Practical Applications of

Is Smart Beta Really Smart?

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Overview

"Smart Beta is much more about smart marketing than it is smart investing," argues **Burton Malkiel**. Some smart beta strategies do outperform their benchmarks over some periods, but not all, he notes. Any excess return these strategies achieve is from the greater risk they take on by tilting toward small-cap, value or other non-cap weighting, Malkiel advises in an exclusive interview with **Institutional Investor Journals**.

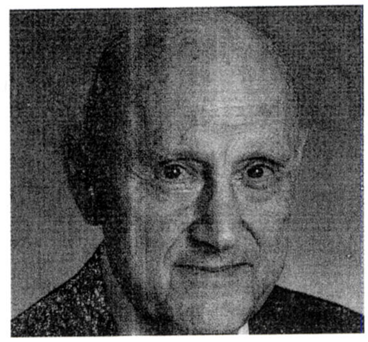
Outperformance of these strategies cannot be attributed to their inherent advantage over traditional market-cap approaches, maintains the **Princeton University** Economist and Author of the seminal book ***A Random Walk Down Wall Street***. The latest edition of the volume details his analysis of smart beta strategies. Read on for Malkiel's assessment of performance data from **Research Affiliates** and **Dimensional Fund Advisors**—and for **Rob Arnott**'s spirited rebuttal.

Practical Applications

- **It's Not Infallible.** Smart beta can work—just not all the time.
- **Tilt to Get Excess Return.** When smart beta works, the excess return comes from the additional risk of tilting toward small-cap, value or other blends of non-market cap flavors.
- **Understand the Risk.** While smart beta portfolios don't exhibit high beta, they do take on risk premiums by tilting toward size or value.
- **Old is Gold.** Market cap-weighted index funds are the way to go for most investors, institutional or retail, over the long term.

Practical Applications Report

Smart beta strategies do not consistently outperform the market, as suggested by the marketing hype that claims their superiority over traditional indexing, warns **Burton Malkiel**, the Chemical Bank Chairman's Professor of Economics, Emeritus,



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Burt is the Chemical Bank Chairman's Professor of Economics, Emeritus, and Senior Economist at **Princeton University**. He is author of the widely read investment book, ***A Random Walk Down Wall Street***, now in its 11th edition (W.W. Norton, 2015). The book has played an important role in encouraging the use of index funds by institutional and individual investors. He also co-authored, with Charles Ellis, ***The Elements of Investing*** (Wiley, 2013).

Burt has long held professorships in economics at Princeton, where he was also chairman of the Economics Department. He was dean of the Yale School of Management and William S. Beinecke Professor of Management Studies there from 1981 through 1987. He is a past president of the American Finance Association and the International Atlantic Economic Association. He is a past appointee to the President's Council of Economic Advisors and has served as an advisor to the Securities and Exchange Commission.

He serves on the board of directors for **Vanguard Europe**, **Theravance Biopharma, Inc.** and **Genmab A/S**. He is the Chief Investment Officer of **Wealthfront**, which provides low-cost computerized portfolio management services. He also serves as an advisor to **Rebalance IRA**, which provides a similar service for Individual Retirement Accounts. Burton chairs the Investment Committee of **WaveFront**, an investment management firm focused on China and other emerging markets. He is a frequent contributor to ***The Wall Street Journal*** and the ***Financial Times***.

Key Definitions

Beta

A measure of the systematic risk of an investment or portfolio compared to the market. Beta of more than 1 means the investment is more volatile than the market. Beta of less than 1 means the investment is less volatile than the market.

Smart beta strategy

While there's no universally accepted definition of smart beta, it broadly refers to a relatively passive investment strategy that implicitly—or explicitly—tilts toward a non-market cap weighting to beat its benchmark without taking on additional risk. Some common tilts include value, small-cap, low-volatility or blended factors.
—Burton Malkiel

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> —**Burton Malkiel**

at Princeton University. They sometimes do better, and sometimes worse, than their benchmarks. "But to the extent that they do better, it is, in my view, largely a matter of taking on more risk," he says.

By definition, smart beta strategies explicitly—or implicitly—tilt the portfolio toward value versus growth, small-cap versus large-cap, or low-volatility stocks versus high-volatility stocks, Malkiel says. That tilt effectively means the portfolio takes on more risk and, therefore, achieves higher return versus its benchmark, he says. For instance, investors take on a risk premium by investing in small companies that face higher risks versus large companies.

Malkiel outlines his argument in his article ***Is Smart Beta Really Smart?*** for ***The Journal of Portfolio Management***'s ***40th Anniversary Issue***, in which he presents his analysis of performance data for smart beta funds by **Dimensional Fund Advisors** and the **Research Affiliates**' Fundamental Index® (RAFI®), among others.

