DEBUNKING MYTHS ABOUT SMART BETA AND ETFS

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This is part one of a four-part blog series addressing the attacks on smart beta and ETFs. Today we address the supposed academic consensus that the only recourse for investors frustrated with active management is to turn to market capitalization-weighted index funds.

"That's the Way It's 'Always' Been Done"

In Market Capitalization-Weighted Indexes: An Accident of History, we laid out our case that much of the impetus for trillions of dollars to continue tracking market capitalization-weighted indexes appears to be little more than "that's the way it's 'always' been done."

In this blog series, we'll address the most common lines of attack against smart beta and ETFs.

For clarity, our discussion of smart beta will refer to this excerpt from the Financial Times:

> *Smart beta strategies attempt to deliver a better risk and return trade-off than conventional market cap weighted indices by using alternative weighting schemes based on measures such as volatility or dividends.*[1]

The truth is that the "active management versus passive market cap-weighted indexing" argument is a classic false dilemma. It presupposes that investors are confronted with a binary decision between just these two choices, conveniently leaving out a third road: indexing in a smart beta format.

As our Chief Strategist, Luciano Siracusano, is keen to point out, our industry is better served by discontinuing this "active versus passive" question and transforming it to one of "passive versus passive." The solution to active management's problem—the fallibility of human behavior and higher fees associated with paying for a full analyst and star portfolio management team—is to utilize rules-based alternative indexing, which WisdomTree helped pioneer.

Before and After

Furthermore, as we pointed out in "An Accident of History," it appears that market capitalization weighting as a methodology came about solely as a means of measuring the average returns of the average investor, not because it was based on the academic rigor of the efficient market hypothesis (EMH). In fact, early academic work that formed the basis for EMH, such as that conducted by Eugene Fama in 1970[2] and Burton Malkiel in 1973,[3] appears in the timeline almost a full generation after Standard & Poor's developed the modern-day version of the S&P 500.

Yes, you read that correctly: EMH came after the S&P 500's modern-day index construction came into being, not the other way around.

Further, as far as the so-called academic consensus that cap-weighted indexing is the optimal strategy, none other than Malkiel himself crossed over to embrace the smart beta trend in 2017.[4]

As for Eugene Fama, he later became known for his work with Ken French, conducting the now-classic studies that identified the presence of value and small-cap factors as being accretive to long-term returns.[5] In support of this research, Wharton Professor Jeremy Siegel, Senior Strategy Advisor to WisdomTree, also concluded that the quintile of stocks with the highest earnings-to-price ratio (the cheapest ones) outperformed the S&P 500 by 249 basis points (bps) per year from 1957 to 2016.[6]

Siegel's findings run parallel to data from French's database, which show value stocks provided 230 bps of outperformance over the broad market during the course of more than a half century.[7]

Given data like this, we're glad to be in the smart beta business.

[1]Chris Flood, Financial Times. Excerpt is a subset of a 12-paragraph definition of smart beta in the Financial Times Lexicon.

[2]Source: Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," 1970.

[3]Source: Burton Malkiel, "A Random Walk Down Wall Street," 1973.

[4]Source: James B. Stewart, "An Index-Fund Evangelist Is Straying From His Gospel," The New York Times, 6/22/17.

[5]The Fama & French three-factor model posits that stock returns are a function of beta, which is the measure of the relationship between a stock's movement and that of the market, along with the size and value factors, which are a function of the market capitalization of stocks and their valuations.

[6]Source: Jeremy Siegel, "The Future for Investors" (2005), with updates to 2016. Data from 12/31/1957 to 12/31/2016, using the S&P 500 universe as of 12/31/16.

[7]Defining value stocks as those in the highest 30% by the book-to-market ratio, with higher values indicating a lower market price relative to this fundamental factor, within the large-cap universe. Broad market refers to a market capitalization-weighted measure of the returns of all firms captured by the Center for Research in Security Prices and listed on the New York Stock Exchange, American Stock Exchange or NASDAQ. Data from the Kenneth R. French data library.

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DEFINITIONS

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

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.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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

Dividend : A portion of corporate profits paid out to shareholders.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they 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.

Basis point : 1/100th of 1 percent.