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Smart Beta 2014:

Institutional interest drives growth

Second-phase of development ensures robustness

Equally-weighted risk contribution: a new approach

Multi-factor products offer absolute return

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Alternative investments can involve significant risks and the value of an investment may go down as well as up.

Institutional interest in smart beta continues to grow

By James Williams

A recent survey of 300 institutional investors in the US and Europe by State Street Global Advisors (SSgA) – "Beyond Active and Passive, Advanced Beta Comes of Age" – found that 42 per cent of investors currently use advanced beta (or smart beta depending on your semantic tastes) and a further 24 per cent plan to do so over the next three years.

In addition, research conducted by Amundi in partnership with EDHEC-Risk Institute to measure investor interest in smart beta yielded similarly positive results among a poll of 200 European institutional investors. What it found was that the market was split into thirds: one third are currently investing in smart beta products, one third are considering it and one third are not.

"The trend in Europe is clearly growing. Index providers and asset managers have done a lot of work educating investors on smart beta. The space itself has also evolved from fairly basic single factor strategies (e.g. value, momentum) to more sophisticated multi-factor strategies. People realise that investing in one risk factor could be more efficient in certain market conditions but less efficient in other market conditions," comments Mathieu Guignard, Director of product development, ETF & Indexing at Amundi.

Smart beta uses a rules-based approach in an attempt to harvest both alpha and beta by constructing alternatively weighted indexes to that of the traditional market cap-weighted model; which still dominates portfolio construction but which fails to adequately reward investors with respect to various risk factors. In particular these include size, value, momentum and minimum volatility, which have delivered long term risk reward according to academic literature.

"I'm part of the passive equities team and most of the discussions we are having now with clients revolve around 'advanced beta'. Five years ago, those discussions would probably have centred more on cap-weighted indices," says Ana Harris, portfolio strategist at SSgA.

If, as the above studies show, more than half of institutional investors will be using smart beta strategies in the near future, it would signal a real coming of age for this asset class and clear evidence that investors are looking for ways to diversify across both their passive and actively-managed portfolio allocations.

"Advanced beta strategies play an important role in helping investors to construct holistic investment strategies while keeping risk and costs in check," said Lynn Blake, CIO, global equity beta solutions at SSgA when its report came out. "The recent spike in equity market volatility, and a reduced appetite for active strategies, may encourage further adoption of advanced beta based on its track record of improving risk adjusted returns."

Indeed, in its DB SYNDEX Outlook Report 2014, Deutsche Bank found that the attraction of getting higher risk-adjusted returns through lower-cost index products led to around 25 per cent of ETF inflows going into alternative beta strategies – this is a theme that Deutsche Bank expects to continue in 2014.

The most popular smart beta ETF in 2013, in terms of inflows, was the MSCI Emerging Markets Minimum Volatility product issued by BlackRock. It attracted USD1.76bn of net inflows.

Figures released by Russell Indexes on 16 April 2014 show that its fundamentally weighted index series – where stocks are ranked based on economic factors

"The trend in Europe is clearly growing. Index providers and asset managers have done a lot of work educating investors on smart beta. The space itself has also evolved from fairly basic single factor strategies to more sophisticated multi-factor strategies."

Mathieu Guignard, Amundi

rather than stock price – outperformed normal cap-weighted indexes in 2013. The Russell Developed Europe Index returned 22.3 per cent in 2013 whereas the Russell Fundamental Developed Europe Index returned 24.6 per cent.

"What smart beta represents is actually very powerful. It's a form of performance attribution. In the past institutions bought funds that gave them exposure to US mid cap or large-cap stocks only. They didn't provide a level of granularity on specific risk factors whereas now the growing range of smart beta ETFs is allowing investors to be much more specific on risk factors," comments Dan Draper, Managing Director of Global ETFs at Invesco PowerShares.

PowerShares has arguably the longest history in sponsoring smart beta ETFs, with Draper adding: "We have the broadest range of smart beta ETFs, as well as the greatest number, with historical track records of greater than five years than anyone else in the ETF industry. PowerShares offers both single and multi-factor products; for example, our FTSE RAFI range, where we bring together a combination of single factors in a way that can add value to investors' portfolios."

In order to meet the growing demand from institutional investors, asset managers and index providers are pushing smart beta into a new realm.

As mentioned, the single factor approach is now tried and tested. Apply a factor tilt such as small size to filter stocks with the highest value to reconstruct an index and

▶ 9

Entering 'second phase' of smart beta

By Valérie Baudson

Providing our institutional clients with the most innovative and proven solutions has been the key driver behind the successful development of Amundi ETF & Indexing's business. Today, smart beta is clearly a strategic development axis for us.