MALKIEL'S TAKE ON WHY RAFI® WORKS

"One of my pet peeves about smart beta is that it is so often oversold, particularly in the case of fundamental indexing," Malkiel says. Among other funds, he analyzes performance data of the Research Affiliates' Fundamental Index® Exchange-Traded Fund (ticker PRF).

The RAFI® ETF has outperformed its benchmark Russell 1000 Index by approximately 1% over its seven-year period to early 2014, Malkiel points out. He notes the portfolio weights stocks by what the company calls their "economic footprint," or fundamental measures, such as sales, earnings and book value, rather than by capitalization. This weighting essentially tilts it toward value and size, Malkiel holds.

So the excess return results from the higher risk the portfolio takes on by tilting toward more small-cap and value stocks, Malkiel adds. You cannot attribute the return to the avoidance of overpriced stocks (large-cap or other) that Research Affiliates' CEO **Rob Arnott** maintains, according to Malkiel.

"I've debated this with Rob, who's prone to say that smart beta explores an inefficiency in finding the excess return. I've told him you'd better believe it is risk … and it may not be likely to continue to outperform," Malkiel says.

The period that's given the RAFI® portfolio its outperformance history was a large overweighting in bank stocks in 2009, 15% of which was in two banks—**Citigroup** and **Bank of America**, Malkiel points out. That bet, at a time when there was talk of a nationalization scare for banks, paid off for the portfolio. "Smart beta is not a better way to manage money. It's a reward for taking on more risk," Malkiel maintains.

"Rob is one of the best money managers out there," he adds, "But don't look at what he does via rose-colored glasses." Advises Malkiel, "If you want to have implicit tilts in your smart beta portfolio, do it with your eyes open."

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ARNOTT’S TAKE ON WHY RAFI® WORKS

Arnott calls the performance of RAFI® funds during the seven-year period to early 2014 a “huge win.” He told **Practical Applications**: “Value has been *savaged* during most of this period. So, winning by 1.55% to 1.87% per annum, when value has been relentlessly underperforming, is a huge win.” In a classic Fama–French three-factor regression (against beta, size and value), their residual alpha, net of the size and value effects, since end-2007, are −0.04% for the Russell 1000, 1.67% for the FTSE–RAFI US 1000 index and 2.06% for the Russell Fundamental US Large index, according to Arnott.

“RAFI has a value tilt relative to the cap-weighted market. But, it has essentially no size tilt. This is an argument that Burt and **Jack [Bogle]** have been making for a decade. They’re mistaken,” Arnott says. “How big is the small-cap tilt? Surprise! In a Fama–French attribution, the Russell 1000 has more of an average tilt toward small-cap than either the FTSE–RAFI US 1000 or the Russell Fundamental US Large index over the last seven years.”

Arnott adds, “As for the value tilt to be provocative, cap-weight has a growth tilt relative to the broad macro-economy.” “**Priceline** is a tiny company, but its cap-weight is bigger than **Southwest Airlines, Hertz** and **Marriott**, combined, with less than one-tenth the sales,” he notes. “**Zillow**, **Tesla** and **Facebook** all priced to prepay for immense growth rates for years to come and for large profit distributions to shareholders in the decades to come. How much did the value tilt help us since end-2007? Not at all. Value underperformed. We won anyway.”

Arnott added: “I can’t wait to see how well RAFI® performs when value is winning!”

Malkiel points out that his analysis of the RAFI® portfolio does not show a positive alpha relative to a multifactor risk model. His full analysis is detailed in the chapter on smart beta in ***A Random Walk Down Wall Street*** (11th edition), published by W.W. Norton in January 2015.

AGREE TO DISAGREE

“Of course, as one of the originators of the efficient-market hypothesis, Burt will believe that any incremental return must carry seeds of its own destruction,” Arnott counters. “I believe that the market is not entirely efficient. I believe that there are legions of investors who chase fads, who shun the deeply out of favor, the feared and loathed assets. I believe that a disciplined process that reliably takes the other side of their trades will convert their discomfort into profit. It’s that simple.”

Will it always work? No, admits Arnott. “In a growth-dominated market, in which momentum and a flight-to-safety dominates, of course we’ll lose temporarily. But, by contra trading into a deeper value stance, we recoup the shortfall with room to spare.” The strategy may not be right for everyone. “We need trend-chasers in order to win; they fund our success,” he adds.

“Bless you, Burt.” Arnott says. “That’s the first time anyone has ever associated me with rose-colored glasses. Thank you!”