

HERE'S THE THING!

A good part of your active manager's return is a function of the broad market in which she invests; we call that "Beta". Another portion of your active manager's return derives from her unique investment "Style". Broad market "Index Funds" can capture the Beta portion of your manager's return, but newer to the market are "Smart Beta" products that try to mimic more precisely your manager's investment Style. Beta is cheap; Smart Beta somewhat less so. But both present a challenge to traditional active managers to deliver more than Beta, and more than Style, to justify higher fees.

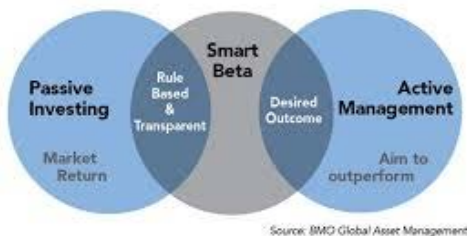
SMART BETA FOR DUMMIES

Today, no discussion of the active/passive issue is complete without reference to the possible integration of "smart beta" strategies into your portfolio mix. Pretty sophisticated, eh? Not really. Here's a story to explain smart beta in terms that even I can understand:

I've heard that passive investing is all the rage these days, that fees are more significant to my wealth accumulation potential than most people realize, that over the past ten years most active managers underperformed their passive benchmarks and that by using (semi-passive) smart beta strategies I can anyway capture a good part of what my active manager is doing at much lower fees. What should I think about all this, and where do I start?

Let's start at the beginning, with the idea of a simple market index—comprised of all, or some pre-defined number, of the stocks ("constituents") traded in my chosen equity market—U.S., Canada, global, whatever. I add up the market capitalization (stock price times the number of shares outstanding) of each of my market constituents, et voilà, with a few technical adjustments, I have calculated my broad market index value! And I needn't worry about the calculations or the technical adjustments—index providers like MSCI, FTSE Russell, and S&P Dow Jones Indices do all that for me.

So, if I want to invest passively in a broad market index, one way of doing so is to buy an index fund or an ETF structured to mimic my preferred broad market index. And I know I can do that very inexpensively—for just a few basis points, (1 basis point or "bp" = 1/100 x 1% of the dollars invested), or none at all. So I call my investment advisor and our conversation goes something like this:



Me: Hi Sarah, I am thinking of indexing some of my equity investments to save on fees; what are your thoughts?

Sarah: Look Ralph, pure indexing is for dummies because, by definition, you will be investing more dollars in the market's big companies and fewer dollars in small companies, with no consideration for the investment value of the companies you are buying. There are smarter ways to capture the benefits of lower fees.

Me: (excited by the possibility of outdoing all my dummy friends) Oh?

Sarah: Yes, there are several possible strategies. But here's a simple, and intuitively appealing one that is well supported by the academic literature. It's called an 'equal-weighted index'; it's a stock market index, just like the pure, broad market index, but each constituent is weighted equally such that the performance of each company's stock carries equal importance in determining the total value of the index.

Me: Cool (and not wanting to seem an easy sell, I continue) but what about the academic evidence you spoke of?

Sarah: (cornering me with this well-rehearsed pitch) Building on reams of earlier research, Eugene Fama and Kenneth French of the University of Chicago took CAPM two steps further in the early 1990s. In a now-famous paper they created a new model that included two additional factors showing that value stocks (those with a low price relative to their fundamentals) outperformed growth stocks, and small companies outperformed large ones.¹ So you see, because the equal-weighted index invests more dollars in small companies than the broad market index does, you are betting on the very positive history of this "size" (small-cap) factor. And intuitively, smaller companies in general should have more growth potential than very large companies, shouldn't they?

Me: (trying to sound thoughtful) Wow, yeah, I get it. Even discounting the academic evidence which is entirely dependent on history repeating itself, your intuitive argument is hard to refute. Please move one-third of my equity portfolio into the equal-weighted ETF of your choice.

And there you go; I've made my first smart beta investment, an interesting, differentiated strategy supported by rigorous research performed by renowned academics and with a lay person's intuitive appeal that I can tout to my dummy friends at our next cocktail party!

