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Inside smart beta: Making sense of investment factors.

To complement active management, investors are increasingly looking to smart beta to optimise their portfolios. But which smart beta factors (value, momentum, low-volatility, quality, size) are right for them? Russell suggests the answer requires a careful look at risk, return, and correlation between factors.

The evolution toward smart-beta investing is often seen as a rejection of cap-weighted indexes, but that may be a false perception. The real trend appears to be moving investors toward a more balanced relationship between smart-beta and cap-weighted indexes rather than a divisive split between the two approaches.

Increasingly, investors are looking for ways to complement active-management investing, which relies heavily on the skill of individual managers. Smart-beta investing offers a systematic approach aimed at balancing investors' exposures. By choosing to invest in smart beta exposures, investors are not necessarily shunning traditional cap-weighted indexes or the principles of active management. In fact, they are looking for a way to optimise the range of active strategies that make up their portfolios.

A lot of what we're seeing within the smart beta world is just investors gaining systematic access to investment exposures that have been primarily the domain of active managers.

Smart beta strategies are designed to add value by systematically selecting, weighting, and rebalancing portfolio holdings on the basis of characteristics other than market capitalisation. However, not all smart beta strategies are the same. It is important to apply the same level of due diligence to a smart beta strategy as you would a traditional active manager.

The anatomy of smart beta

As a starting point, we define smart betas as, "transparent, rules-based portfolios designed to provide exposure to specific factors, market segments or systematic strategies." In practical terms, smart beta can be publicly available indexes or proprietary investment strategies and come in two basic types: strategy-based and factor-based.

Strategy-based smart betas offer an alternative approach to constructing portfolios. They weight companies by fundamentals, such as five-year averages of cash flow, sales, dividends, and the most recent book value of shareholders' equity. They do not weight companies by market capitalisation as traditional indexes do. Smart betas do not attempt to identify specific characteristics of the stock; they simply place the weighting emphasis on something other than market cap.

Factor-based smart betas, on the other hand, look at particular characteristics of stocks, and make selections accordingly, rather than just simply weighting the portfolio.

At Russell, we focus on factor-based approaches, supported by a consistent methodology for evaluating each company's particular characteristics. We consider this a more efficient method of achieving what we're trying to represent as we build our portfolios.

What are the performance patterns of factors commonly used in smart beta investing?

The four most common factors used in smart beta investing are value, momentum, low-volatility and quality. Size also is a frequently used factor. Here are a few details about each of these factors, including what they emphasise and how they tend to perform:

VALUE: One of the oldest forms of active equity investing, value investing harks back to the days of Benjamin Graham and David Dodd, who literally wrote the book on this method after the catastrophic stock market crash in 1929. Value investing focuses on companies with high intrinsic value, where the stock is selling at a market price below the true value. Plenty of empirical and academic evidence supports the notion that value-based strategies perform well over time in the market. We often find that value investors can go for extended periods where their portfolios are underperforming the market, and then recover in a relatively short time. When investors are considering a value-based allocation, we encourage them to take a long term view in terms of when they expect to see returns.

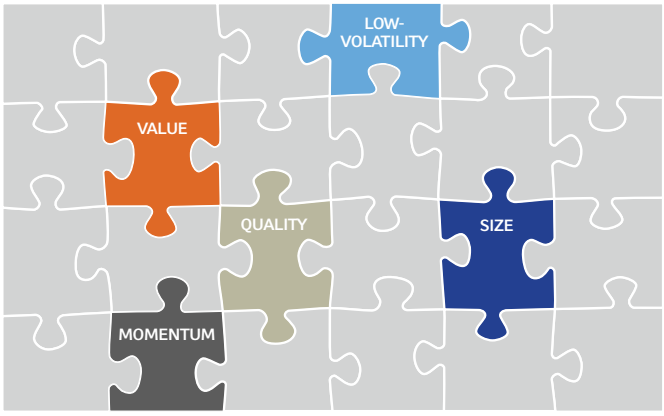
MOMENTUM: Pioneered in the early 1990s, momentum investing presumes that if stocks have performed well for the past 12 months, they probably will continue outperforming the market for a short period in the future. Momentum and value tend to be negatively correlated – when value is outperforming the market, momentum often isn't doing well.

LOW-VOLATILITY: Low-volatility investing identifies stocks that display a lower level of risk than the overall market. Low-volatility equities often outperform when the market is falling, and frequently lag when the market is rising. From a performance pattern perspective, low-volatility carries very low levels of absolute risk, but high levels of active risk.

QUALITY: Quality, the most recent factor to join the list, considers three essential elements of a company: management efficiency, financial strength, and earnings-profile stability. Quality is also considered one of the most stable factors, which means that excess returns can be fairly consistent over time. This factor also tends to see small active drawdown levels, but that means the excess returns delivered by quality are often not as strong as those from factors such as value or momentum.

SIZE: This factor is based on a belief set that says smaller companies often are more capable of outperforming the market than larger companies. Size generally carries the same level of volatility as the overall market, but it can carry a high level of active risk. Typically, size investment strategies perform well when investors want to increase their risk appetite.

What factors are missing from your portfolio?



How do factors affect outcomes?

At Russell, we believe in having positive strategic exposures to value, momentum and quality—three factors that we believe are often rewarded in the market. Value, momentum and quality are well-suited to investors who are striving to outperform the market, or who want a strong balance against a cap-weighted benchmark.

Although low-volatility certainly can reduce overall risk, for many investors its performance is often too low to help them reach their goals. They may need to take on an equity exposure with a higher level of risk.

Size can be a powerful factor to consider when building a portfolio. At Russell, we believe in active management and in taking active risk relative to benchmarks. We believe that size is best exploited through skilled managers that can find better results with smaller companies.

How do investors' preferences and objectives align with various factors?

We encourage investors to assess three key elements when looking at any active investment strategy:

1) **RETURN:** When considering any active investment strategies, investors should begin by considering potential return. We believe investors should favour strategies with the highest expected return. Based on extensive research and experience, at Russell we believe that the highest factor returns are associated with value, followed by momentum, then low volatility, and finally quality.

2) **RISK LEVELS:** Once investors take into account risk in relation to return, some factors become more relevant than others due to different levels of risk. From an absolute risk point of view, we believe low volatility is the most relevant strategy, followed by quality, value and finally momentum.

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However, when considering risk relative to a traditional cap weighted index, we believe quality carries the lowest risk, followed by value, momentum, and finally low-volatility.

3) **CORRELATION OF THE RETURN PATH:** Once investors have considered the potential return, and the level of risk they are willing to take for that return, we believe the next element to consider is the correlation of the return path. This means identifying factors that complement the overall portfolio.

This three-point assessment can help investors decide which factors will serve them best and how they want to combine them to achieve their desired outcomes. From a total portfolio point of view, it often makes sense to give preference to factors that provide the highest levels of return with low levels of risk, but other priorities may need to be considered as well.

When an investor is looking at a potential allocation within their portfolio, it is important to make sure the factor they are considering is aligned with their fundamental view of the world as well as their investment objectives. With factor-based smart betas, long-term performance may be promising, but underperformance in the short-term is a real risk. Investors need a clear rationale for following a particular strategy, so they remain disciplined enough to stay the course during difficult times.

For many investors, a core equity portfolio with a fixed strategic allocation to a combination of these four factors is a way to provide well-diversified exposure to the desired factors and achieve more consistent risk-adjusted returns over time.

To learn more about how Russell is using factor exposures to improve investment outcomes please contact:

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