Investors' interest in smart beta solutions has been growing in recent years in response to some of the limitations of existing market cap-weighted indices and as risk criteria are increasingly incorporated into the allocation process. To meet this demand, asset managers and index providers have developed a variety of offers.

The first phase of development of the smart beta framework model focused mainly on analysing and selecting individual strategies such as value, minimum volatility, high dividend, diversification or risk parity.

We have now entered a second phase, which focuses on combining smart beta factors using either dynamic signal-based or systematic approaches, rather than employing individual strategies which do not react in the same way under different market conditions. This promises to ensure long-term robustness.

Amundi's Index Equity process enables the replication as closely as possible of any smart beta index from any index provider, based on either single or multi smart beta approaches. This can be structured as either an ETF or an index fund/mandate. The process is designed to deliver an efficient replication of smart beta indices with a constant focus on minimising costs and monitoring turnover and liquidity. It also benefits from Amundi's critical mass – the group has over USD1tn of assets under management* – which is critical when it comes to efficient indexing.

With an existing range of single strategy ETFs and strong capabilities in tracking customised indices in mandates, we are now entering a new era of smart beta development.

Valérie Baudson, Global Head of ETF & Indexing, Amundi

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As the first step in this direction, we have recently partnered with EDHEC-Risk Institute and Scientific Beta teams to create a multi smart beta index that can be replicated either as an index mandate or in ETF format. This strategy index combines a selection of four factors which are expected to produce performance over the long term – low volatility, valuation, size, momentum – with five smart beta strategies, and aims to provide improved risk-adjusted performance compared to a cap-weighted index.

More broadly, the objective of this partnership is to offer tailor-made index investment solutions by combining Amundi's know-how in index replication and ETF construction and ERI Scientific Beta's expertise in the design of smart beta indices (ERI's 'Smart Beta 2.0' platform provides access to nearly 3,000 indexes with transparency).

Besides product development, it is essential that asset managers offer both education and advice, as the smart beta arena can be confusing.

With already around USD12bn of AuM* in smart beta solutions in both active and passive management, Amundi has developed a dedicated advisory service to help investors with the mapping, selection and implementation of smart beta allocations. Amundi has built this service after a thorough review of the existing smart beta products on the market, with a view to sharing its expertise with investors and help them to make investment choices at a time when the appetite for smart beta exposure continues to grow.

Our key words in this new area of development will remain transparency, clarity and cost effectiveness, which have been at the core of Amundi ETF & Indexing's successful strategy from the outset. ■

**Source: Amundi – 31 December 2013*

Be smart with your factors

Many investors are seeking to invest today by allocating to risk factors, such as Value, Momentum, Size or Low Volatility, that are well rewarded over the long term.

By offering indices, as part of the Smart Beta 2.0 approach, that have well controlled factor exposures and whose good diversification enables specific and unrewarded risks to be reduced, ERI Scientific Beta offers some of the best performing smart factor indices on the market.

With average improvement in risk-adjusted performance of 68% observed over the long run* in comparison with traditional factor indices, ERI Scientific Beta's smart factor indices are the essential building block for efficient risk factor allocation.

For more information on the Scientific Beta Smart Factor Indices, please visit www.scientificbeta.com
or contact Mélanie Ruiz on +33 493 187 851
or by e-mail to melanie.ruiz@scientificbeta.com

www.scientificbeta.com

* Average of the differences in Sharpe ratio observed between 31/12/1972 and 31/12/2012 for all long-term track record multi-strategy factor indices and their cap-weighted factor equivalent calculated on a universe of the 500 largest capitalisation US stocks. All the details on the calculations and the indices are available on the www.scientificbeta.com website.

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Smart factor investing

By Noël Amenc, EDHEC-Risk Institute

Two of the main points of criticism of cap-weighted indices, which only offer limited access to the risk premia of equity markets, are the following:

- Poor exposure to a small number of poorly rewarded risk factors such as growth and large cap.
- Concentration in a small effective number of stocks, which leads to an excessive presence of non-rewarded specific risk and therefore low returns for a given level of risk.

Cap-weighted indices do not give access to the risk premia of factors, apart from the market factor, and even for the market factor, only offer inefficient access to the risk premium due to the presence of non-rewarded stock-specific risks relating to the high level of concentration.

By proposing indices with contrasting factor exposures that correspond notably to factors whose reward is well documented in the academic asset pricing literature (value, momentum, size) or to anomalies that correspond more to an approach that is behavioural or explained by limitations (e.g. a leverage constraint) that prevent rational agents from acting in an optimal manner, ERI Scientific Beta allows investors to distance themselves from the poor factor exposure of cap-weighted indices.