But how smart, after all? Over beers after work on a Friday I share my new strategy with my good friend, Freddy:

Freddy: Interesting Ralph, but are you not concerned about your "single factor" bet? You've left a lot of your semi-passive eggs in the "size factor" basket! Small-caps took a beating over the past twelve months. The Russell 1000 Index (a large-cap universe) returned 9.3% against the Russell 2000 Index (a small-cap universe) at 2.1%!

¹ <https://seekingalpha.com/article/4004159-brief-history-smart-beta>

Me: (thinking that my friends may not be so dummy after all) Ouch! What do you suggest Freddy?

Freddy: For starters you may want to review the literature pertaining to “value”, “momentum”, “quality”, “low volatility” and “high dividend” stocks. All of these are so-called “smart beta” factors that are now accessible to folks like us.

So, I call Sarah again and ask:

Me: Sarah, shouldn't I consider diversifying my allocation to factors?

Sarah: (gasping at the leaps in my knowledge) Well Ralph, now you are advancing your thinking into the realm of “multi-factor” funds; they are gaining in popularity with investors who understand the important advantages of diversification of their holdings and there are plenty of those to choose from as well.

Me: I still like the idea of maintaining a small-cap bias in my portfolio, but “multi-factor” sounds more in tune with my risk preferences; please move another one-third of my equity portfolio into your favorite multi-factor ETF.

So here I sit, with time on my hands, reflecting on lessons learned in the last little while, satisfied that I have built a well-diversified, multi-factor equity portfolio that reflects my own investment beliefs and combines active and passive investing in a way that should reduce my overall fees paid (mental note to verify the expense ratios that I am paying on the ETFs that Sarah chose for me, and the resulting cost savings). I decide to catch up on some market news, having fallen behind with all this personal investment work, so I click on Matt Levine's [Money Stuff](#). Matt writes for Bloomberg Opinion; his insights are impressive, and his writing style makes his stuff really fun to read. The opening paragraph of his April 3 article “Betting Against Alpha”² reads as follows:

MONEY STUFF'S
MATT LEVINE
Bloomberg Opinion



“A well-known stylized fact in investing is that, once academics discover and publish an anomaly—some pattern in stock prices that can be used to get predictable superior risk-adjusted returns—the anomaly tends to go away. The intuition is that anomalies represent stocks that are consistently over- or undervalued by the market and publishing them corrects that . . . This is not completely true—some apparent anomalies might represent real risk factors that don't go away; others might represent deep psychological factors that can't easily be arbitrated; etc.—but it is a useful stylized fact and makes a certain amount of intuitive sense.”

Whoa! Is that why the Size Factor (small-cap stocks) did so poorly over the past year? And why the Value Factor did so poorly over the past ten years? Am I playing poker at the professionals table? Maybe, which reminds us of Bernard Baruch's famous quote:

“The main purpose of the stock market is to make fools of as many men (women too) as possible.”

² <https://www.bloomberg.com/opinion/articles/2019-04-03/buying-the-good-stocks-can-be-bad>

TO CONCLUDE:

There may be something in the ideas behind “Smart Beta”, or there may not be. But if we are skeptical of mediocrity and high fees in the active management landscape, smart beta is worth a look.

Nevertheless, and index is an index is an index and understanding that investment style replication through smart beta techniques is not of unreachable sophistication—fundamentally a slicing and dicing of the broader market indices to create rules-based subsets—much of the smart beta universe available SHOULD BE CHEAP.³

• ON STAYING HUMBLE:

“My own buffoonery can be real and of the most profound substance, pure humbug. I am constantly in a dilemma: I do not know when I start to pretend or when I tell the truth.”

Salvador Dali

• OUR HOPE:

For all investors . . . discernment in sorting out true from false. Wisdom, without arrogance. Humility and Resolve®.

® Two primary drivers of effective leadership from Jim Collins’ book “Good to Great: Why Some Companies Make the Leap...and Others Don’t” (New York: HarperCollins Publishers, 2001).

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³ For more on pricing in the asset management industry, see <https://www.nytimes.com/2019/04/05/business/price-war-fund-fees-zero-negative.html?smtyp=cur&smid=tw-dealbook> and <https://www.etf.com/sections/etf-strategist-corner/choosing-us-multifactor-etfs?nopaging=1>, the latter of which reminds us that price is but one of several important dimensions when choosing the your multi-factor ETF.

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