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How Smart is Smart Beta or Factor Investing?

By George M. Klar…..President, Alternativ Solution Inc.

What are the most important things investors should understand when it comes to investing? The answer shouldn't be a surprise. For amateurs and professionals alike, strong analytic skills and patience are the keys to success.

We are often reminded that great results cannot be achieved using simple rules or models. Instead, every decision must be thoroughly and carefully analyzed. At a bare minimum, to get really good at investing you need a solid financial foundation and time to examine the many opportunities that arise each day. Lots of time!

Amateurs simply don't have time due to pesky impediments such as jobs, families and outside interests. This means it's best to leave investing to trained professionals who will offer their services for a fee.

For obvious reasons, the investment industry strongly advocates hiring an agent (portfolio manager) rather than doing it yourself. This is one of the main reasons the mutual fund industry exists.

But is this advice correct? Do amateur investors perform worse than the professionals or broad market indices? There are many studies examining this question. Sadly, the results confirm that average folks simply aren't good at investing, even though they believe otherwise.

Recently, Oppenheimer Funds in the US compared returns for a wide array of asset classes versus the returns of average people over the period 1985 to 2014. The average investor earned 2.5% per annum versus to 7.4% for government bonds and 11.1% for US equities. This is a huge opportunity loss. The main driver of this shortfall is simply human behavior.

What about professional money managers? Does advanced training and business acumen provide better results? Do managers overcome behavioral issues? We turn again to empirical evidence. It turns out there are many truly excellent investment managers. At the same time, there are many average and many weak managers. As a group, active managers tend to earn returns pretty close to market returns. But after fees are factored into the equation, average managers underperform their respective benchmarks when examined over longer time periods.

Now you might say, if this is true, let's just select the winning managers of tomorrow. But this is much harder to do than it *(con't pg. 2)*

"Investing is Easy! Ain't it?"— top 10 lessons

By George M. Klar…..President, Alternativ Solution Inc.

Every year, I am fortunate to teach a few 3rd year undergraduate investment courses at the Schulich School of Business at York University. Students in each class form teams of 4 and get one million dollars to build a portfolio. For 10 weeks, teams try to maximize returns while managing risks. Securities can be purchased on New York, Toronto, London and Hong Kong stock exchanges. Teams can also leverage their portfolio by 100%. Positions can be either Long or Short. So effectively, this means teams can mimic either well known traditional mutual fund strategies or more risky hedge fund strategies. Since the final ranking forms a portion of each person's final grade, students take this game seriously. This past semester, some team names selected by the students included ROCandROAr, Big Bank Bandits, That's WACC, Yellen-4-Returns, U-R-Not-Alone, and the Bay St. Ballers. *(con't pg. 2)*

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Fundraising — So Far:

To all my wonderful supporters — thus far I have raised $5,000 for Alzheimer's research. But there's still time left for donations.

Over the past 6 years, I have personally raised over $50,000, my team raised over $550,000, and the event has raised $12 million.

Alzheimer's was virtually unheard of 20 years ago. Now we know its devastating impact. Thanks for your continued and unwavering support.

ASI — What we do:

Alternativ Solution Inc. (ASI) offers advice on capital market for institutional clients on an assortment of topics ranging from active vs. passive investment strategies, asset mix and strategy selection. The firm also provides education services to Boards.

ASI is focused on the asset side of the pension question, helping retirement plans achieve their goals.

Mr. Klar is also a faculty member at the Schulich School of Business and advisor to York University's $2.1 billion pension plan.

…...Cheers, GMK

sounds. It's easy to identify who was successful in the past, but extremely challenging to figure out which managers **will be great in the future.** Only a handful of consultants can do this well.

My colleagues and I at York University's pension plan have been succeeding at this challenging task. As a result, the pension earned a 4-year annualized return of 13.2% (as of Dec 31, 2015) while bigger or better known plans earned less.

