Smart beta or Smarter Beta…

Beta is a term that has been prevalent in the money management industry for most of a generation now. It is a measure of a stock's volatility relative to the broad market. It would be useful to a 'top-down' manager that predicts the direction of the market. In a rising market, that manager would want to hold high beta stocks in the portfolio, and vice versa.

By contrast, we manage portfolios from the bottom-up. We seek the opportunity to make a respectable return on every portfolio holding. Beta is of little consequence in creating our portfolios. Rather, we take measure of the business risks in companies and try to minimize them when creating portfolios.

Recently, the concept of smart beta has been articulated in our industry. Smart beta is interesting to us, based on our work creating low volatility equity portfolios. The premise of our Low Vol mandate is that a normal benchmark (index) contains a default level of risk in portfolios that may, or may not be appropriate for investors. They usually find out the hard way.

The Economist identifies several approaches under the heading of smart beta: "… one is to give each market constituent equal weight…A second approach, dubbed "fundamental indexing", is to weight each company by its financial characteristics—sales, dividends, assets or cash flow. A third is to weight the index in terms of the volatility of the stocks, with the least volatile being favoured. A fourth is to use the "momentum effect" to buy stocks that have recently risen in price." 1

These approaches may sound novel in today's benchmark orientated world of index funds and ETFs, but in our management of Low Vol equities, we have always employed portfolio management construction techniques that allow us to better understand and manage volatility. We might argue that we have utilized a "Smarter" beta approach to portfolio construction because we capture several of these individual approaches, simultaneously. For example, we begin by identifying companies that meet our low volatility criteria. We establish equal weight positions as a beginning weight. Then we adjust the weights, up or down, based on our forward looking view of the fundamentals such as balance sheet, management, growth, risk, and valuation. Together, our approach ensures that each security's final weight is a function of our bottom-up assessment of the company's fundamentals and risk profile. This is our own proprietary effort to manage risk, which turns out to be a compilation of several of the smart beta methodologies.

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