

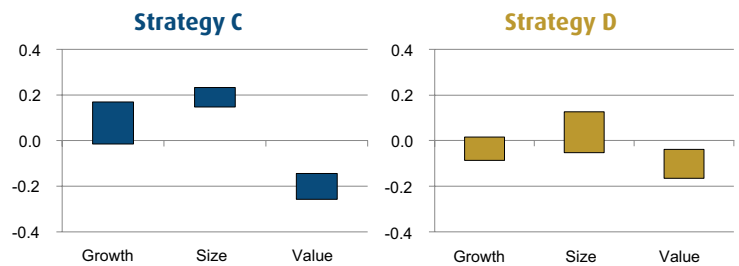
Note:
 Strategy C = MSCI USA Quality Index
 Strategy D = MSCI USA Sector Neutral Quality Index

GRAPH 3: SECTOR ALLOCATIONS OF QUALITY ETFs
 As of January 31, 2016



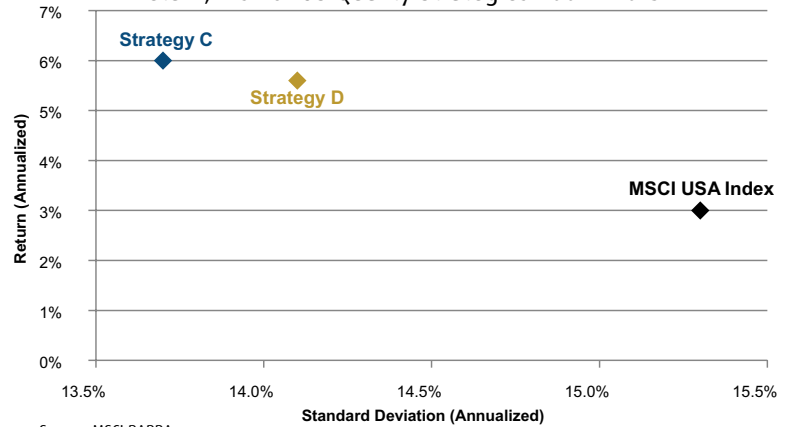
Source: MSCI

GRAPH 4: DIFFERENT FACTOR EXPOSURES
 Ranges of Factor Exposures from 2006 to 2015



Source: MSCI BARRA

GRAPH 5: SIMILAR RISK/REWARD TRADE-OFF
 Return, Risk of US Quality Strategies 2001 - 2015



Source: MSCI BARRA

Putting it All Together

In order to ensure that all desired outcomes have been identified and prioritized, we created the following list of issues to review.

Policy

- Factors that drive the liabilities, whether to hedge them and by how much
- What kind of mismatch is tolerable versus liabilities
- How much downside and volatility is tolerable
- How much return is needed to ensure fund sustainability

Strategy

- Missing sector or factor exposures necessary to achieve the policy target
- Investment beliefs that certain factors will outperform broad markets over the long run
- Elimination of unintended beta exposures

Tactics

- Temporary allocations that reduce gaps during transitions
- Factor timing

Having addressed those questions allows investors to prioritize desired outcomes, then identify available solutions and how to measure success. In assessing manager skill and construction methodology, investors should consider:

- asset behaviour and correlations in normal up and down markets, as well as worst case scenarios; and,
- diversification of strategies and exact characteristics relative to portfolio gaps.

This exercise allows investors to understand their trade-offs in order to weigh the best solution or combination of solutions.

Previous Articles

- Part 1 – Achieve More Precise Portfolio Structures with Strategic Beta ([click here](#))
- Part 2 – Choosing an Effective Low Volatility Strategy with Strategic Beta ([click here](#))

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Footnotes

1. Pension Investment Association of Canada (PIAC) website
2. All historic data begins July 1, 2005 and runs to June 30, 2015 based on actual returns except the following periods of simulated data:
 - BMO Low Volatility Canadian Strategy: July 2005 to September 2011
 - BMO Low Volatility US Strategy: July 2005 to March 2013
 - BMO MSCI USA High Quality Strategy: July 2005 to November 2014
 - BMO Low Volatility International Equity Strategy: July 2005 to September 2015

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