What is Smart Beta?

Smart Beta are factor investments whose origins go back to the academic literature of the 1930s and which have already been used in the financial industry for decades. The term smart beta describes the indexed variant of these factor investments. The aim of a Smart Beta ETFs is to outperform the broad market in the long term or to replicate it with less risk. Like all ETFs, the products track an index, giving a high level of transparency and can be traded on exchange, but with the added advantage of providing exposure to certain long-term and persistent drivers of returns - so-called factors.

Why did they appear in the market – wasn't passive ETFs profitable enough?

Smart Beta ETFs give all investors the opportunity to use factor strategies, which until now have usually only been available to large institutional investors due to high computing and data requirements. The investment in form of an ETF also brings the advantages of transparency, liquidity and low costs. It is a real revolution in the way it grants investors access to these drivers of return, it democratizes these investment insights and empowers end investors with a new set of tools to enhance their portfolios.

What's their target?

Factors are broad and persistent drivers of return which can be used by investors to seek higher risk-adjusted returns versus the broad market cap weighted indices. We distinguish two general categories of factors: Return-enhancing and risk-mitigating strategies.

How do they work?

While return-enhancing factors like Value or Size achieve the risk-adjusted outperformance by increasing the return, the risk-mitigating Minimum Volatility strategies seeks to return market performance with less risk.

When did they appear in the market?

Factor investing has been successfully used for a long time, especially in the active mutual fund industry, but with the innovations in data availability and computing power the concept of factors is now available to all investors via ETFs in a transparent, liquid and cost efficient vehicle. In Europe, the majority of the 169 now available factor ETF have been launched since the year 2012.

How big assets are invested in Smart Beta?

The assets in European domiciled factor strategies account currently for 4% of total ETF AUM while exhibiting over-proportional growth rates of 57% annually since 2012. In Q1 2019, 7% of all flows went into Smart Beta ETFs.

What are the factors that can drive the Smart Beta ETF?

Long-term returns of the overall equity markets are generally determined by macro factors such as economic growth or inflation. But within the stock market there are securities that have performed better and those that have performed worse than the market. Factors are the patterns that distinguish stocks which outperform from those which don't. Take value stocks, for example, which outperformed growth stocks in the long term. Hence, systematically tilting towards Value stocks could help investors to enhance the risk and return profile of their portfolio. Besides Value, the factors Momentum, Size, Quality, and Minimum Volatility established as time-tested concepts in the industry.

How is Smart Beta ETF managed?

Smart Beta is the term often used for indexed factor investments. The factor indices are created using a fixed methodology which is then tracked by the portfolio managers of the ETF provider the same way it is done for standard benchmarks like the MSCI World.

Is it reasonable to filter all the stock using the same factor? For instance P/E – net earnings are often not comparable between stocks.

The index construction of different strategies can vary a lot. Not all Value strategies are build the same way. BlackRock undertakes extensive research before launching new factor strategies on how to target the unbiased factor premia in an efficient way. This starts with the definition of the factor itself with the metrics which should be used to determine it. Additionally, there might be some unwanted risk factors that could affect the targeted premia. For example, as balance sheet and earnings based metrics are often not comparable across sectors, our Value and Quality strategies apply sector-neutrality.

Among largest Smart Beta ETFs we can find value stocks' funds, low volatility funds etc. How can average investor know, which to choose?

Factors are broad, persistent drivers of return which can deliver an outperformance in the long-run. Because they are driven by different economic rationales, they have tended to outperform at different times. Minimum volatility strategies for example have proven track records of delivering market returns with less risk. They've performed well in distressed equity markets, such as the market selloff from June–September 2015. Value stocks on the other hand have tended to perform well in the early stages of a business cycle—for example, during the expansionary period from April 2003– October 2007. BlackRock believes investors should hold multiple sources of return either by blending single factor strategies or investing in a multifactor strategy which gives exposure to a mix of factors in a single product.

How many Smart Beta ETFs outperform the market? What is the right horizon in which we should evaluate them?

Factor investing is a time-tested concept which has been successfully applied by active mutual funds for decades capturing static factor premia over their benchmarks. Factors are cyclical as they exist due to different economic rationales. Given this cyclicality, they should be evaluated over longer time periods – but at least one economic cycle.

In closing, factors are broad, persistent drivers of return that have the potential to transform the way investors achieve their long-term objectives in the most cost-effective and risk-conscious manner.