What's in a name?

Capital Fund Management explores the differences between smart beta and alternative beta

Are smart beta and alternative beta the same thing? Some people use the terms interchangeably.

No, they are not the same – despite some people mixing them up. Often, the mistake stems from a lack of understanding of what 'traditional' equity beta actually is, and from there, the differences between the strategies that diverge from it.

'Traditional' beta is the return investors receive for holding the stocks in the simplest form of an index – the market capitalisation weighting. When the market goes up, they generally make a positive return, when it goes down, a negative one.

It is crucial for investors to understand the difference between choosing an alternative beta or a smart beta strategy as each will react very differently to market movements.

They should also be aware of the many differences between the two strategies including the portfolio volatility and processes involved.

What are the key differences between the two strategies?

The main thing to realise it that smart beta strategies include the equity beta of the market but are designed to give a better risk-adjusted return. The Sharpe Ratio – or the measurement of the return you get for the amount of risk you take – is usually higher for smart beta equity strategies than for traditional long-only equity portfolios.

This is because smart beta strategies give investors exposure to equities that have proved over time to have higher Sharpe Ratios than the market as a whole, due their factor make up.

Factors are present in all securities and the precise mix of them are responsible for how a security acts in certain market conditions.

Research has found that up to 86 per cent of the risk taken by smart beta strategies is that an investor would have taken by holding a market-cap-weighted portfolio.*

Alternative beta on the other hand, aims to produce a higher return than 'traditional' beta by creating a diversified market-neutral portfolio. These strategies are designed to have almost no correlation with equity markets, and instead track certain factors.

By doing this, the volatility profile of an alternative beta strategy should be quite different to the general market or a smart beta portfolio.

How do the strategies differ in practice?

Smart beta strategies provide exposure to equities by weighting an index to something other than market cap. They buy stocks and generally avoid derivatives and other financial instruments that have embedded leverage.

They rebalance frequently, but not strictly in line with market movements, meaning exposure to factors can lag.

Alternative beta strategies are constructed as long/short portfolios to ensure minimal beta exposure. They buy stocks and derivatives, and typically use leverage to meet risk and return targets.

Alternative beta strategies usually have a higher turnover of holdings as they typically target a constant risk, reassessing both this position and factor signals daily, based on the market environment.

Where should an alternative beta strategy sit in an investor's portfolio?

Unlike smart beta equity strategies, which mainly take a long-only approach and can sit in a standard growth stock portfolio, alternative beta funds are different.

As they are largely uncorrelated to equities, alternative beta strategies need to sit alongside absolute return strategies or in the diversifying section of an investor's portfolio.

Are the fees between the two strategies comparable?

Smart beta strategies can initially appear a cheaper option than taking an alternative beta approach, but taking the costs at face value largely ignores the differences between the two that we have discussed.

Most of the returns from smart beta strategies come from the performance of the equity markets themselves. The active part of the portfolio is relatively small – up to just 14 per cent of the risk, in some cases.

Today, investors can access market returns either exceptionally cheaply or, in the case of the larger indexes, at no cost at all.

In contrast, nearly all the of the risk for typical alternative beta strategies should be derived from non-market factors. Once investors take this into account, the price comparison is much fairer.

Capital Fund Management

CFM is a global quantitative and systematic asset management firm applying a scientific approach to financial markets to develop alpha and alternative beta strategies.

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*Source: 3 Things to know about Smart-Beta funds' Wall Street Journal, October 4 2015

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