By associating an effective choice of weighting scheme in terms of diversification with this choice of factors through stock selection, ERI Scientific Beta also allows the defect of the strong concentration of cap-weighted indices to be remedied in favour of sound diversification that aims to provide the best return for a given level of risk (Sharpe ratio). The concern for the diversification of smart factor indices proposed by ERI Scientific Beta allows their non-rewarded or

Noël Amenc, Professor of Finance, EDHEC Business School, Director, EDHEC-Risk Institute, CEO, ERI Scientific Beta

specific risks to be reduced.

This category of specific risks corresponds to all the risks that are non-rewarded over the long run, and therefore not ultimately desired by the investor, but that can have a strong influence on the volatility or the maximum drawdown of the index (in absolute terms) or the tracking error or maximum relative drawdown of the index (in relative terms).

Specific risks can correspond to important financial risk factors that do not explain, over the long term, the value of the risk premium associated with the index. There are many of these non-rewarded financial risk factors. The academic literature considers for example that commodity, currency or sector risks do not have a positive long-term premium.

These risks can have a strong influence on the volatility, tracking error, maximum drawdown or maximum relative drawdown over a particular period, which might sometimes be greater than that of systematically rewarded risk factors (e.g. exposure to the financial sector during the 2008 crisis or to sovereign risk in 2011).

In line with portfolio theory, among the non-rewarded financial risks we also find specific financial risks (also called idiosyncratic stock risks) which correspond to the risks that are specific to the company itself (its management, the risk of the poor quality of its products, the failure of its sales team, the relevance of its R&D and innovation, etc.).

Specific or non-rewarded risks can also correspond to operational or non-financial risks that are specific to the implementation of the diversification model. It is better to avoid this risk by investing in a well-diversified portfolio. ■

5 ▶ away you go. The investor gets exposure to a value-based index using a variety of potential different weighting schemes – let's say fundamentally-weighted to keep it simple.

This highly popular index creation approach can best be thought of as 'smart beta 1.0'.

Now, the shift is towards creating indexes that use a multi-factor approach: 'smart beta 2.0'.

This is something that Risk Based Investment Solutions (RBIS), a subsidiary of Rothschild Group, has been focusing on and which has led them to create the Equally-weighted Risk Contribution (ERC) model to portfolio construction; something that Herve Foucault, Head of Business and Product Development, refers to as "the next stage of the smart beta evolution".

Later in this report more detail is given on the evolution of the smart beta product space, but in brief what Rothschild has done with its ERC model is minimise unwanted risk by creating a matrix combining two risk factors – volatility and correlation – to produce a portfolio where each position contributes the same level of risk.

The methodology is completely transparent and one where RBIS encourages its clients to perform the weighting calculation themselves to prove that it is indeed doing what it says on the tin.

"They can ask us questions to determine whether what we are doing is just marketing (playing on the 'smart beta' theme) or if there is really something behind our approach. Can they effectively monitor the risks we are talking about? In the early days of smart beta you weren't investing in a methodology but the constraints applied to that methodology.

"This is something that investors want to clarify with smart beta providers – are we actually delivering the product or are we delivering something that looks like it?"

By providing the weightings on a given index to the investor they simply need to multiply them by the volatility and correlation in the matrix and what they should end up with is an equal risk weighting for each position in the index.

With market cap-weighted, the weights of each stock are known from the start. The observable output is the correlation and volatility (risk factors) of the portfolio. What

"For institutional investors, fund size and liquidity are important differentiating factors for smart beta ETFs. You can have the greatest methodology but if it's only got USD20mn in AuM institutions are not going to be interested."

Dan Draper, Invesco PowerShares

RBIS is doing with its ERC approach is to flip that completely on its head.

"At RBIS, we begin with the risk factors and make weighting the output. We have moved from a 'weight-to-risk' process for portfolio construction to a 'risk-to-weight' process. This is the paradigm shift," notes Foucault.

Evidence of this new era for smart beta can be seen by the recent announcement that both Amundi and Morgan Stanley have signed partnership agreements with ERI Scientific Beta (the indexing arm of EDHEC-Risk Institute). Their platform is designed to empower investors by leveraging academic research to provide better transparency and risk controls.

"We believe that investors should be able to decide what to do based on their investment beliefs. Our platform is giving institutions the opportunity to decide what they want to achieve with a particular index; all we are doing is providing the tools," says Peter O'Kelly, EDHEC-Risk Institute's Director of Marketing.

What the Scientific Beta team has done is create a 'smart factor' methodology for what it calls a Multi-Beta Diversified Multi-Strategy Equal-Weight Index; quite a mouthful but what it essentially means is that investors can get exposure to global equities using four factors – small size, high momentum, value and low volatility. Five different weighting strategies are then applied to each risk factor to build the index.

Amundi has created its own global index using this approach with ERI Scientific Beta,

which is now available to institutions.

