Opinion **Financial Times**

Smart beta products risk misleading investors

Investors may be surprised by two fundamentally different approaches under one smart-beta label

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In the aftermath of the Great Financial Crisis, regulators around the world have taken a hard look at how investments are labelled and sold.

One of the more successful innovations in recent years has been the introduction of "smart beta" products, so-called because they are meant to resemble passive beta-generating products but with returns that nevertheless beat the market. This appealing proposition has helped smart-beta investments garner more than $150bn in new asset flows since 2013.

Yet the reality is that just because a product has a catchy name, can be easily positioned and becomes a sales success, does not necessarily mean it benefits those buying it. Indeed, many prominent experts have come out in opposition of the nomenclature: Bill Sharpe, the "inventor" of beta, famously stated that the idea of smart beta "makes me sick". Rick Ferri, an index-investing pioneer, has referred to it as "silly talk".

Nevertheless, the name persists, tempting investors to buy attractive-sounding, inexpensive products they do not fully understand. For example, investors may be surprised to find that there are two fundamentally different investment approaches included under one smart-beta label.

The first approach assumes that the capitalisation-weighting scheme of a traditional index is inefficient, and that more efficient exposure can be obtained using alternative weightings. Here, smart implies — wrongly — that investors will get higher returns at the same level of risk, or the same returns with less risk.

In turn, beta tacitly — and again incorrectly — promises exposure to the broad market itself, as opposed to what it really delivers, which is alpha — or market-beating performance — from a narrower position. Many investors also are not aware that the performance of these alternative-weighting schemes is actually explained not by fundamental weightings based on book value or earnings, but by implicit factor exposure to value, small-cap or other styles — something active managers have known for years.

The second approach professes that markets are too efficient to allow for "better" indices, and that outperformance can be best obtained by exposure to these very same investment factors — which is not something the makers of alternatively weighted products care to admit. With these factor-based investments, smart refers to factor exposure that is prepackaged in a transparent and cost-efficient manner, while beta stands for individual factors and not the broad market — quite a different definition indeed.

While there are many flaws present in how these products are packaged and promoted, the fact remains that factor investing is one of the oldest quantitative approaches offered, which makes this kind of smart beta merely another name for active quant.

Whether alternatively weighted or factor-based, smart-beta products have been positioned as something new that lies between passive and active approaches — something better than beta but still not alpha. These arguments are flawed.

Indeed, smart beta is neither smart nor beta. Making a beta investment implies taking a position in the broader market, which also suggests lower or at least low risk. Yet because these portfolios provide exposure to subsets of the market, they in fact offer alpha, which by definition is an active bet on risk. Furthermore, the idea of "smart" implies that these portfolios are taking a smarter position than the market, which therefore must be "dumb" — and investors on the opposite side of the trade must be extremely stupid. Even if this were true, the markets will eventually correct themselves, and the so-called smart-beta strategies — and their investors — will be victims of their own success.

While AllianzGI is a purely active investor, we see the value in passive investing that seeks to capture beta. However, the obfuscation surrounding smart beta results in investors buying active products dressed in passive clothing, or purchasing a passive index that can actually add risk to their portfolios.

Until this message reaches investors, the flashy label and seemingly competitive pricing of smart-beta products will entice them to take on more risk than they realise — and, quite possibly, lower returns than they were hoping for.

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