

Plain Talk about Smart Beta

What, precisely, is “smart beta”?¹ The term is often used to describe a variety of rules-based investment strategies which seek to outperform a traditional market index² or reduce risk versus that index. If this explanation sounds technical, that’s because it is—and therein lies the challenge. In our view, investors need more than “technical” explanations when considering new investment ideas. As smart beta strategies are increasingly incorporated into investment portfolios,³ how can investors better understand them, and how can financial advisors better explain them to their clients?

In search of answers to these and related questions, Goldman Sachs Asset Management conducted a series of focus groups in August 2015 of several dozen individual investors’ opinions on Exchange-Traded Funds (ETFs), smart beta, and related topics, including views on which descriptors might clarify smart beta’s potential role in a portfolio.⁴ The feedback we received suggested three conclusions:

- Many investors are unfamiliar with smart beta investment strategies and therefore may be starting with a blank slate when attempting to understand the concept.
- The natural inclination may be to view smart beta as a potential answer to the limitations of market-weight indexing. But we found that this approach may obscure smart-beta strategies’ potential value, rather than clarify it.
- We believe a proper understanding of smart-beta may involve two elements: (A) an understanding of the similarities between smart beta and traditional market-weight indexing,⁵ with an acknowledgement of the differences; and (B) an understanding of their potential to outperform the market, as well as the risks and rewards inherent in that potential. The key, in our view, is to understand that smart beta can be an incremental evolution over traditional approaches, not a departure from them.

¹ Smart beta refers to quantitative index-based strategies. Neither smart beta nor investments based on traditional market-weight indexing are riskless investments, so investors can lose money.

² The terms “traditional market index,” “market-weight index investing,” “index-tracking strategies,” “traditional exchange-traded funds,” and “market-weight investment approaches” refer to market-cap weighted strategies designed to track a given market or index.

³ Source: Morningstar, as measured by the roughly 25% of total 2014U.S. exchange-traded fund flows into Morningstar’s Strategic Beta category.

⁴ In conjunction with a market research partner, GSAM conducted a three-week series of focus groups involving roughly 75 subjects in New York, Chicago and San Francisco. The goal was to examine the views of affluent investors on subjects pertaining to exchange-traded funds, smart beta and related topics. See important disclosures at the end of this commentary.

⁵ Defined as an index which apportions investment allocation according to stocks’ size, or “market capitalization.”

All investing involves risks, so investors can lose money. Please see end disclosures for risk considerations and a glossary of financial terms.

Smart Beta as a Blank Slate

A useful starting point in assessing smart beta in today's marketplace is to ask: How do potential investors view smart beta? Here is our perhaps surprising answer: They don't.

In our focus groups, only a handful of participants reported having heard of smart beta investment strategies. Even those familiar could not accurately explain them. We found this to be notable in light of the broad demographics we selected. Although all participants reported owning Exchange-Traded Funds (ETFs), even the most affluent of investors were unfamiliar with smart beta. Hence, in our view, other individual-investor categories may be even less familiar.

For this reason, investment professionals and individuals alike may be facing a "blank slate" when it comes to being informed about the potential roles smart beta investment strategies can play in a portfolio. So how should financial advisors and their clients start to consider this unfamiliar concept?

Understanding Smart Beta: A Common Misnomer

One often-used but, we believe, flawed approach in describing smart beta is as a "blend" between two dominant investment philosophies, active investment management and passive indexing. We see a few drawbacks in this approach.

First, it is not fully accurate: Smart beta consists of index-tracking investment strategies which are, technically speaking, passively managed (even as they may pursue many of the same goals as active managers).

Closely related to the first drawback, our focus groups suggest that many investors may have a different interpretation of the terms active and passive management—in which case, discussing smart beta in those terms may be less than effective.

For instance, asked to define active investing, one participant responded, "It's trading frequently and timing the market." But another defined passive investing as "Letting someone else do the work."

In other words, "active" means the investor carries out the investment decisions and "passive" means someone else (such as a financial advisor) manages the account. These are different uses of the terms than are common among investment professionals and industry insiders, for whom the term "active" generally refers to the portfolio management functions of security selection and passive means index-based investing.

For these reasons, in our view, describing smart beta as a "blend" of active and passive investing can be confusing, and thus ineffective, in explaining its potential benefits, risks, and rewards.

⁶<http://corporate.morningstar.com/US/documents/Indexes/Strategic-Beta-FAQ.pdf>.

⁷ Stocks which exhibit a tendency toward relatively smaller swings in price over a given period of time, as compared to an index or other benchmark.

Defining Smart Beta by What it is Not

Many smart-beta strategies begin with the premise that market-weight investment approaches may fail to capture many attractive investment opportunities. Surveying the commentary and marketing literature of asset managers, indexers, and other voices in the financial industry⁶ reveals another common method of explaining smart beta is to describe what smart beta is not. Namely, market-weight index investing.

