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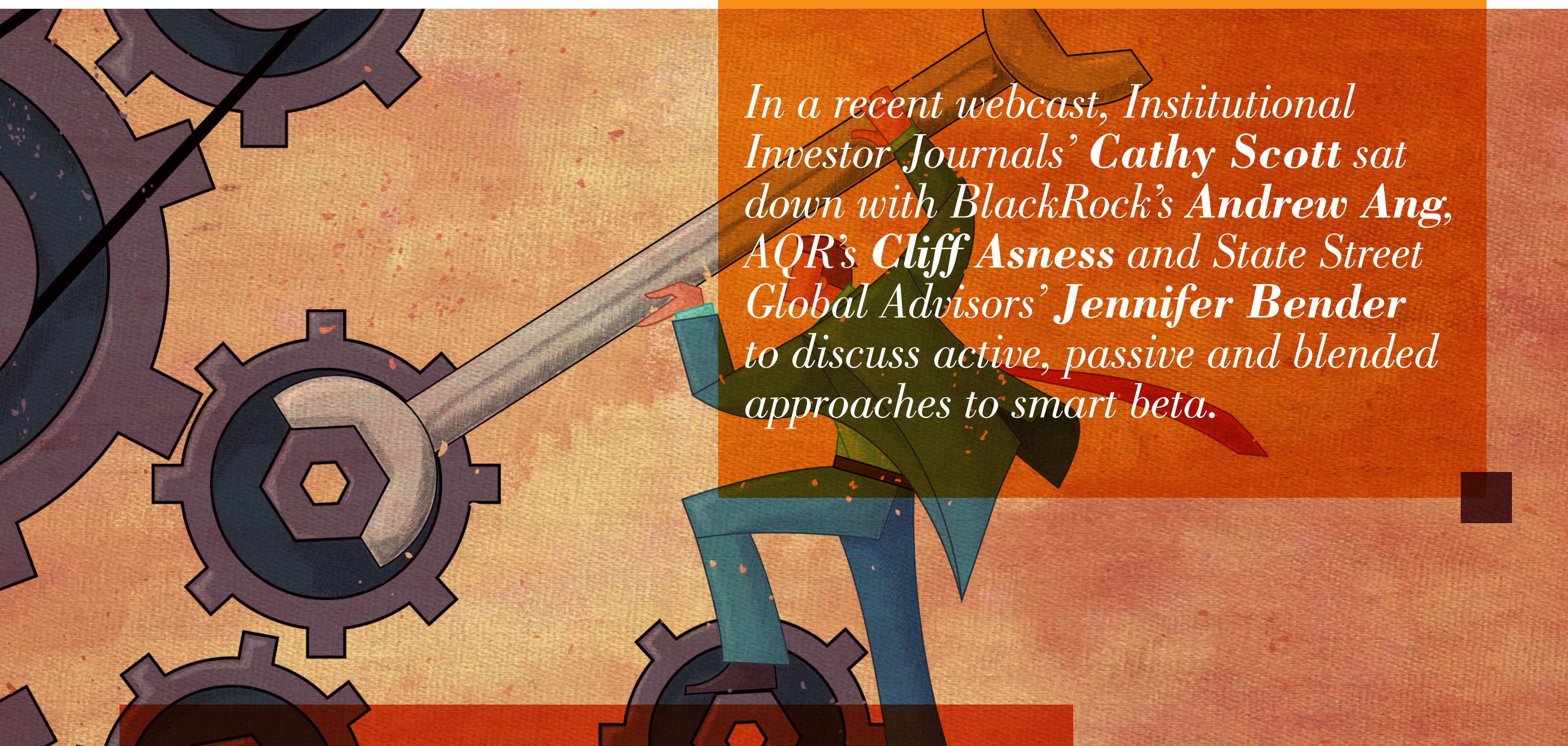
SMART BETA

Special Issue



*In a recent webcast, Institutional Investor Journals' **Cathy Scott** sat down with BlackRock's **Andrew Ang**, AQR's **Cliff Asness** and State Street Global Advisors' **Jennifer Bender** to discuss active, passive and blended approaches to smart beta.*

ALPHA, BETA & THE BLEND

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Alpha, Beta & the Blend

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Overview

BlackRock's **Andrew Ang**, **AQR**'s **Cliff Asness**, **State Street Global Advisors**' **Jenn Bender** and I recently debated the merits of active, passive and blended approaches to smart beta. It was a lively discussion that kept gravitating to semantics. But it brought clarity to these firms' approaches and revealed more common ground than one might expect. Here are a few excerpts from the conversation, edited for clarity.

