The Promise of Smart Beta

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By the early 1970s, the finance literature had already documented that the average mutual fund consistently underperformed the market index, net of fees. The literature also demonstrated that a diversified "market" portfolio would naturally earn a positive equity risk premium without the help of a skilled stock picker. Armed with these academic findings, Paul Samuelson (1974, p. 18) challenged investment practitioners to consider creating investment portfolios that track the S&P 500 Index.

Samuelson's short article struck Jack Bogle (2014, p. 42) "like a bolt of lightning." Recounting the early history of Vanguard, Bogle identifies Samuelson's challenge as a major impetus for the creation of the first index mutual fund. Vanguard's low cost index funds, to me, were born out of a deep awareness of the academic literature and a deeper concern for the welfare of the end-investor. Nothing in our industry has so inspired me.

As a champion of smart beta and a spokesperson for Research Affiliates, which regularly debates Vanguard on the definitions of "beta" and "index," I am unlikely to be confused for a "Boglehead." However, I have the highest respect for Jack Bogle's contributions. In fact, I would love to see the smart beta revolution yield the next wave of low cost investment solutions firmly grounded in academic research and the investor-centric philosophy he championed. However, we're a long ways off from there at the moment and I'm concerned. Let me explain.

It is no secret that investment management firms are profit-seeking organizations relentlessly competing for more assets. Even small investors who are unsure of the difference between active and passive managers know that both are trying to make a living. So, for the record, let's say it loud and clear: Investment management is a for-profit enterprise. As such, asset managers and asset owners have a relationship beset with natural conflicts.

Asset owners want fees below 10 bps; asset managers prefer "2% + 20%."[1] Asset owners want transparency; asset managers favor black-box opacity. Asset owners want simplicity; asset managers hire rocket scientists to create complex optimized solutions for sex appeal.[2] Asset owners want "future" outperformance after they fund a manager; asset managers would be satisfied with strong past outperformance to facilitate future asset gathering. Asset owners want a bigger alpha; asset managers would happily sell them the possibility of alpha and charge handsomely for the service of selling hope.

So, how does all of this relate to smart beta? Currently, asset managers are arguing heatedly about the right definition for smart beta. Some of our fellow investment managers secretly, and some publicly, hate the smart beta moniker. It's not the "smart" that annoys them. We all think we are plenty smarter than the market. We simply wish it were called "smart alpha." If normal alpha could fetch "two and twenty," imagine what one could charge for smart alpha!

In fact, the debate about the right definition for smart beta reminds me of a parallel debate in risk parity. The absurdity of the fixation around definition is best captured by the following comment made by a senior investment consultant: "The conversation in the risk parity space is pure nonsense. Every quant manager argues that they have the most correct method for achieving risk parity in a portfolio. No one seems to address how achieving equal risk contribution for securities in an investment product is actually good for the end investor or why it is even relevant." Isn't it time to stop debating the definition of smart beta and focus on the most important question, "What's in it for the end investor when it comes to smart beta?"

The same core yet simple insight that motivated Jack Bogle to launch a capitalization-weighted index fund has the potential to be a transformational insight for smart beta as well—and that's simply knowing the right question and having the courage to answer it. Given all we know about modern finance, what is best for investors?

When I think about the original index fund, the promise to investors was clear: a transparent, low-cost, low-governance, high-capacity strategy for accessing the equity risk premium through cap-weighted exposure to market beta. For investors who are under pressure to reduce expenses, who have limited resources for selecting and monitoring active managers, who have extremely large assets, or who have lost faith in active management, the first index mutual fund and its many offshoots delivered on that promise. They provided a portfolio that, over the long horizon, outperformed the average active manager (especially on a net-of-fees basis) while requiring almost no attention. No stock stories, no brilliant but idiosyncratic portfolio managers—and no need for the beauty parade that we call manager selection. Emotionally, index investing deprived clients only of the illusion of control, and in exchange for that trivial sacrifice it entertained them with the daily ups and downs of the market as a whole.

Finance theory and knowledge have advanced tremendously since Vanguard launched the first index mutual fund in 1976. We now know that there is more than just the market factor which generates an equity return premium over time. Eugene Fama won the Nobel Prize in Economics, in part, for demonstrating that there are three reliable sources of equity return. Today the Fama–French three-factor model, or some variant of it, is used by nearly every quantitative analyst to examine equity returns. Robert Shiller won his Nobel Prize in Economics for arguing that investors' enduring behavioral biases can generate persistent anomalies in the financial market that can be exploited for outperformance. The literature today is populated by evidence that value, momentum, and the low beta anomaly are rooted in investors' behavior.

Exactly 40 years later, what would a challenge to our industry like Paul Samuelson's mean? The frontier academic knowledge has changed—there are multiple "betas," not just the market beta, which provide persistent premia over time. But some things have remained the same. Costs always erode investors' returns and skilled stock picking is unnecessary for successfully investing in these alternative equity betas.

I wish for smart beta to be 2014's answer to Samuelson's challenge just as Vanguard's first index mutual fund was the answer in 1974. We know how to design simple, low-turnover, and well-diversified core-like portfolios which access the premia associated with the various known equity return factors. Through the index chassis, which requires systematic and rules-based portfolio construction and thus promotes transparency, we can lower governance cost and reduce investment management expenses. When designed properly, smart beta strategies can be the prime alternative to active management for our times just as cap-weighted index funds served so admirably in that role for the past four decades.

I would be saddened if the allure of gathering assets causes providers to allow smart beta to deteriorate into the deception of "backtest alpha." I hope for a far better outcome. I hope smart beta shakes up the business-as-usual world of investment management. I hope smart beta funds pull assets away from closet indexers and the high-load, high-fee active products which survive, through effective advertising, at the expense of investors. Finally, I hope this disruptive new entrant goes on to transport index investing from the one-factor thinking of old to the multi-factor framework of modern finance. That is the promise of smart beta for me as an investor and an academician. As an asset manager, I pray that my firm and I have the courage to deliver on the promise of smart beta just as the pioneers of indexing did 40 years ago for the cap-weighted market beta.

Endnotes

1. 2% + 20% (“two and twenty”) means a flat fee of 2% on assets under management plus an additional 20% of gains.

2. “Optimized backtests” sell better irrespective of their actual relationship to future performance.

References

Bogle, John C. 2014. “Lightning Strikes: The Creation of Vanguard, the First Index Mutual Fund, and the Revolution It Spawned.” Journal of Portfolio Management, vol. 40, no. 5 (Special 40th Anniversary Issue):42–59.

Samuelson, Paul A. 1974. “Challenge to Judgment.” Journal of Portfolio Management, vol. 1, no. 1 (Fall):17–19.