Can “Smart Beta” Get You In Trouble?

By Mauldin Economics • on March 31, 2016 3:45 pm • in Business

Can “Smart Beta” Get You In Trouble? by John Mauldin, Mauldin Economics

I have been doing a fairly deep study of portfolio construction for the past two years, trying to figure out how to solve some of the most perplexing problems of the day: dealing with risk, volatility, performance chasing, and the ever-elusive challenge of actually figuring out where to find performance. One of the hottest topics in the literature and at conferences I attend is the concept of “smart beta.”

Smart beta is a rather elusive term in modern finance. It lacks a strict definition and is also sometimes known as advanced beta, alternative beta, or strategy indices. According to Investopedia,

Smart beta typically defines a set of investment strategies that emphasize the use of alternative index construction rules rather than simply using traditional market capitalization-based indices. Smart beta emphasizes capturing investment factors or market inefficiencies in a rules-based and transparent way. The increased popularity of smart beta is linked to a desire for portfolio risk management and diversification along factor dimensions as well as the need to enhance risk-adjusted returns above those of cap-weighted indices.

It certainly helps the popularity of smart beta ETFs and mutual funds that many of them have been on a performance tear of late. A lot of money is flowing into smart beta ETFs. At the end of the day, when I look at smart beta, it is really just another way to slice and dice the return stream in a particular portfolio. Thus you can have smart beta value funds, smart beta growth funds, smart beta momentum funds, smart beta…. There are literally multiple hundreds of smart beta funds available now.

I bring this subject up because I am at Rob Arnott’s Research Affiliates conference in Southern California (where it is much cooler than I expected). Between presentations by Nobel laureates and assorted academics, Rob offered a paper called “Can Smart Beta Get You in Trouble?” He has graciously given me permission to use a version of his much longer (and more dense paper) as this week’s *Outside the Box*. In the paper he examines exactly where the performance of many of the smart beta funds come from and then asks the question, “Will it persist?” Kind of like ev
how long it can last. Ho

The first version of Rob's paper generated quite a bit of controversy, as it was interpreted by some in the industry as Rob attacking all smart beta products. These people are being oversensitive – perhaps because the overvalued products he writes about are the ones they sell? Rob's own Fundamental Indexes are a form of smart beta. He is just suggesting that we do a deep dive into any product we are thinking about investing in and perform what analysts call "attribution analysis." If there has been outperformance, why did it happen and is it likely to persist? Are there attributes of the product that are not fully valued – or that are overvalued? And if you can do that sort of analysis, then I think you can maybe look at smart beta products that have massively underperformed and find some value nuggets here and there.

Rob has won more CFA Institute Graham & Dodd Scroll Awards than just about anyone (except some guy named Myron Scholes), which is kind of like getting an Oscar for financial analysis. I have been told that he actually told the group to stop considering his papers so that other people could win. He really is one of the smartest people in the room. I always learn something new and often mind-bending when I'm around him. His paper is not long, and it will cause you to think about where the returns come from in your portfolio. You really should read it.

Speaking of mind-bending, economics professor Cam Harvey of Duke University did a presentation this afternoon on the blockchain, which is the foundation of Bitcoin. I have been friends with Cam for many years, but it has been an online friendship. He was the first to do research and analysis of the inverted yield curve, and I've learned a great deal from talking and writing with him. It was a true pleasure to meet him in person this week. He actually teaches a course on blockchain technology and is probably the most knowledgeable person I've met on the topic. As he began to expand on the literally hundreds of ways to use this technology in our everyday lives, you could see the room come alive with questions. It was a very energizing session.

(As I have written and talked about, I think Bitcoin as a currency will fail in its current version. It has some inherent flaws in its construction. The blockchain identity technology, on the other hand, is fabulously important and one of the most fundamental new ideas to come along in years.)

Cam came over when the day session finished, and we began to talk about some aspects of blockchain technology. Harry Markowitz, the Nobel Prize laureate who created Modern Portfolio Theory, walked over; and after a few minutes he began to challenge Cam on the mathematical impossibility of what he thought Cam was talking about. It was fascinating watching these two genius professors talk about math and ideas, and eventually Harry got a handle on the process Cam was describing.

But I will confess a small pleasure at watching one of the greatest mathematical economists of our time wrestle with the concept of the blockchain. I have to tell you it took me a while to get my head around the concept, too, and it took Harry only five minutes. (It took me days.) Once you really grasp the blockchain, you can understand why hundreds of millions of dollars of venture capital has gone into the technology from some of the smartest VCs on the planet, and why every major bank in the world is working on some aspect of it. You are not going to wake up one morning and find your world suddenly transformed, but blockchain is going to change the workings of a myriad of financial as well as nonfinancial transactions, including the transfer of property. And yes, it will eventually change the process of how money itself works. It is a truly profound concept.

Harry was in his usual affable mood, and we sat for the better part of an hour talking about the world in general and me listening to Harry tell stories. He tells such great stories. As we slowly walked back to the room (he is 88 but still make sure to walk for 30 minutes to an hour a day), he tried to explain diversification, covariance and correlation, and why Modern Portfolio Theory will still be relevant 62 years from now. (It has been 62 years since he presented his paper establishing Modern Portfolio Theory.) Sometimes you just get to bask in the moment – walking by the ocean, taking in the phenomenal view, and realizing that I was walking with history. It doesn't get much better than this.

You have a great week. I think I'll just go ahead and hit the send button and wander over to the reception and see what other great

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Written by **Mauldin Economics**

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