What is Smart Indexing Investing?

How does it help your investment portfolio?

Passive smart index investing strategies have become incredibly popular. From 2012 to 2018, the value of passive smart index funds have grown at almost 30% annually and have surpassed over R20 trillion in assets globally.

But while it's popular, what does it mean? Passive smart indexing investing or "Smart Beta" is one of the more confusing terms used in passive index tracking unit trust funds or exchange traded funds (ETFs). Unlike the relatively straightforward names of many ETFs — such as the Satrix SWIX Top 40 ETF or Satrix DIVI Plus ETF — it takes some deciphering to figure out what is so "smart" and "beta" about these investments.

The basic aim of a smart beta strategy is to outperform a traditional stock index by selectively choosing and re-weighting the stocks in the index. It's a "smart" index because it tries to increase returns by buying a larger proportion of stocks with the predetermined criteria that the asset manager thinks will lead to outperformance. "Beta" refers to how volatile or risky an individual stock is. So smart beta funds seek to achieve better risk-adjusted returns than traditional index funds. In other words, they try to achieve higher

returns (smarter) without greater risk (more beta).

To understand how a smart beta index differs from a conventional index, you must first know what a conventional index does. Usually, the most common indexes, such as the JSE /FTSE AllShare Index, which tracks the largest companies in South Africa, are weighted by a company's size. The bigger the company, the more weight it holds in the index. That's true regardless of whether smaller companies are growing faster or paying a better dividend or trading for a low valuation.

Smart beta strategies identify stocks in the index with these other, perhaps better qualities and make them a bigger part of a smart beta fund. The funds screen for stocks based on criteria deemed important, and when a stock meets the criteria it can carry more weight in the index.

This approach makes smart beta a passive strategy rather than an active strategy. Smart Beta funds don't have managers trying to beat the market. While a purely passive approach keeps fees the lowest, a smart beta strategy can be more expensive, though still cheaper than a traditional actively managed fund.

So, investors like smart beta because it promises potentially market-beating returns, diversification and lower risk. This promise has driven their popularity over the past 15 years since the first smart beta fund was created in 2003.

While there's just one term for this approach, smart beta has many flavours, depending on what an investor is looking for. A smart beta fund can set its preference for:

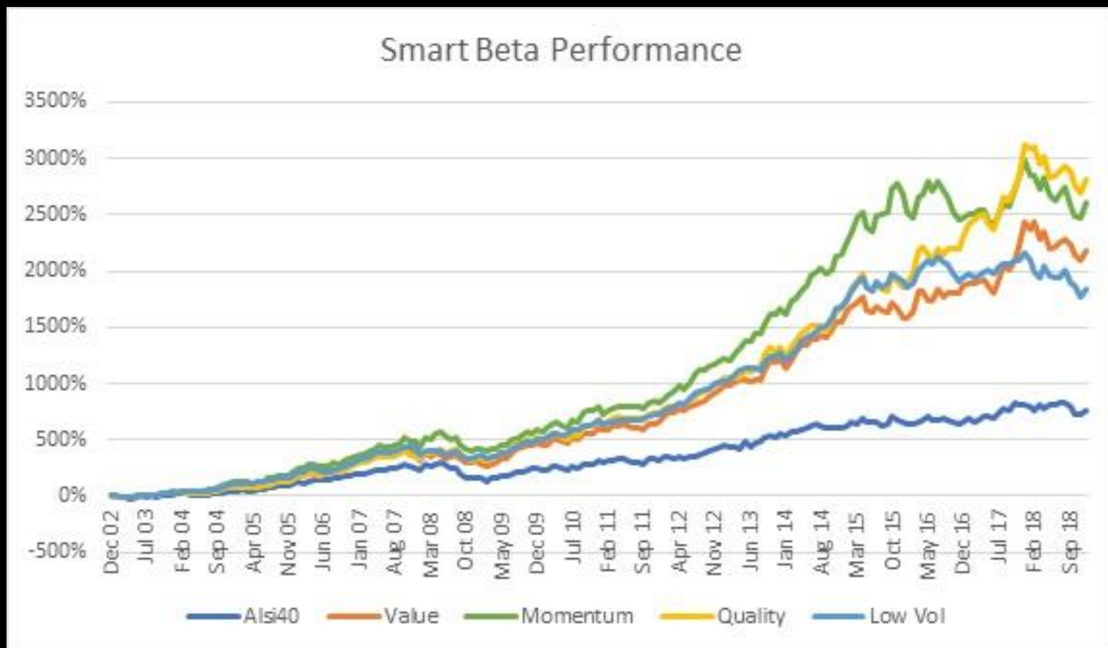
- **Dividends:** Stocks that pay big dividends or show strong dividend growth
- **Low volatility:** Stocks that fluctuate less than the average
- **Momentum:** Stocks that have strong upward price movements
- **Business quality:** Companies that exhibit strong operational characteristics, such as high profit margins
- **Valuation:** Stocks that appear cheap relative to earnings or cash flow
- **Size:** Companies factored by the total value of their stock

But it's important to remember that each of these funds would be different. One asset manager's smart beta fund based on valuation is probably not going to look like another's. That's in sharp contrast to passive index funds based on the Allshare Top 40, where all funds look virtually identical, no matter the provider.

Because of major differences in the composition of smart beta funds, investors must examine a fund and how it has performed over time.

Our long-term study shows smart beta performs well, relative to a benchmark Allshare 40 index fund. Using data from Salient Quantitative Investment Management, we studied the performance of four factors (value, momentum, business quality and low volatility) from 2003 to 2018.

The results looked extremely favourable:



All the factors resulted in higher absolute returns relative to the FTSE/JSE Allshare 40 index as well as delivering higher risk-adjusted returns.

Smart beta strategies weren't always the winners at particular points in time. During some periods the traditional market-cap-weighted index outperformed smart beta. Still, over that entire time, the smart beta approach was a winner, with a clear pattern of outperformance relative to the FTSE/JSE Allshare 40 index.

Watch this space, we will be launching our own Smart Fund soon.

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