

Demystifying Smart Beta

Smart Beta, has disrupted the binary choice between active and passive investing.

Combining the benefits of both active and passive strategies, Smart Beta offers a systematic and rules-based approach to portfolio construction.

What is Smart Beta?

Smart Beta, also known as active quant, offers an alternative to traditional market capitalisation-weighted indexing. Many passive index funds and exchange-traded funds (ETFs) are “capitalisation-weighted”. This means that the individual stocks within the index are based on each stock’s total market capitalisation or size. Stocks with higher market capitalisations are weighted more heavily than stocks with lower market capitalisations. As a result, it’s possible for some overvalued stocks to represent a large percentage of the index’s total value. Rather than relying solely on market size to determine a stock’s performance relative to its index, Smart Beta strategies seek to enhance returns or reduce risk by selecting and weighting stocks based on investment styles that have historically demonstrated the potential to generate superior risk-adjusted returns.

Smart Beta is not a blend of active and passive investing but rather it is a standalone investment methodology that constructs portfolios systematically.

How does Smart Beta work?

Unlike fundamental active management, which relies on subjective judgements and individual stock selection by costly analyst teams, Smart Beta employs an objective, rules-based methodology using publicly available data. To exploit a particular investment style such as Momentum, Value or Quality, Smart Beta strategies use set metrics to determine whether a stock should be overweight, neutral or underweight relative to an index, ultimately aiming to combine the return of the market with the potential of outperformance with stocks that align to specific styles.

Differentiating benefits of Smart Beta compared to traditional active and passive investing:

- 1. Objectivity that cuts out human bias.** Smart Beta strategies rely on a disciplined and transparent set of rules that guide the construction of a portfolio. This approach eliminates emotional biases and the potential for human error that may be present in traditional active management.
- 2. Lower fees that affect client outcomes.** Smart Beta strategies typically have lower fees compared to actively managed funds, making them an attractive option for cost-conscious investors. Furthermore, although they may have slightly higher expenses

than traditional passive funds, the potential for enhanced returns justifies the incremental cost.

3. Potential outperformance relative to benchmark.

Unlike traditional passive funds that track the overall market, Smart Beta strategies focus on specific investment styles. For example, a value-based Smart Beta strategy would overweight stocks with lower price-to-earnings ratios. A quality-based approach would overweight stocks with stable earnings and low debt levels and lastly, a momentum-based

approach would overweight stocks that have demonstrated positive price momentum over a defined period. This targeted exposure allows investors to potentially capitalise on styles that have historically contributed to excess returns.

- 4. Diversification.** Smart Beta strategies construct portfolios very differently when compared to traditional active and passive investing. That in itself is a diversification layer. Furthermore, each investment style represents a unique source of return that may perform differently under various market conditions. By combining multiple styles within a Smart Beta strategy, investors can diversify their portfolios across different drivers of returns.

As a segment of the South African general equity market, Smart Beta assets have grown by approximately 31% per year over the last decade, albeit off a low base. As this innovative strategy continues to gain popularity, it is expected to play a significant role in shaping the future of asset management in South Africa. Investing is personal and Momentum Investments offers a broad Smart Beta offering including individual style unit trusts as well as a blended approach for each client’s unique circumstances. ■

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For more about our Smart Beta funds, visit momentum.co.za.



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