



# AlternativChronicle

## Is Investing via Smart Beta really BETTER?



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#### ASI — What we do:

Alternativ Solution Inc. (ASI) offers consulting services on capital markets to institutional clients. We deal in topics ranging from investment strategy, risk management, asset allocation, manager selection and manager assessment.

Our recent engagements include development of investment policy, searches for money managers, investment strategy (active vs. passive), and alternatives such as infrastructure, real estate and smart beta.

ASI also offers Trustees and Board members with financial education or training.

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

....Cheers, GMK

Investors who purchase risky assets (like equities) love the potentially high returns that might be earned but hate the possibility of sudden and shocking losses.

This is a global issue affecting sophisticated investors (pensions, endowments) and individual investors alike.

Historically, the best way to cope with this problem was to hire professionals who would make solid decisions and diversify risk. Between 1930-80, such analytical firms became the wealth fiduciaries, gathering trillions in assets as they morphed into the mutual fund industry.

By the 1960s, new academic theories plus the start of cheaper computing technology forced a review of whether professionals actually added value. The new theories said that they couldn't. By the 1970s, sufficient data was collected that showed a large percent of active money managers had worse performance than plain indices.

So do talented money managers actually exist? The answer is "yes" and it is known as the "paradox of skill". They do exist.....but there are a lot more mediocre managers and more are entering the business every year. Only a handful of them win regularly. But finding the winners before they prove themselves is nearly impossi-

ble. Consequently, in the 1980s, a proliferation of low cost institutional index funds sprung up. It later spawned Exchange Traded Funds (ETFs) for individual use.

During the 1960-2008 period, equity markets repeatedly experienced large downward shocks. Investors clamoured for products that could better cope with this problem. They wanted better downside protection



while increasing the probability of earning positive long-term

returns. The industry's answer was "smart beta", a product class with a brilliant marketing name. It should therefore come as no surprise that over \$500 billion in assets have moved to several varieties of this strategy.

Since 2009, the world has experienced very low (near-zero) interest rates. Investors have clamoured to alternative assets to earn higher returns. This explains why trillions have flowed into infrastructure and real-estate .....both viewed as lesser risk assets with better downside. A concern for these assets is there is a herding effect causing over-valuation. But more importantly, these assets are very interest rate sensitive. As rates rise, their valuations

drop. In the US, interest rates appear poised to rise.

To all this, another factor is important...human decision-makers who have strongly engrained behavioural biases. Some biases are learned while others are hard-wired (possibly even genetically). Behavioral biases affect everyone including trained professionals. They lead to sub-optimal decisions and lower returns.

So finding a low-cost investing process that largely reduces these critical biases, and gets returns from several proven investment factors simultaneously is "smart".

In my opinion, smart-beta strategies will continue to attract investors and assets will grow. One day in the future, just like infrastructure, real-estate and private equity, smart-beta might become a crowded trade. But that is certainly not the case today!

Smart-beta investing will likely produce better results ....either from a reduction of volatility or smoother return patterns. Both of these are desired characteristics for investing. And smart-beta products come at low cost.

A key assumption is that smart-beta won't be used for active trading. It is designed for patient investors whose time horizon is longer. So yes, I believe smart-beta will prove to be better. ■