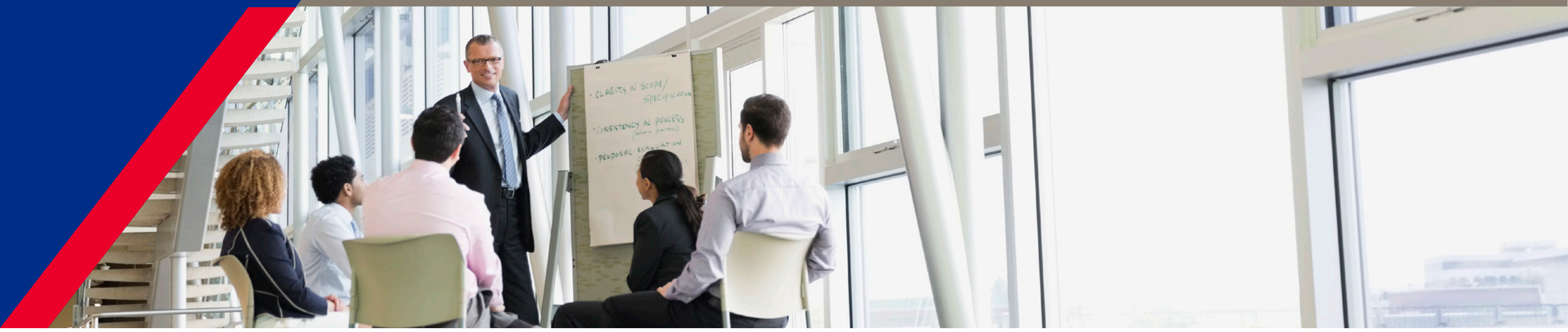
# Investing in Smart Beta

## A Conversation with AXA Investment Managers



### What is Smart Beta?

There are many different types of Smart Beta strategies, but what they have in common is the objective to move away from the weighting approach followed by traditional market capitalization weighted indices. Instead of weighting companies purely according to the price and number of stocks outstanding, these strategies focus on other attributes – such as their historical price volatility, or fundamental characteristics, like profits – when determining the weight of each company in the index.

### What has driven the growth in Smart Beta strategies and how could they be used within a diversified portfolio?

Investors are increasingly viewing Smart Beta as an alternative to a passive allocation to a market capitalization weighted equity index. One consequence of the global financial crisis was to bring the shortcomings of these indices into sharper focus, such as company weightings that are based on past (and not necessarily future) success, poor levels of diversification and exposure to other uncompensated risks. In response, index providers created a range of alternatively weighted indices (see graphic) that caught the attention of investors looking to improve the risk-adjusted returns generated by their core equity allocation. These indices can be thought of as the first generation of Smart Beta; the second generation adopts many of the same tools, while also seeking to manage their drawbacks. This is the approach we take in our Smart Beta strategies, which aim to avoid a range of unrewarded risks associated with equity investment.

### Examples of First Generation Smart Beta

| Alternative Index Method | Description | Drawbacks |
|---|---|---|
| Equal Weighting | Each individual stock has the same weight | Increased liquidity risk and volatility |
| Fundamental Weighting | A number of metrics related to the financial performance of the company other than share price performance are used to determine a stock's weight in the index | Introduce value and small cap biases, which may both lead to increased volatility. Also, does not address concentration risk. |
| Minimum Variance or Maximum Diversification | Rely upon the past behavior of stocks relative to each other using a risk model as a single input | Concentration risk. Overly reliant on mathematical models. Do not directly take stocks' fundamental characteristics into account. |

Source: AXA Investment Managers, December 2018

### What is meant by an 'unrewarded risk' in equity markets and can you give an example?

It is a generally accepted investment principle that if an investor accepts a higher degree of risk, they should be compensated with a higher return. However, we believe the expectations around the risk/return trade-off should be readjusted. We have identified additional risks within the equity market that we believe over a full investment cycle go 'unrewarded' and thus should be mitigated. One example of these additional risks is price volatility. Our analysis of the historical risk and return characteristics of stocks has demonstrated that high volatility stocks, in the aggregate, have delivered lower annual returns than both mid and low volatility stocks at a significantly higher level of risk. To us, this means that investors have not historically been sufficiently compensated for taking on the higher risk associated with high price volatility stocks.

## How should a Smart Beta equity strategy address diversification?

The problem with market cap indices and many alternative market cap index approaches is the concentration of weighting in the very largest names. Take for example the S&P 500. With 500 constituents this would seem to be diversified but actually the largest 30 stocks represented nearly 35% of the index at the end of 2014. The level of concentration can of course vary through time, becoming famously acute in the technology bubble, but it's also worth noting that in late 2006 the top 30 names contained many of the 'too big to fail' financials.

As such, a Smart Beta equity strategy should incorporate diversification that addresses the problem of 'concentration' in the largest stocks; it should be responsive to the varying presence of concentration risk over time, rather than a naïve diversification approach that comes at the expense of liquidity or creates other investment risks.

## How do you see the Smart Beta market evolving over the next two to three years?

We expect that the market for Smart Beta will continue to grow, but as investors become more aware of the investment drawbacks of many alternative market cap indices, we expect greater demand for second generation Smart Beta strategies.

In our opinion, an effective Smart Beta strategy should provide flexibility to build portfolios that deliver beta in an improved way, according to the desired outcomes of the investor. We believe that Smart Beta is already becoming an established part of the investment landscape. However, in our view, only those approaches that are designed to provide long-term added value (more predictability and control over investment outcome) will become permanent fixtures in an investor's toolkit.


### Q&A with Jonathan White, Deputy Head of Client Portfolio Management, AXA Investment Managers

**Jonathan joined AXA Investment Managers in 2007 as a portfolio manager and is currently deputy head of client portfolio management. Prior to joining the firm, Jonathan was a strategist with the global equity strategy team at Credit Suisse. Before then, he was a research analyst with the global asset allocation team at UBS.**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