So what should investors do if they can't find future winners today? Finance theory makes a bold suggestion. Don't even try. Instead, buy something that mimics the broad market. In this way, you earn exactly the market return without paying for professional management. This is called index investing and is ground zero for ETFs. In theory, all you need is time and patience.

In 2004, some academics suggested that index returns (eg., the S&P 500) could be improved by roughly 2-3% per year by simply modifying the composition of the index. The concept underpinning this is the fact that certain known factors generate better expected returns over the long run.

Most traditional indices are capitalization weighted (meaning the most valuable firm in the index has the highest weight). This implies that

as a firm's share prices rises, it gets more heavily weighted (and vise versa). This potentially implies that temporarily overvalued shares could dominate an index. Recall names such as Nortel, Bre-X, and more recently, Valeant, as but a few examples of this phenomenon in Canada.

The researchers suggested creating a new index that was not cap-weighted but instead weighs stocks by a series of **factors** with a proven history in generating higher results. To name a few, these factors might include metrics such as revenue growth, valuation and profitability. Firms with the highest score in the combined factors become the most heavily weighted. The concept was dubbed Fundamental Indexing (FI).

Almost from its inception, academics and industry critics panned the FI concept. The biggest criticism was that markets were efficient and therefore impossible to beat consistently. The proposed new FI index might "beat" traditional indexes by 2-3%, but it might accomplish this simply by tilting the total risk. This occurs because the FI index buys more stocks with lower valuations (cheaper, or out-of-favor names) and more smaller company stocks. Both these biases alter the portfolio risk level.

Interestingly, the original FI concept spawned a 2nd generation of products that are collectively called "smart-beta". These products are also designed to earn higher returns than traditional cap-weighted indices (such Canada's TSX indices).

Finance professionals are always on the lookout for great seductive marketing that can overwhelm the math and logic. Our investment industry is known for inventing new or exotic products that ultimately disappoint and prove unable to deliver on their lofty promises.

Nevertheless, smart-beta's promise is very intriguing. What if the "smart" is actually a design advantage that could persist over time? If yes, this would be fantastic for all sorts of investors. These smart products could offer a combination of great diversification, lower risk and better returns than our traditional indices.

I am currently working on a project to examine smart-beta products for use as building blocks in an investment strategy. Upon completed, I will provide readers with my findings and it's application for investing. ◘

"Investing is Easy! Ain't it?" — the top 10 lessons (continued)

At the end of the course, every team presents results to the class and reveals their investment strategies, results and learning outcomes. This year, the game started on Jan 11 and ended on March 18. This coincided with a particularly turbulent period in the financial markets, and specifically, the equity market collapse in January. There were several catalysts for this volatility including (but not limited to) a continuing collapse in oil prices, fear of a Chinese economic slowdown, fears the Fed would raise interest rates, and ever-present worries about ISIS, Europe, Russia, and the Mid-East.

Teams were encouraged to try different strategies but were limited to just 100 trades over the 10 week period. Interestingly, a few teams tried as many as 8 different strategies to get a better sense of investing. Of the 9 teams enrolled, only 3 teams earned a positive return. The top team earned +5.72% and the bottom lost –10.09% (un-annualized).

So collectively, what did they learn from their experience? According to the reports submitted, the students learned that; (i) investing is a lot harder than textbooks suggest, (ii) it's not easy to achieve consistent results, (iii) risk management is a critical element for success, (iv) you need to have BOTH buy and sell targets, (v) inexperience can kill returns, (vi) leverage is fun until you lose, (vii) in the short run, results are a matter of luck rather than skill, (viii) be wary of experts offering advice, (xi) predicting the future (and profiting from it) is mission impossible, and (x) foreign exchange can overwhelm a strategy. Lastly, they learned that their own behaviour was a huge determinant in their outcomes. In just 10-weeks, these 20 year-olds learned more than most investors do by the age of 40. Kudo's…..very well done! ◘