Andrew contends that there is no passive approach to smart beta: "Everything is active! Nothing is passive in the investment process." Jenn begs to differ, and she challenges Andrew to be careful about making promises. Cliff finds himself in the unusual position of being the peacemaker as he attempts to uncover similarities. He goes on to defend his previous assertion that "smart beta is nothing more than a marketing ploy."

Authors: Andrew Ang, Clifford Asness, and Jennifer Bender
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You may view the webcast, Alpha, Beta & the Blend, at **http://j.mp/Alpha_Beta**.

Practical Applications

- **All smart beta is factor investing.** Smart beta targets factors in a straightforward and transparent way. It is a vehicle for investing in factors.
- **All factor investing is not smart beta.** There are more complex ways to target factors—such as adding leverage and taking long/short positions. Some would say these aren't technically smart beta, the difference being more active decision-making by the manager and higher fees.
- **Smart beta is empowering.** It takes investment insights—previously available only to professional or elite investors—to the ordinary investor.

SEMANTICS Matter.

Questions And Answers

How do you brand your approach to smart beta?

Cliff: We think factor investing is deeply related to smart beta. Factor investing is the idea that there is a relatively modest set of systematic factors. Factors are long one type of thing, short another type of thing. That's useful for explaining returns and also much more interesting for building investment products.

Cliff: Smart beta is a set of very specific ways to use factors. AQR believes in 4—Value, Momentum, Quality and Carry.

Jenn: For us, smart beta is long only. Our active quantitative equity group is separate.

Andrew: We fill the complete menu—from low-cost smart beta vehicles to enhanced versions with more discretion.

Smart beta is a set of very specific ways to use factors. It's mostly been in the equity world, using the more straightforward factors people have known about. If you have a factor only you know about, most people would call that alpha. Smart beta is an attempt to beat standard market cap-weighted investing through factor exposures.

At **AQR** there are four families of factors that we believe in: Value—cheap things tend to beat expensive things. Momentum—things that are winning tend to keep winning, and vice versa. Quality, or defensive—things that you would call safer or higher quality, higher returning, lower volatility and lower risk tend to win. Carry—it's nice to be paid!

Having an economically intuitive story about why those factors make sense to you and having the classic back-tested data are great, but the best thing is out-of-sample data. You can find something that's worked in the past fairly easily; finding it works again in substantially similar form gives you a lot of confidence.

Jenn: SSgA started running our first equal-weighted portfolio in equities in 1990. In the mid-2000s, we started running fundamental index-based portfolios that might also be called smart beta. We think of these alternatively weighted, non-market-cap-weighted portfolios as smart beta.

Factor investing is a much broader genre than smart beta. Factor investing includes any investment process that thinks of factors as sources of return.

We believe that smart beta is a transparent, rules-based investment process to help capture certain exposures that an investor wants to capture. We believe those exposures should be well-known factors that are well founded in the academic literature, that are easily implementable, that are expected to be durable and that are scalable. We don't want these things to be very costly to manage, so that investors can embrace them in large amounts of assets.

This does allow for both factor-based portfolios and more nuanced proprietary portfolios, as long as they're transparent. An asset manager can say, "I have a portfolio that's factor based," and if he or she is willing to be transparent about it, we still think that's smart beta. And it is applicable across all asset classes. Where we differ from AQR is that for us, smart beta is long only.

Andrew: We're in the business of factor investing by targeting broad, persistent drivers of returns. These take advantage of economic insights, and I fully agree with Cliff and Jenn that that's the foundation for why these risk premium exist. We want to diversify, and we want to efficiently execute these strategies.

