

Smart Beta ETF: Characteristics and Implications

Kwon, Min Kyeong*

As smart beta ETFs have recently gained worldwide popularity, an analysis on the actual performance of flagship smart beta ETFs in the US has confirmed the following characteristics. First, not all smart beta ETFs performed as superbly as expected. In other words, no matter how superbly a product performed in a simulation using long-term, historical data, this does not guarantee the product's future results. Second, nevertheless, smart beta ETFs provide differentiated performance from traditional passive funds, serving positive roles by offering investors an easy way for portfolio diversification and widened investment opportunities. The only concern is that investors unfamiliar to quantitative analysis may have difficulties in reaping such benefits by their own, which seemingly requires the assistance of professional portfolio management services based on smart beta ETFs.

Rise of smart beta ETF

Recently, smart beta ETFs have become one of the hottest buzzwords in the global asset management industry. The popularity is especially evident in the US where the asset management industry is fully developed. In 2015 alone, a total of 34 asset managers launched 156 smart beta products in the US, representing 57.1% of overall new ETF products.¹⁾ Asset managers from leading ETF providers such as BlackRock, State Street, and Vanguard, to smart beta-specialized players such as PowerShares, WisdomTree, and First Trust, and mutual fund leaders such as Goldman Sachs, John Hancock, and Franklin Templeton are flocking to releasing new smart beta products. And those products are receiving heated attention. As of 2015, US

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* Ph.D., Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0681, E-mail: mkkwon@kcmi.re.kr

1) ETF annual review & outlook, Market Research, Deutsche Bank, 2016.

smart beta ETFs attracted a net inflow of \$71.9 billion, accounting for one third of the \$235.6 billion net inflow to overall ETFs. Also increasing is the proportion smart beta products represent in the overall exchange traded products. As of June 2016, the proportion stood at approximately 21% (\$489.8 billion).²⁾

Characteristics of smart beta ETF

Although smart beta is one of the passive investment strategies, it differs from traditional passive in the use of different portfolio construction rules from traditional market cap-weighted portfolios. Instead of market cap, smart beta constructs a portfolio using other quantitative measures, e.g., using the book-to-market ratio to give more weight to high-value stocks, or to invest in top 50 stocks only. At the early stage, only typical measures, e.g., growth, value, dividend, etc. were used. But more recently various indicators such as volatility, momentum, quality, and fundamental have been utilized, and the multifactor approach using them has been increasingly used.

Although the term smart beta became prevalent only recently, the concept has long been adopted by some mutual funds or hedge funds that use quant strategies. Quant strategies here refer to an investment strategy that uses quantifiable data for setting up a series of trading rules, according to which trades are executed mechanically. In this regard, smart beta is also one of quant strategies. Although quant has long appealed to investors, purchasing any fund managed by the quant strategy takes high costs, and most hedge funds do not accept small-sum investments. Also problematic is those funds' non-transparent management processes that are highly likely to give managers arbitrary discretion. Smart beta ETFs came to effectively address those issues. While executing the quant strategy, smart beta ETFs allow for small-sum investments at low costs. Also, they disclose their holdings daily, leaving relatively little room for arbitrary discretion of managers.

In general, a smart beta strategy in most cases is adopted once its performance is tested and verified via a simulation using long-term, historical data. Asset managers use such empirical data before launching a smart beta ETF product, and investors buy it expecting that strategy to outperform in the future as well.

2) Refer to A Global Guide to Strategic-beta Exchange-traded Products (Morningstar, 2016). Exchange traded products (ETP) comprehensively refer to ETFs, exchange traded notes, exchange traded commodities, etc. In the US, ETFs account for roughly 98% of the ETP market.

Then, how are smart beta ETFs performing in the real world? An analysis on the performance of flagship smart beta ETF products in the US³⁾ reveals the two findings below.

First, not all smart beta ETFs performed as superbly as expected. A closer look at the returns for 61 months from June 2011 to June 2016 demonstrated that four out of the nine flagship smart beta strategies underperformed the benchmark.⁴⁾ In terms of risk-adjusted performance, dividend, quality, and low volatility strategies outperformed the benchmark, whereas value and momentum strategies were at a low ebb. This evidences the fact that although smart beta strategies have been verified for their long-term, past performance, it does not necessarily guarantee their performance in the real world. In other words, smart beta ETFs are not free from the basic principle in financial investment products that past performance does not guarantee future results.

Second, despite the aforementioned finding, smart beta ETFs' performance was differentiated from that of traditional passive funds. This may sound contradicting to the first finding. However, differentiation here means not about the absolutely low or high level of returns, but the movement out of sync. Simply put, when the benchmark has a positive return, a smart beta ETF's return could turn negative, or vice versa.⁵⁾ Such differentiated performance was not only found between traditional passive funds and smart beta ETFs, but also between smart beta ETFs using different strategies.

The finding that smart beta ETFs provide differentiated performance has grave implications for investors. Investors could utilize smart beta ETFs by a means of portfolio diversification. Simply by investing in smart beta ETFs, investors can diversify the sources of investment returns and the risks arising from their existing cap-weighted portfolios. The only concern is that ordinary investors unfamiliar to quantitative analysis may have difficulties in reaping such benefits by their own. It is advisable for them to seek help from professional portfolio management services using smart beta ETFs.

Smart beta ETFs serve positive roles also in terms of widening investment opportunities. Traditional passive funds have the merit of low costs, but their drawback is the limit in investment

3) Flagship products here are defined as the product in each investment strategy category with the largest net asset at the beginning of the analysis period.

4) The benchmark includes a portfolio of the market cap-weighted universe following the method of traditional passive funds.

5) Due to ETFs' general constraints, smart beta ETFs also consist of long-only portfolios, and thus are not entirely free from the impact of the benchmark. Nevertheless, smart beta products are differentiated because they are affected by not only market factors, but also alternative factors.

opportunities.⁶⁾ In that each strategy of smart beta ETFs offers performance differentiated from that of not only traditional passive funds, but also other smart beta ETFs, investors could enjoy widened investment opportunities that will surely encourage more investment. Hence, large institutional investors such as the National Pension Fund need to pay close attention to smart beta ETFs.

Closing and implications

Taken altogether, smart beta ETFs do not necessarily produce “smart” investment outcomes. But with their differentiation from traditional passive funds, they offer investors to enjoy portfolio diversification and widened investment opportunities, playing a positive role.

Korea’s market for smart beta ETFs are still at its nascent stage. According to Morningstar, smart beta products account for 4.2% of Korea’s ETP market, far lower than developed countries, e.g., 21.0% in the US, 9.5% in Canada, and 7.3% in Europe. For Korea to make the next leap forward, asset managers of course should develop competitive smart beta ETF products, while actively working to provide professional portfolio management services to help investors. Lastly, large institutional investors should give more thought to smart beta ETFs in order to enhance their efficiency in portfolio allocation.

6) For example, among products investing in Korean stock markets, it is difficult to find a passive fund whose individual or industry risk is well diversified, except for those tracking KOSPI200 and KOSDAQ150.