QIS
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Smart Beta, beyond fundamental indexing


By Benedicte Rabier Sector Specialist
& Antti Suhonen Member of AllenbridgeIS Specialist Network

It would have been a challenge for an investor to escape the topic of smart beta in 2013. More broadly, smart beta (or alternative, liquid, quantitative, efficient/factor beta or quantitative alpha, depending on your nomenclature of choice) has been widely discussed among practitioners, with the product offering available from both banks and asset managers being broader than ever. This is probably due to the fact that providers have recently gone through several development stages of their quantitative investment strategies ('QIS') offering, which is now more mature and aims to provide better adapted solutions to investors' requirements, constraints and appetite (including but not limited to better attention to governance, transparency, reporting and fee auditing as an example).

Whilst many potential investors are yet to make the concrete step of adding QIS to their portfolios, this is a good time to bridge the gap between the different actors in this field, present a more holistic approach to understanding the breadth of the QIS market and what an investor may achieve with it.

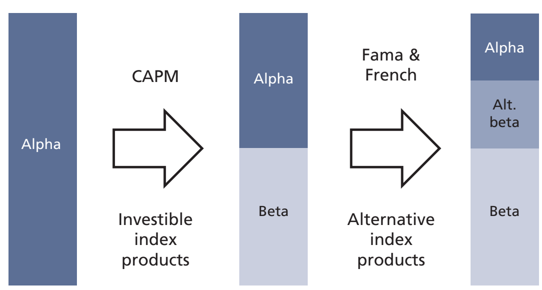
A closer look at the market indicates that the bulk of public attention, in the UK at least, has been focused on alternatives to the market capitalisation weighted equity indices. The QIS market extends far beyond long-only equities though. Since at least 2005 for pioneers in the field, asset managers and investment banks have become active providers of QIS, covering asset classes from equities to currencies, fixed income and all the way to volatility. A significant proportion of the new strategies aim to be market neutral, seeking to extract a pure premium from market returns. Such market neutrality usually results in a need for somewhat more sophisticated investment techniques such as short selling and leverage.

The basic concept behind QIS traces back to the Capital Asset Pricing Model, which first proposed the separation of beta (or general market return) from alpha (excess return not explained by market risk). Fama and French subsequently presented a departure from this simple one-factor framework, by identifying factors such as 'value' and 'firm size' as additional drivers of investment returns.

Further research has suggested other factors as possible sources of premia, hence re-classifying what used to be seen as 'alpha' as just another type of (alternative) beta (see Figure 1). Broadly, QIS seek to identify such persistent sources of returns in the financial markets and capture these returns through quantitative, rule-based investment methodologies. Conceptually, QIS can be thought of as being part of the building blocks behind active asset management: investment managers use quantitative tools to screen opportunities and time entry/exit into markets, albeit with a discretionary oversight.

Figure 1

Evolution of Alpha - Beta Separation

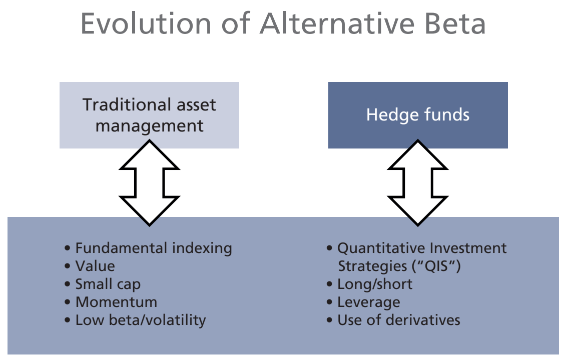


A major consideration for any investor evaluating QIS as an addition to their portfolio is the robustness and sustainability of the chosen risk premia. The providers of QIS have responded to the needs of investors by moving away from overly complex, and at times over-filtered algorithms, towards simple, transparent and economically justifiable strategies. At its most fundamental, any investment return can be considered a compensation for a risk that the investor is taking, whether consciously or otherwise. Somewhat more controversially, QIS may also seek to capture returns stemming from market imperfections, restrictions impacting some of the actors in the market or anomalies arising from investor behavioural biases.

Institutional interest in QIS has grown substantially over the past few years but it would be misleading to attribute the success of these strategies only to the heightened demand for liquidity and transparency following the financial crisis. Investing in alternative beta strategies and asset allocation beyond traditional asset classes has become mainstream especially in North America and Northern Europe (Holland and the Nordics). Both practical and academic research has established the existence of persistent risk premia beyond traditional betas and large institutional investors appear well placed to harvest such premia over long investment horizons. Ongoing scrutiny on costs such as fees for active management is another important driver behind the success of QIS.

Implementation of QIS varies greatly between countries and institutions. In many cases, QIS is still seen mainly as an extension of traditional long-only investing - much in the same way that UK pension funds have embraced fundamental indexing. However, the early adopters of quantitative strategies have, for some time, gone beyond equities into other asset classes and towards market-neutral strategies that are being used as complements and sometimes replacements for 'traditional' alternative investments such as hedge funds (see Figure 2). Although funds (whether commingled or dedicated) remain the most common investment format for institutional investors, QIS are also being used as an overlay on an investment portfolio, as many of the strategies can be accessed via derivatives requiring little or no initial cash. Anecdotal information from the variety of QIS providers suggests that the size of the market

Figure 2



today probably runs into hundreds of billions of dollars across different asset classes and strategies. Somewhat frustratingly from an investor's point of view, the market remains opaque and non-standardised, with little or no common market practices or even systematic use of terminology between asset managers and banks. When it comes to the commercial aspects of investing - from the form of investment to documentation, fees and reporting - services can vary greatly between providers. Whilst this should not prevent investors from committing capital to QIS, they would be well advised to do their homework or discuss the investments with a qualified and experienced adviser who understands both the strategies and the broader objectives of the investor.

In an effort to objectively map the present scope and scale of the QIS market, AllenbridgeIS has recently published a survey (June 2014) based on responses from two dozen providers of quantitative strategies, both from asset management and investment banking, discussing topics ranging from product offering, investment philosophy, governance, reporting and fees, and including commentary on current and anticipated market trends.

For further information, and to receive the full report, please contact: Benedicte Rabier
+44 20 7079 1000 | benedicte.rabier@allenbridgeIS.com