WHAT IS SMART BETA ANYWAY?

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There has been a lot of talk recently about smart beta —and some of you may be wondering what it is. First, let's take a quick look at what defines "beta." Beta is a measurement of the volatility of an investment compared to the market. An investment with a beta of 1 is, in theory, delivering the same volatility and performance experience as the market. Consider that the majority of indexes dominating the investment landscape tend to be market capitalization-weighted (and remember that you cannot invest directly in an index). The very first exchange-traded funds (ETFs)—and the majority of those that followed—were created as a way to get the "index" investment experience. Since these capitalization-weighted indexes are considered "the market," the ETFs that passively mirror them are considered "beta," as their goal is to track the performance of indexes that are themselves designed to measure the performance experience of "the market." So, you may be wondering, if market capitalization-weighted ETFs are beta, what is smart beta? Some define smart beta as simply any type of index that is not market capitalization-weighted. Others may define it as investments that apply unique screens or alternative weighting methodologies to existing indexes. In our opinion, the smart beta approaches attracting the greatest attention include: • **Equal-Weighted Indexes:** Components are often selected from established indexes such as the S&P 500 Index, but are equally weighted so that all components have identical weights when rebalanced. • **Fundamentally Weighted Indexes:** Components are selected to provide broad exposure to an equity market based on market capitalization, but companies are weighted by a fundamental factor such as aggregate dividends or earnings. • **Factor-based Indexes:** Components are selected based on one or more fundamental factors and are weighted based on one or more fundamental factors. Factor-based Indexes can also be modified equal weighted, where stocks are first divided into tiers based on certain factors, and then equal weighted within the tiers. • **Low Volatility Indexes:** Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility. Managers who use these methods to create portfolios are, in effect, combining elements of active and passive investing by actively creating portfolios, which may then be passively or more actively managed on a day-to-day basis. So, from our perspective, the difference between "beta" and "smart beta" may be the idea that smart beta seeks to provide an exposure with the potential to outperform the market, isolate or accentuate a certain characteristic of the market, or generate better risk-adjusted returns than the market, rather than merely measure the performance of all investable stocks in an equity market. To learn more about smart beta, read our full paper here. In future installments, we'll discuss what to look for in smart beta investments—and much more.

For more investing insights, check out our Economic & Market Outlook

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Aggregate dividends : Weighting constituents according to the proportion of cash dividends that they generate compared to the sum total of cash dividends for all constituents within the index.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.