Richard Bernstein Advisors

Uncertainty = Opportunity℠

Richard Bernstein,
Chief Executive and Chief Investment Officer

Richard Bernstein Advisors

- *Independent investment advisor with a unique top-down, macro approach to investing with quantitative security selection.*
- *$3.3B AUM/AUA as of 9/30/14*
- *Strategies include global asset allocation, global equity allocation, income, and promising undiscovered investment themes.*
- *Investment themes focus on disparities between fundamentals and sentiment.*

Is "smart beta" smart enough?

Investors have become fascinated with so-called "smart beta" strategies. These strategies can be interesting, but they are hardly a panacea that will solve all investors' problems. The term "smart beta" is somewhat new, but the strategies have existed for decades with relatively mixed performance. These strategies were once called tilted index funds. Enthusiastic proponents of smart beta strategies have been somewhat selective regarding which portion of that long history to show. Every smart beta strategy highlighted today seems to be a winning strategy.

As smart as smart beta might be, it is not smart enough to answer the most important question in beta management. The key to successful beta management, regardless of whether the beta is smart or dumb, depends primarily on the choice and timing of beta. A strategy that focuses on smart beta without consideration for full beta management seems very likely to underperform.

Smart beta

Stock indices are constructed in various ways. The traditional Dow Jones Industrial Average™ index is a price-weighted index, which means that the stock with the highest absolute prices get the biggest weight in the index. The S&P 500® is a share weighted meaning that companies with a greater number of shares (in essence greater market value) get a larger weight in the index. Some indices equal-weight the component stocks so that each stock gets equal representation.

Smart beta questions whether these traditional weighting schemes are optimal for performance. The theory suggests that investors should weight stocks in order to maximize the return associated with the rationale for investing. A smart-beta version of an index can be constructed using the same constituent stocks to accentuate any particular factor that one might want to emphasize (yield, value, growth, size, stability, volatility, etc.) by reweighting the stocks by the particular factor. In other words, if one wants to invest in undervalued stocks, then one should weight stocks by their valuations so that the most undervalued stocks get more weight in the index. Similarly, if one wanted to invest for earnings growth, then one might want to weight the stocks so that faster growing companies get a larger emphasis within the index.

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Chart 1 shows the long-term performance of the S&P 500® versus the S&P 500® Equal-weighted index and the S&P 500® Low Volatility Index. The equal-weighted index is a good proxy for smart beta strategies that focus on size, and the low volatility index is a good proxy for strategies that try to minimize market volatility. Over the full time period, both smart-beta strategies outperform the traditional S&P 500®.

Investors need to realize that there is considerable survivorship bias in such charts. Strategies that outperform have indices to represent them. Strategies that underperform don't.

Chart 1:

Source: Bloomberg

The key decision isn't "smart" vs. "dumb" beta. It's which beta to hold and when.

Regardless of whether one invests in a smart beta strategy or a dumb beta strategy, the choice and timing of beta is considerably more important than is the decisions to be "smart" or "dumb". A smart beta strategy in an underperforming sector of the equity market is unlikely to outperform a dumb beta strategy in an outperforming sector.

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Chart 2 compares the performances of proxies for smart and dumb beta strategies for the Russell 2000® to the performance of emerging markets. The chart compares the last five years' performance of the Russell 2000® growth index, the Russell 2000® index, and the MSCI Emerging Markets® Index (in US dollars).

The smart beta proxy for the Russell 2000® did outperform the Russell 2000® itself, but that's relatively immaterial to the decisions investors were making five years ago. At that time, US small cap stocks were very out of favor, whereas emerging market stocks were favorites. In fact, recent mutual funds flow data from the ICI suggest that EM stocks continue to be preferred to US stocks. Since 2009, emerging market stocks have significantly underperformed US small cap stocks regardless whether one had invested in a smart or dumb beta US stock strategy.

The important choice was not whether to invest in smart or dumb beta. The important choice was the selection of beta itself. Simply put, most investors chose the wrong beta to which to gain exposure. It's unlikely that a smart beta strategy for emerging market stocks implemented five years ago would have outperformed a dumb beta strategy for US small stocks.

Chart 2:

Source: Bloomberg

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There is no magic potion for outperformance

To summarize:

1) There is no magic potion for outperformance. We question whether smart beta, by itself, will improve portfolio performance.
2) Smart beta strategies have their strong points, but the adjective “smart” or “dumb” is relatively immaterial to portfolio performance.
3) The choice of beta is more important to portfolio performance than is the choice of smart or dumb strategies to gain exposure to a particular beta.
4) A dumb beta strategy in the correct beta is likely to outperform a smart beta strategy in the wrong beta.

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INDEX DESCRIPTIONS:
The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P 500® Equal Weight: The S&P 500® Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance

S&P 500® Low Volatility Index: The S&P 500® Low Volatility Index measures performance of the 100 least volatile stocks in the S&P 500. The index benchmarks low volatility or low variance strategies for the U.S. stock market. Constituents are weighted relative to the inverse of their corresponding volatility, with the least volatile stocks receiving the highest weights.

Russell 2000®: The Russell 2000® Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

Russell 2000® Growth: The Russell 2000 Growth® Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000®Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

MSCI Emerging Markets®: The MSCI EM® Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

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About Richard Bernstein Advisors:

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $3.3 billion collectively under management and advisement as of September 30, 2014. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund, and the Eaton Vance Richard Bernstein Market Opportunities Fund. The firm also offers income and unique theme-oriented unit trusts through First Trust and is the index provider for the First Trust RBA American Industrial Renaissance® ETF and the First Trust RBA Quality Income ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS and Merrill Lynch and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at www.RBAdvisors.com.