"It's a new way to offer our index capacities to clients," says Guignard. "Talking about this new era of smart factor investing (smart beta 2.0) has clearly generated some interest from clients.

"The flows we're seeing into smart beta at the moment are more in dedicated mandates than ETFs. Large institutions usually prefer tailored solutions rather than open-ended products."

Using an open architecture is sating investor appetite for greater transparency in the smart beta space and perhaps explains why investor demand for these alternative indexing options is on the rise. "Investors can see inside the index. The ERI Scientific platform gives investors access to performance and risk analytics on all the indices at any time, so there are clear transparency and risk control benefits to clients," adds Guignard.

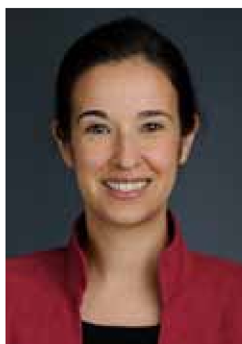
But not all investors are pursuing this multi-factor approach to indexing. SSgA's Harris says that for most clients smart beta is a journey, with different clients at different stages of that journey. Most are still in the early stages of embarkation and therefore favour the single factor approach.

"The larger institutions that have more internal resources or have a mandate to broaden their allocations are at the forefront of this trend. It also seems to be more popular within Europe than the US and in particular, countries like the Nordics," says Harris.

"The majority of clients are still just looking at single factors. Investing in factors is a significant departure from thinking about stocks and investors need to build their level of comfort with this approach. Most are at the stage of implementing a single factor methodology either to diversify their passive allocation (cap-weighted) or reduce some of their active manager allocation," he adds.

What EDHEC is doing is refining a lot of the portfolio construction "but it may be hard to explain where performance is coming from when you introduce added complexity", suggests Harris.

When assessing what makes a good smart beta product, Draper says that transparency and understanding the methodology are crucial for institutions because of the fiduciary responsibility they have to their end-investors.



"I'm part of the passive equities team and most of the discussions we are having now with clients revolve around 'advanced beta'. Five years ago, those discussions would probably have centred more on cap-weighted indices."

Ana Harris, SSgA

"They need to be able to explain why they are buying a particular ETF to fit a particular purpose in the portfolio. So having an index methodology that is well tested, effective and can be clearly communicated is key. But also, because of the large investment positions that institutions put on, trading liquidity of an ETF is a key consideration.

"For institutional investors, fund size and liquidity are important differentiating factors for smart beta ETFs. You can have the greatest methodology but if it's only got USD20mn in AuM institutions are not going to be interested," says Draper.

Indeed, the Invesco PowerShares RAFI range is over USD6bn.

"A good example is our PowerShares Senior Loan Portfolio, which is now heavily used by institutional investors. Senior bank loans are OTC products but the fact that we put this product on the stock exchange means investors can now buy a million shares of that ETF at a four basis point spread. That is much tighter than going out and buying individual senior bank loans in the OTC market. The ETF wrapper has enabled us to really bring liquidity to that underlying asset class," says Draper

He adds: "Before we bring anything to market we've already had a lot of dialogue across the entire value chain, starting with our clients. It may be a great idea but how practical is it? Will it work in the marketplace? Will it attract liquidity? That's where having a strong track record of bringing smart beta ETFs, like ours, makes a difference." ■

Smart beta to grow faster than broader ETF market

Interview with Dan Draper

Invesco PowerShares has been leading the "ETF Intelligent Revolution" since 2003, so when it comes to understanding the key growth drivers at work in this space, the firm is uniquely placed.

In January 2014, the firm published a report with Cogent Research entitled *The Evolution of Smart Beta ETFs*. Two key findings emerged in relation to institutional investor sentiment towards smart beta: first, one in four institutional decision makers now use smart beta ETFs; second, 53 percent said they would look to increase their allocations over the next three years.

"Within the US, we estimate that the current smart beta market is roughly USD200bn. We see that growing to between USD450-500bn over the next three years. We see smart beta growing two to three times faster than the overall ETF industry," says Dan Draper, Managing Director of Global ETFs at Invesco PowerShares.

To understand the growing adoption of smart beta products among institutions one needs to look at both the macro and micro level. From a macro perspective, post-2008 has seen global monetary policy create a perniciously low interest rate environment. This has led to a knock-on effect within the investment industry where correlations across asset classes have been pushed higher and volatility – especially in equities – was dampened.

"Post-2008, that combination of macro factors really benefited traditional market cap-weighting. Markets were moving up and down together. You had a high level of correlation across markets and investors weren't being rewarded as much for asset allocation and security selection strategies," comments Draper.

Today, the macro environment has started to shift. Global economic growth is slowly returning, equity volatility has seen an uptick, and at some point in the near future interest

Dan Draper, Managing Director of Global ETFs at Invesco PowerShares

rates will likely rise (at least in the US).