These strategies are going to get us higher returns than the traditional market-cap index. They endure, but they're well understood. Because they represent a reward for bearing risk, they arise through structural impediments, or they arise through behavioral biases of actors in the economy.

At **BlackRock**, we think about factor investing in enhanced versions. These are dynamic, and they have lots of discretion. We time them. They're often long/short, and we do them within and across multi-asset classes and lots of different types of securities.

The SUBTLE Difference—
Asset managers are making the calls in an active strategy. Investors are making them in a passive, smart beta strategy.

A CHALLENGE *to Active Investing…*
Quite a bit of active returns can be explained by very simple rules-based factor portfolios.

Smart beta is at the other extreme. We're talking transparent, low turnover, very broad securities, and we implement them at low cost in a rules-based manner. If you take the factor exposures in smart beta, but you allow more discretion—the ability to take on leverage and more risk—then eventually you're going to get to the enhanced versions. And we want to fill in that compete menu.

Smart beta fundamentally is democratization of what used to be only achievable by professional, elite investors. It's empowerment. We've known about these things for a long time. They are collections of proven investment insights: Buying low, buying what's trending, focusing on macro fundamental drivers.

BE CAREFUL ABOUT MAKING PROMISES

Jenn: Andrew, you mentioned that you're delivering superior returns through smart beta. Are you promising superior returns? That's a very important point. We believe it's what makes active investing different from smart beta.

For smart beta, the end investor makes a decision to have exposure to certain factors he believes will persist over the long term, and he implements that view in a passive, transparent, rules-based way. This is very different from, say, a traditional quantitative manager who would use factors, but employ them dynamically and in a discretionary way to generate alpha.

That said, the two are not completely orthogonal to each other. They have similarities, and in much empirical research, quite a bit of active returns can be explained by very simple rules-based factor portfolios. And that does present a challenge to active investing overall!

Andrew: We can't promise anything. The markets will dictate that. But what we can base it on are proven track records, economic theory and long decades of investing experience.

Cliff: I do agree with Andrew—the word "promise" is a loaded one. In an intellectually honest way, I am a strong believer these things will deliver in the future. Meaning, I think it's highly unlikely they won't. But that's sort of a promise, and I want that clear to anyone.

Jenn: The subtle difference is that asset managers are making the calls in an active strategy, whereas investors are making them in a passive, smart beta strategy.

SEMANTICS

Will someone own up to an active approach to smart beta?

Cliff: We have products across the spectrum. Some with well-known factors, and some where we do things that some people call aggressive. They're more aggressive than the techniques they use, but they don't always come out as more aggressive portfolios. They may be truly long/short and market neutral, but the drivers are very, very similar.

It is a complex topic for all of us, but I think we agree that smart beta is applying these ideas in straightforward, known ways that can be explained to large groups of people and make their portfolios better. Smart beta uses factors, but doesn't push into the more esoteric areas, even if they're areas that we think can occasionally be useful. They won't be useful to an investor community that doesn't get it!

Jenn: We have our own active quantitative equity group with strategies that are factor based, but they're not transparent. We believe that there's skill there that should be recognized. We've made a decision to call those active strategies, whereas smart beta is not active.

Andrew: It's all about empowerment, and how we offer that is entirely up to the client. If the client requires a transparent, low-cost solution, we'll call that smart beta. If we want to target those return drivers by taking on more risk—because the investor can tolerate a lot of risk and discretion and leverage—then we'll call those enhanced, long/short and even hedge fund strategies.

"It's all about empowerment, and how we offer that is entirely up to the client."

—Andrew

A MARKETING PLOY?

Cliff, in 2014, you said smart beta is nothing more than a marketing ploy. What did you mean by that?

Cliff: I said it was a marketing ploy to sell some really good ideas to people, and I won't run from that. Not new; not beta; still awesome. We've all been delivering these strategies for quite a while, but smart beta is delivering them in an even simpler format: Clearer, more transparent. Smart beta is a catchy label that can help people get to the right thing.