These approaches argue that smart beta can be an alternative to traditional market-weight index investing, for the reason that smart beta strategies apportion the portfolio according to a given investment goal, such as low-volatility stocks⁷ or some other attribute deemed to be desirable. Market-weight index investing, in this approach, is sometimes presented as flawed due to the potential exposure to overpriced stocks or otherwise less than ideally desirable investments.

We call this the “market weight critique.” The impulse to define smart beta by comparing it to something else is, in our view, understandable in light of these strategies’ origins, and it is an impulse we shared heading into our focus groups. But we came to believe on the basis of participants’ views that defining smart beta by what is flawed in traditional ETFs may be the wrong approach for a few reasons.

- Most participants in our focus groups report having enjoyed positive investment experiences with traditional market-weight investing through ETFs. Asking them how they would improve traditional ETFs generally elicited silence.
- Although focus group participants reported that they like traditional ETFs, many did not know exactly how they work. Many did not realize that their investments are market-weighted. Nor did most know what, exactly, “market-weight index” means.
- Finally, many investors lack familiarity with some of the financial terms commonly used to describe smart beta strategies, such as “factor” investing (meaning the pursuit of specific equity characteristics), “beta” (a measure of the sensitivity of a security in comparison to moves in the market as a whole), and “alpha” (the excess return of an investment manager related to a benchmark return).

We believe approaches which seek to critique traditional market-weight index ETFs make it more difficult to understand these strategies for what they can offer a portfolio.

The Smart Beta ‘Evolution’

If comparisons to popular investment styles, immersion in detail, or explanation of what’s wrong with market-weight ETFs may not work, what does?

We believe that key to understanding smart beta is (1) understanding the similarities with traditional market-weight indexing, while acknowledging the material differences and (2) understanding the risks and potential rewards of smart beta’s effort to outperform traditional indexes.

To be sure, there are a number of differences between smart beta strategies and traditional indexing. Smart beta may, in some instances, provide investors with more exposure to mid- or small-capitalization stocks than traditional market-weight indexing, making it less reliant on large “size” (meaning the performance of large stocks) as a driver of investment returns. Size is one example of the way that smart beta strategies may apportion portfolio weightings to sectors or other types of exposures (such as countries in global portfolios) in a different manner than traditional market-weight indexing.

Smart beta strategies’ use of these and other approaches also potentially may cause returns to diverge meaningfully from traditional market-weight indexing. For this reason, we believe investors should be careful judges of the “concentration risk” which some smart beta strategies may introduce into a portfolio (meaning a reduction in diversification benefits), and they should be sure to understand differences of investment objective, liquidity, costs, and other key metrics of smart beta strategies versus traditional market weight indexing.

But there are also similarities between smart beta and traditional market-weight indexing—and too often, in our view, the differences are emphasized at the expense of the similarities. Let’s look at the similarities. Both traditional market-weight indexing and smart beta use defined methodologies for security selection (that is, index-based methodologies), which distinguishes them from actively managed strategies. Both smart beta and traditional market-weight indexing may offer low total costs,⁸ especially as seen in expense ratios.

Both smart beta and traditional indexing may also offer features such as portfolio transparency—meaning daily access by investors to detailed information about portfolio holdings. Both also potentially may be designed to seek tax efficiency.

Given these similarities, we believe investors should not think about smart beta as something radically different, changed, or improved when compared to traditional market-weight index investing. Rather, we think smart-beta strategies could be described as an effort to seek outperformance of a market index at low total cost (as measured by factors such as expense ratios) and with the features which have made ETFs popular, such as transparency into portfolio holdings or relative tax efficiency.

⁸Ordinary brokerage commissions apply. Brokerage commissions will reduce returns.

Glossary of Terms

Alpha: A measure of the volatility of a security in comparison to the market as a whole.

Beta: A measure of the volatility of a security in comparison to the market as a whole, as measured by an index or other benchmark.

Factor Investing: Investment strategies which pursue specific equity characteristics.

Index-Tracking Strategies: See definition of "market-weight indexing."

Low Volatility Stocks: Stocks which exhibit a tendency toward relatively smaller swings in price over a given period of time, as compared to an index or other benchmark.

Market-Weight Indexing: Market-cap weighted strategies designed to track a given market or index.

Tax Efficiency: Refers to low portfolio turnover which can help manage the impact of capital gains taxes.

Traditional Exchange-Traded Fund (ETF): Market-cap weighted exchange-traded funds designed to track a given market or index.

Traditional Market Index, Market-Weight Index Investing, or Market-Weight Investment Approaches: See definition of "market-weight indexing."

Transparency: Refers to the extent to which investors have ready access to any required financial information about a company such as price levels, market depth and audited financial reports.

Volatility: Refers to the tendency of a security to swing in price over a given period of time.

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