"As we move to more normalised global monetary conditions, and de-correlation among different asset classes and geographies, that should favour smart beta and help add to the alpha creation process," says Draper. "While our smart beta ETFs are index based, the product development phase is a very active process as we work with our index providers to understand exposures and methodologies," he adds.

At the micro level, as the depth of liquidity in smart beta products deepens, institutions will have more ways to gain smart beta exposure. Historically, many institutions have used bank-issued products such as swaps and structured products. But with banks facing rising capital requirements, traditional asset management solutions via '40 Act funds, UCITS funds and ETFs, stand to benefit in this smart beta demand surge.

"We believe that with increased liquidity coming into the smart beta ETF space, we will be able to capture some of that growth," says Draper. "Low volatility strategies, momentum, commodities that offer forward-rolling yield optimisation capabilities – all of these products will likely be increasingly considered by institutions whereas in the past they may have only had access to bank-issued products."

Most likely, large institutions will still use banks for sophisticated services and take advantage of the more commoditised area of smart beta by using ETFs in a fiduciary-friendly, transparent fund wrapper to better manage their risk budgets.

"What smart beta represents is actually really powerful. It's a form of performance attribution. Invesco PowerShares offers both single and multi-factor products; the FTSE RAFI suite for example, uses a combination of single factors together in a way that can add real value to investors' portfolios," concludes Draper. ■

Multi-factor products begin to offer absolute-return potential

By James Williams

There was a clear example this April of just how far smart beta investing has come. Goldman Sachs Asset Management (GSAM) announced that it had agreed to acquire Westpeak Global Advisors, a firm that offers full-customisable solutions for smart beta investing; a clear sign of endorsement by GSAM that this area of equity investing has value.

At the same time, GSAM announced the launch of an Advanced Beta Strategies platform. The platform combines Westpeak's smart beta business with GSAM's S&P Global Intrinsic Value Index (GIVI®) strategies, a set of tax-sensitive equity strategies, and a range of liquid alternative beta strategies. The new platform will be overseen by Armen Avanessians, head of GSAM's quantitative business.

"This acquisition reinforces GSAM's focus on investment innovations across global equity markets," says Avanessians. "Westpeak's proprietary ActiveBeta® Strategies complement well GSAM's existing capabilities in the beta space, which includes liquid alternatives, rules-based, and tax-efficient strategies. The combination of these capabilities, inclusive of Westpeak's proprietary factor-based equity solutions, form our new Advanced Beta Strategies platform, which we believe is critical to our engagement with our clients.

"We believe that Advanced Beta will be among the most prominent trends to emerge in the asset management industry over the next decade."

Through the identification and implementation of investment factors (e.g.,

value, momentum), investors have the opportunity to achieve a more efficient capture of the broad market, says Avanessians, adding: "ActiveBeta® Strategies is a fully customisable smart beta solution. For example, investors can:

- Customise the capture of individual and diversified factor returns at desired levels of target tracking error (i.e. customise risk tolerance);
- Create customised factor diversification strategies to reflect their philosophical biases (i.e. customise beliefs);
- Develop customised solutions to help them better manage portfolio exposures and design completion strategies (i.e. customise exposure risk)."

One area within smart beta that asset managers are increasingly focusing on is the development of multi-factor products. This is, in large part, being pushed by institutional investors who, over recent years, have grown increasingly comfortable with single factor investing but who are now looking for more effective implementation using a multi-factor methodology.

This year, State Street Global Advisors (SSgA) announced the launch of a multi-factor solution to allow investors to combine more than one risk premium in a single portfolio.

"Say an investor likes value and quality factors and they have two separate portfolios – high quality stocks may mean higher valuations so the investor might be buying a given stock in one portfolio and selling it in the other. If they had a combined portfolio they could hold those stocks for a bit longer – but maybe at a lower weighting. Multi-factor investing can make the implementation process more efficient if the investor believes in more than one factor," comments Ana Harris, portfolio strategist at SSgA.

Running a multi-factor portfolio rather than numerous separate portfolios also helps to reduce trading costs.

Harris confirms that SSgA has two multi-factor index products in the pipeline – "one for two factors, one for three factors", she says. These indexing products are geared more towards sophisticated institutional investors who prefer to have segregated mandates. Having said that, SSgA has also filed for approval to launch a multi-factor ETF in the US.

"We believe that Advanced Beta will be among the most prominent trends to emerge in the asset management industry over the next decade."

Armen Avanessians, GSAM

"The ETF would track MSCI Quality Mix Indexes, a multi-factor index launched by MSCI at the end of last year," says Harris.

The three factor indexes that make up the composite index are: MSCI Value Weighted, MSCI Minimum Volatility and MSCI Quality.