"Smart beta is a catchy label that can help people get to the right thing."

—Cliff

NOTHING PASSIVE ABOUT THE INVESTMENT PROCESS

What constitutes a passive approach?

Andrew: There is nothing passive about the whole investment process. Even when an index is constructed there are arbitrary, sometimes well-reasoned decisions, on what goes into that index and how those things are weighted.

Alibaba, for instance, was the largest IPO in history with terrific exposure to economic growth in emerging economies, and it's not in an index today. That's an active choice. And when we rebalance a traditional cap-weighted product, that's an active decision, too. We can go all the way to illiquid alternative investments, which clearly are traditionally active.

Smart beta and these enhanced other types of factor strategies, they all fit along a spectrum, but there is nothing passive about the whole investment process, everything is active—only to greater or lesser degrees.

"We've made a decision to call those active strategies, whereas smart beta is not active."

—Jenn

Cliff: Every factor we are talking about is quite active within the factor. They vary in degree. Momentum is probably the most active, value is probably the least active—but they're not buy-and-hold portfolios. So at the very least, we might be talking about buy-and-hold strategies of non-buy-and-hold. This shows that semantics is still young in this field. So you get into situations where we are using terms like "active" differently.

Jenn: If you are investing in smart beta, you're making an active decision away from market cap-weighted benchmarks, which we know are the only macro consistent indices out there. If someone is holding a factor index that is going overweight value stocks, then somebody else has to be underweight value stocks.

The question of TIMING is a holistic one...

THE IMPORTANCE OF TIMING

How important is timing of factors?

Cliff: There is some modest ability from the very logic of the factors themselves. Timing is not nearly as important as getting a consistent exposure to good factors and sticking with it. Most of your market-timing ability isn't really there. The media gives way too much ink to this subject, when you consider the minimal role timing plays.

With that said, in the more active, proprietary world, where it's not just about providing the exposure, it's a direct reflection of our honest belief about what's important.

Cliff—*Timing is not as important as getting a consistent exposure to good factors and sticking with it.*

Andrew: We time, but the average guy should not. It's very hard to time, and I think what's behind the demand for these timing frameworks is the desire to take on factor exposures that will give returns in excess of traditional cap-weighted indices.

We're concerned about the downside, and we undertake timing to mitigate that downside risk and enhance returns when markets are doing very well. We protect our factor portfolios for those left-hand-tail downside risks.

In the smart beta categories, if you can put it into a rule, you might be able to time. The other category of ETFs is active, which means you can time there. I think this question of timing is more of a holistic question. An investor would ask, "What are you doing to manage risk?"

Jenn—*There is a rebalancing mechanism within multifactor.*

Jenn: The first generation of products in the ETF space were all single factor; clients were responsible for figuring out which factors they wanted and how much to allocate to each factor. They could do timing on their own. They asked us what our opinion was, but there was nothing systematic. No one was offering an actual timing of ETF strategy that wasn't active.

Andrew—*We time, but the average guy should not.*

Now, multifactor ETFs have become popular. Value and momentum are seen as great diversifiers. There is a lot of potential diversification across factors. When one is doing well, typically the others are not doing quite as well. So you can harvest the premiums of these factors over the long run and get some short-term diversification. Typically, the multifactor ETFs are equally weighted in the sense that the factors are treated the same. But there is a rebalancing mechanism within those ETFs that trades off between those factors.

Are we in danger of MOVING BACK away from the principles we're trying to SET UP?

I think index vendors will begin building timing into their rules. Obviously, it's not going to be really complex, and the rules have to be clear. You can put pretty simple timing mechanisms in place: If a factor gets a little bit more expensive than its norm, or expensive relative to the other factors, we don't want to own as much of that factor. Or, if a factor has been exhibiting positive momentum over the last year, we want to own more of that factor.

Andrew: Yes, the first generation was buying a strategy off the shelf. And the multifactor diversified products are the next stage, with some timing mechanisms. As Jenn points out, if you are rebalancing those factors, that is a form of timing. It's implicitly there.

