849,751% Return from a Cat-themed Smart Beta ETF

By Joana Allamani | June 7, 2017 — 10:47 AM EDT

It was only an experiment, but one that allowed Bloomberg’s Dani Burger to show how themes without any economics behind them can seem promising, but give false signals. She ran a back test in order to understand the pitfalls and benefits of this strategy. Burger created a fund that was: a) rules-based, b) had equal weights for stocks, and c) required the word “cat” anywhere in the name of a stock.

She created a cat-themed Smart Beta ETF and it gave spectacular returns: 849,751%! Smart Beta ETFs are exchange-traded funds that use different and alternative construction rules to make an index and exploit the market. Instead of stocks weighted based on market capitalization like in the S&P 500, Smart Beta ETFs apply equal weights. In general, Smart Beta ETFs are designed to increase portfolio returns, maximize dividends, and lower portfolio risks. Costs are minimal with them since they are not actively managed.

According to experts, there are a few problems with the strategy:

• **No economic intuition:** Experts usually come up with an economic rationale first and then they test it. Burger ran a test first, got the result and after built up a theory. She has seen so many “factors” that experts have come up with, but they usually have a thesis first. Instead, she decided a criteria first – the letters ‘cat’ in the company name, and then ran the test, and based on the data she derived a hypothesis.

• **P-Hacking:** or, as economist Campbell Harvey has put it, “torturing the data until it confesses”. When Burger restricted the criteria to include only companies that have CAT as the starting three letters, she did not get any promising returns. But she continued to manipulate it and opened up the selection criteria of the fund to include companies with the three letters CAT anywhere in its name, and then she got great returns. The main problem is that one can make any backtest look good by continuing to tweak the criteria.

• **Equal weighting for stocks:** The idea of smart beta is that traditional indices weighted based on market capitalization of the company are not a good idea. But as Burger’s backtest showed, equal weighting means for penny stocks as well that have terrible liquidity, and this will give a false signal. For example, one of the stocks in her fictional fund, Catskill Litigation Trust, made big gains but it is so illiquid that you would need paperwork to file before investing.

Themes for real funds have included generational change (millennial preferences), organic products, and “biblically responsible”. Fundamentally, however, as Cliff Asness, founder of AQR Capital Management maintained to Burger for Bloomberg, “factors need some economics” or intuition.
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