Herve Foucault is Head of Business and Product Development at Risk Based Investment Solutions (RBIS), a subsidiary of the Rothschild Group. Its approach to product evolution within smart beta has been to develop a matrix that seeks to measure stock volatility and correlation and create Equally-Weighted Risk Contribution (ERC) index portfolios for its clients. It is a 'risk to weight' methodology rather than 'weight to risk' methodology long used by market cap-weighted indexes.

"As soon as you introduce more than one component into the portfolio you have what we call 'hidden assets'; these are the correlation between each stock and their individual volatility. If you focus on the hidden assets in the portfolio construction process this is the most efficient way to extract value from them.

"At Rothschild, we believe that combining volatility and correlation to create an Equally-weighted Risk Contribution portfolio is the next stage of the smart beta evolution," comments Foucault.

This is not to suggest that single factor investing is about to become redundant. Indeed, SSgA's Harris says that there are still plenty of its large clients still using single factor in separate portfolios.

Popular indexes like the Nikkei225 are tentatively entering the smart beta arena to deliver something new for investors. On 6 January 2014, Japan Exchange Group Inc, Tokyo Stock Exchange Inc and Nikkei Inc began calculating a new index: the JPX-Nikkei Index 400.

"The index employs an element of smart ▶ 16

A new approach to portfolio construction

Interview with Herve Foucault

At Risk Based Investment Solutions Ltd (RBIS), a wholly-owned subsidiary of the Rothschild Group, there is a firm belief that smart beta has a promising future. In fact, Herve Foucault, Head of Business and Product Development, goes so far as to say: "This is a real paradigm shift from the traditional cap-weighted model."

For decades, the approach to traditional portfolio construction has been anchored in using market cap-weighted models. But in Foucault's opinion, there is a growing recognition among academics and asset managers that this approach is too disconnected from reality.

"Historical data demonstrates that a cap-weighted approach for equities is not the most efficient way to achieve an optimal risk/return profile for portfolio construction. There is room in the market to explore alternatives to traditional portfolio construction, such as smart beta. It started with minimum volatility and minimum correlation, and now we have equally weighted risk contribution models," says Foucault.

At RBIS, they are pushing the next evolution of portfolio construction under the 'smart beta' moniker by using a multi-factor approach, which Foucault refers to as Equally-weighted Risk Contribution (ERC).

Think about a standard portfolio of 100 stocks tracking the FTSE 100 index. There are a number of different ways to weight the portfolio: one could allocate 100 per cent to the single largest stock, 100 per cent to the single smallest stock, and all other options in between including the cap-weighted one.

The ultimate stock selection, using this defined approach, would be to have a future view on which stocks are the best performers. This would create the most possible performing portfolio on a day-to-day basis. But nobody has that view into the future. The best

Herve Foucault, Head of Business and Product Development at Risk Based Investment Solutions Ltd

one can hope for is to destroy as minimal an amount of value as possible compared to this hypothetical portfolio. At RBIS, rather than focusing on portfolio weighting – and subsequent risk output – they first focus on the risk parameters.

"We have moved from a 'weight-to-risk' process to a 'risk-to-weight' process. Once yoy have more than one component in the portfolio you have what we call 'hidden assets'; these are basically the correlation between each stock and their individual volatility," says Foucault.

As the name suggests, it is an asset and an asset has a value. "We focus on these hidden assets of the portfolio. For the 100 stocks in the portfolio, there are 100 different volatilities, which we measure. Then we use a 100 x 100 correlation matrix to measure inter-correlation between stocks; this is the core of our portfolio construction. Taking into account the "hidden assets" in the portfolio construction process is the most efficient way to extract value from the hidden assets."

Volatility and correlation are the two primary risk factors that RBIS focuses on in order to then create an equally-weighted risk contribution portfolio where each line in the portfolio has the same risk budget.

"ERC is the next stage in the smart beta approach. We are transforming the hidden assets into real-life assets. We've used this approach to backtest simulations on every global market," says Foucault.

The approach is systematic. Once the index components are defined the formula is applied on a monthly basis.

So far, the methodology is yielding attractive results. For a typical equity portfolio, volatility in an ERC portfolio is reduced by 20 per cent, the Sharpe ratio increases by a third and maximum drawdowns are reduced by 25 per cent. ■

Expanding to Continental Europe and Asia ex-Japan

Interview with Khalil Mohammed

Last September, Man Group's GLG broadened out its highly successful broker-driven Europe Plus strategy which launched in 2011 as an ETF, to include two more strategies covering Continental Europe Plus (ex-UK) and Asia Plus (ex-Japan).