The next thing is to actually build solutions: Portfolios that include both smart beta and other factors. But the big thing is these turnkey asset management platforms, or TAMPs. And for these, timing is really the key.

Cliff: In relatively normal times, we find timing does add some value, but it's rather modest. One thing we think people don't consider enough is that the power of diversification is amazingly strong, especially if you have four factors, most of them uncorrelated, two of them—particularly value and momentum—negatively correlated. Imagine you have no skill at timing, and I think people can have some, imagine you have none. Your first thought is, "Well, no skill, no harm, no foul, I'll time a little, I won't add, I won't subtract." It's not true. You're giving up the power of diversification; while you time, you're owning a worse portfolio. The hurdle is not zero. You have to be fairly good at timing. I think there's some timing you should do, particularly in some extremes, but I think it is a small part of the total value add relative to the balance.

I'll be very blunt. I worry about us moving back towards where we're coming from. If this is all simple, straightforward, low fee, provide an exposure to good long-term stuff, someone is going to say, "Well, how are we going to market against the next guy; oh, we can time it, they can't." We're in danger of moving back away from the principles we're trying to set up.

To order reprints of this report, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.

Andrew Ang

Andrew is Managing Director and Head of Factor Investing Strategies at **BlackRock**. He leads BlackRock's Factor-Based Strategies Group.Throughout his career, Andrew has has focused on identifying and harvesting factor risk premiums within and across asset classes.

Before joining BlackRock in 2015, Andrew was chair of the Finance and Economics Division and the Ann F. Kaplan Professor of Business at Columbia Business School. He has published widely on equities, fixed income, asset and factor allocation, and alternative assets. His recent book, ***Asset Management: A Systematic Approach to Factor Investing***, is a comprehensive guide showing how factor risk premiums can be harvested in portfolio design and incorporated in all aspects of investment management.

As a professor, Andrew advised several large institutional managers, including Canada Pension Plan Investment Board, Norges Bank and the Norwegian Ministry of Finance, on factor investing strategies.

Andrew earned a BEc(Hons) degree in actuarial studies from Macquarie University and a PhD in finance and an MS in statistics from Stanford University.

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Cliff is a Co-Founder, Managing Principal and Chief Investment Officer at **AQR Capital Management** in Greenwich, Connecticut. He is an active researcher and has authored articles on a variety of financial topics for many publications, including ***The Journal of Portfolio Management***, ***Financial Analysts Journal*** and ***The Journal of Finance***.

He has received three **Bernstein Fabozzi/Jacobs Levy Awards** for Best Article in ***The Journal of Portfolio Management***. ***Financial Analysts Journal*** has twice awarded him the **Graham and Dodd Award** and has also recognized his work with the **Graham and Dodd Best Perspectives and Readers' Choice Awards**. In 2006, CFA Institute presented Cliff with the **James R. Vertin Award**.

Prior to cofounding AQR Capital Management, Cliff was a managing director and director of quantitative research for the asset management division of Goldman Sachs. He is on the editorial board of *The Journal of Portfolio Management*, the governing board of the **Courant Institute of Mathematical Sciences** at New York University, the board of directors of the **Q-Group** and the board of the **International Rescue Committee**. He received a BS in economics from the Wharton School and a BS in engineering from the Moore School of Electrical Engineering at the University of Pennsylvania, graduating summa cum laude in both. He received an MBA with high honors and a PhD in finance from the University of Chicago, where he was **Eugene Fama**'s student and teaching assistant for two years.

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Jenn is Managing Director for Research at **State Street Global Advisors** (SSgA) in Boston. Prior to moving to SSgA in January, 2014, she was vice president for research at MSCI in New York for nearly eight years.

At MSCI, Jenn focused on research related to MSCI indices, including asset allocation and active and passive fund management. Her research has also included issues in quantitative portfolio management, risk management and risk modeling.

Previously, Jenn was a quantitative analyst at State Street Associates and an economist at Standard & Poor's DRI. She also held research assistantships at Harvard Business School and MIT.

Jenn holds a PhD and an MS from Brandeis University in international economics and finance.