

## Smart Beta - Diffusing the Active vs Passive investment debate

Following an investment strategy that is low in cost, liquid, diversified and adds value over the longer term makes a lot of sense – this is called a Smart Beta strategy typically focusing on extracting the premium derived from the value and quality investment styles in the markets.

Traditional market cap index funds have been the proxy for passive investing for a long time. These funds have been very effective in attracting flows into them over the past decades, and for good reason – they not only have low direct costs in the form of management fees, but they also have low indirect costs, like trading costs, that are not always visible in active funds.

This is according to Adriaan van Niekerk, a portfolio manager at Private Client Holdings, who says that traditional market cap index funds tend to be liquid, well diversified and a very good proxy for the broad market that you want to invest in. “For example if you wanted to invest in South African large cap shares, a single investment in the Satrix 40 fund would give you exposure to the largest 40 shares weighed by market capitalisation, or similarly, a single investment in the Vanguard 500 Index fund would give you exposure to the largest 500 US shares weighed by market capitalisation.”

“Active fund managers would typically give you evidence that the market is not efficient and that evidence exists that the market capitalisation weighting methodology of traditional index funds is suboptimal. The main (negative) characteristic of such a weighting methodology would be that the more a shares price increases relative to the other shares in the index, the more its weight in the index or fund would be. The argument is that there is an automatic mechanism to overweight *expensive* shares and underweight undervalued shares at some point by using such a weighting mechanism.”

Van Niekerk says that proponents of traditional index funds will tell you that while the previous point might make sense, it still cannot get around the fact that the sum of all out-performance and under-performance in a certain investment universe (say large cap US shares or the S&P 500) will add up to the performance of the index again.

“Smart Beta strategies seek to mitigate the challenges of market cap-weighted indices. Instead of blindly weighting companies solely according to their size, some Smart Beta uses screens based on fundamental analysis principles to determine which companies should be given a larger piece of the index pie. The goal is increased returns or enhanced risk profile.”

### **Stalemate, or not?**

Van Niekerk advises that this is where the risk factor premium, or Smart Beta enters. “Whilst Smart Beta may lack a strict definition, it can be understood as an umbrella term for rules based investment strategies that do not use the conventional market capitalisation weights. Smart Beta strategies attempt to deliver a better risk and return trade-off than conventional market cap weighted indices by using alternative weighting schemes based on measures such as volatility or dividends.”

According to van Niekerk, there has been compelling evidence to suggest that Smart Beta can implement certain investment styles that beat the index over the longer term. These factors specifically concentrate on the value, momentum, quality and the small cap effect.

“One can create rule based weighting methodologies to extract these premiums while still

preserving the qualities of traditional index funds. Even though there is ongoing fine-tuning, the cost remains low compared to active funds and still would maintain the positive attributes of traditional index investing.”

This would suggest that there are investors that invest sub optimally for such risk premiums to continue to exist. And according to van Niekerk, there are. “Behavioural finance explain this irrational investment behaviour where fear and greed drive many traders and investors to act irrationally and create these risk premiums in the markets. These are indeed human attributes that should persist into the future and keep the risk premiums intact.”

“At Private Client Holdings we use these Smart Beta strategies to specifically extract the value and quality premium in the markets that we invest in. This ensures that the core of the portfolios follow a strategy that is low in cost, liquid, diversified and adds value over the longer term by extracting the value and quality premium,” concludes ~~v~~an Niekerk.

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