Since 2005, GLG has been capturing broker recommendations to capture alpha in the form of medium-term market anomalies and turning them into a long-only portfolio. Each broker provides what they believe to be their best fundamentally driven ideas over an investment period of 60 to 90 days; the threshold for capturing these market anomalies.

The Europe Plus strategy has now grown to approximately USD800mn and as Khalil Mohammed, portfolio manager at Man Group says: "The Continental Europe Plus and the Asia Plus ETFs have gathered assets of USD135mn and USD130mn respectively. Add in the other funds we run using the same broker driven process, such as the retail fund and managed account, and the total strategy assets are approaching USD2bn as at the end of the first quarter 2014."

The underlying benchmark for the Asia Plus strategy – the MSCI AC Pacific ex Japan – comprises over 600 stocks whereas the Asia Plus strategy only holds between 170 to 250 names.

"When we do the portfolio construction we use robust rules to ensure that we are size neutral relative to the benchmark; that means we get the same beta as the benchmark we're trying to beat. Furthermore, it ensures that we deliver the same variability in returns but aim to add an extra bit of alpha on top; approximately 3 to 8 per cent alpha for the Asia Plus strategy because we think the Asia markets are more inefficient," explains Mohammed.

When Man Group acquired GLP Partners in 2010 it allowed the team to start thinking about how to expand the strategy to include other regions such as Asia where Man has a presence in Hong Kong with its AHL business.

"We have to understand the business model behind each of the brokers that come into our system. We have one employee in London responsible for all of our European brokers and one in Hong Kong responsible for all the Asia ex-Japan brokers," says Mohammed.

The Asia Plus strategy currently captures ideas from 45 different brokers to ensure that enough recommendations for both developed and emerging Asia markets are put into the portfolio to limit tracking error. In total, 11 markets are covered, four developed and seven emerging markets including Thailand, the Philippines and Malaysia.

"Even though emerging Asia markets cover less than 10 per cent of the benchmark index that we are trying to beat they cover nearly 40 per cent of the trading costs," says Mohammed. "It's taken a while to launch the Asia Plus strategy because we had to collect the ideas, test our rules against those ideas and then confirm whether or not any alpha was being generated."

When it launched last September, the Asia Plus strategy returned 1.6 per cent of alpha over the last four months of 2013 with a 4 per cent tracking error. The same is true for the Continental Europe Plus strategy, which generated 4.2 per cent of outperformance (relative to the MSCI Europe ex UK Index) in 2013 with a 2.5 per cent average tracking error.

"Certain investors are going long our strategy and short the benchmark to extract the alpha and remove the beta component completely. They like the fact that the strategy offers stable and consistent alpha," concludes Mohammed. ■

Khalil Mohammed, portfolio manager at Man Group

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13 ▶ beta filtering with cap-weighting," says Ari Rajendra, Synthetic Equity and Index Strategist at Deutsche Bank. "More of the established index providers like MSCI, FTSE and STOXX have started to construct new smart beta indices, which appeal to a broader investor base. As a result, we could see ETF assets tracking these indices to grow significantly in the future."

Nikko Asset Management, one of Japan's largest ETF providers, launched the JPX-Nikkei Index 400 ETF. Crudely speaking, the difference between the new index and the TOPIX is that the TOPIX is market cap-weighted on 1,700 stocks. The JPX-Nikkei Index 400 uses qualitative and quantitative criteria including return on equity (ROE) and the degree of governance within individual companies to select high quality companies.

"In Japan what you're beginning to see is the early evolution of products from cap-weighted towards a smarter outcome. This is certainly more sophisticated than products that have launched previously in Japan. The JPX-Nikkei Index 400 uses a combination of quantitative and qualitative inputs, including measures of governance and investor reporting, to focus on better managed companies," comments Geoffrey Post, Head of International Product Development at Nikko Asset Management.

One firm that has been particularly successful in developing a scalable smart beta strategy is Man GLG. Since 2005, GLG partners has been collecting the best BUY recommendations from a network of 65 European brokers to run its Europe Plus strategy of between 200 to 250 stock positions. In 2011, ETF provider Source teamed up with Man GLG to launch the Source Man GLG Europe Plus ETF, which has grown to approximately USD800bn in AuM.

After deciding to extend the strategy to Asia Pacific in 2010, Man GLG launched two new ETFs last September: Source Man GLG Continental Europe Plus (which excludes UK equities) and Source Man GLG Asia Plus (which excludes Japan). Both have grown to around USD130mn and there are now plans afoot to widen the strategy even further to incorporate broker ideas from Japan and North America.

"At the start of 2014 we began talking to Japanese and North American brokers. We

"More of the established index providers like MSCI, FTSE and STOXX have started to construct new smart beta indices, which appeal to a broader investor base."

Ari Rajendra, Deutsche Bank

now have 27 brokers in Japan giving us their best recommendations whilst in the US we will have around 40 brokers contributing ideas. We haven't given any firm dates to clients on when we might launch the Japan and North American strategies as it is dependent on the idea pool and the strength of the alpha.

"We know there is around 100 basis points of alpha (over 30 to 60 days) to be extracted in North America but we want to be sure that there's enough alpha to allow us to run a well diversified strategy," explains Khalil Mohammed, portfolio manager at Man Group.

These are all interesting developments but one firm that is keen to add academic ballast to the multi-factor approach to smart beta investing is EDHEC-Risk Institute, whose indexing arm ERI Scientific Beta has recently been promoting the virtues of what it calls 'smart factor' investing.

The 'smart' part is the weighting scheme. One of the problems when moving away from the market cap-weighted model to alternative weighting models is that if you don't have sufficient diversification of the factor you might end up being highly concentrated in a number of stocks; e.g. a low volatility factor tilt might produce a concentration of utility stocks in the portfolio, thus creating sector bias.

"So the 'smart' element for us is the diversification element. We have various diversification schemes all of which we think have merits. These include: Maximum Deconcentration, Maximum Decorrelation, Diversified Risk Weighted, Efficient Minimum Volatility and Efficient Maximum Sharpe Ratio," explains Peter O'Kelly, EDHEC-Risk Institute's Director of Marketing.

The 'factor' part includes four specific risk factors, which academic research has shown deliver reward to investors over the long

term. These include: high momentum, small size, low volatility and value.

What the ERI Scientific Beta team then does is combine the four risk factors with the five different weighting schemes to diversify away all the unrewarded risk.

"The 'smart' part is diversifying away unrewarded risk and the 'factor' part is the quality of the risk factors being used," adds O'Kelly.

Felix Goltz, Head of Applied Research at EDHEC-Risk Institute said that such an approach allows investors to manage systemic risks through explicit stock selection, and also to diversify strategy-specific risk by combining different strategies.

"ERI Scientific Beta allows investors to benefit from additional factors with reduced specific risks, which simple cap-weighting does not allow," Goltz was quoted as saying.

One of the problems with single factors is that whilst they have been proven (academically) to reward investors over the long term, that's not necessarily the case over the short term.

"Low volatility might do well in a bear market but less well in a bull market but if you diversify your factors you might be rewarded for momentum, for example, at a time when volatility is still low. The aim is to diversify your factors to do well in all market conditions and diversify your weighting schemes to reduce any unrewarded risk," adds O'Kelly.

Amundi has partnered with ERI Scientific Beta to develop a global index base on this smart factor methodology.

"We do an equal risk-weighting contribution for each of the four risk factors and in the end this gives us a smart combination of factor selection and weighting schemes used in the index construction," explains Mathieu Guignard, Director of product development, ETF & Indexing at Amundi.

By combining all four factors to construct the index, the objective is to deliver better performance in all market conditions. What this shows is that smart beta investing, by adopting a multi-factor approach, is beginning to offer investors more of an absolute return solution.

"We have worked together with ERI to create a global index – the 'Scientific Beta Developed Multi-Beta Multi-Strategy ERC' index – and plan to launch an ETF this June. Partnering with ERI offers us many ways to customise indexes for clients. We can technically do it for any geography and customise the approach itself for client mandates. If a client isn't convinced by the momentum approach we could remove it from the stock selection process in the index creation and just use the other three factors," says Guignard.

Looking ahead, SSgA's Harris says that the next step in factor investing will be how to apply it beyond equities. The reason why smart beta lends itself so readily to equities is because the data to build passive strategies is readily available. Moreover, the variety of parameters used for measuring equities is way beyond other asset classes like fixed income.

"In fixed income, because there's less data available there's been less growth in passive strategies. However, what could boost the growth of fixed income passive strategies is applying this concept of smart beta. Thinking about other ways to construct indexes beyond the historic debt-weighted approach; are there any quality thresholds that could be used to better construct fixed income indexes?" opines Harris.

Foucault confirms that RBIS is applying the same ERC philosophy to fixed income and commodity futures. Wth respect to fixed income indices, he comments:

"As we can maximise the risk budget using the ERC approach, we believe there is more value using this hidden asset approach to budget the risk country by country with regards to their respective GDP. If a country has twice the GDP of another we'll allocate twice as much risk exposure."

This is the opposite approach to debt-weighted fixed income indices where countries with the highest levels of indebtedness have the highest weightings.

"Because we have the same rationale to weight each portfolio based on the risk budget associated line by line it makes it easy to combine asset classes. We will be able to combine equities and bonds in one portfolio to achieve the same objective but in a multi-asset profile that we can compare to other traditional multi-asset class portfolios," concludes Foucault. ■