Smart Beta: Caveat Emptor

Smart Beta is not Beta, which measures the volatility of a stock or portfolio to an index, nor far too often Smart. It is unfortunately a horrible moniker for Factor Investing that we appear to be stuck with. The unedited version: http://mebfaber.com/2017/04/27/paying-filet-getting-bologna/

Paying For A Filet, And Getting Bologna

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Most of you (one of us) reading this are old enough to remember the Beech-Nut fake apple juice scandal in the 1980s. (I'm not, but Jeff wrote the intro and he's a couple years older than me…)

In short, Beech-Nut was marketing "100% apple juice" yet its product didn't quite make good on this claim. Not only did the drink not consist of 100% apple juice, it actually contained 0% apple juice. Instead, it was loaded with beet sugar, corn sugar, and a few other non-apple ingredients.

Until the curtain was pulled back, customers bought countless bottles of healthy "apple juice," not realizing they were guzzling down something decidedly different.

There's a similar dynamic (though not as egregious) happening today in the investing world. Certain funds are marketing 100% apple juice, so to speak, yet selling a product that's definitely not 100% apple juice.

I'm talking about the problem of "closet indexing." To help explain this, let me quickly back up…

In recent years, one of the hottest investing trends has been "smart beta" or factor investing. To make sure we're all on the same page, this style of investing attempts to identify and invest in specific attributes that historically have been associated with higher returns.

So rather than an investor buying a broadly-diversified fund or a market-cap weighted fund, he might look to concentrate his investment with a smart beta approach, targeting, for instance, only "value (cheap stocks)", or size (all small caps)," or "low volatility." These smart beta funds have become incredibly popular with investors. (We highly recommend diversifying among Factors supported by solid academic evidence.)

But what if these investors weren't buying what they believed they were? What if it wasn't really 100% apple juice?

Enter "closet indexing," the beet sugar of the investing world.

Paying for One Thing, Buying Another

With closet indexing, a fund that purports to be "different" in some way (pick your favorite smart beta style) is actually all but tracking a market cap weighted index. This means investors aren't getting the concentrated exposure they're being sold.

That's bad, but it gets worse…

When you have an actively managed fund claiming to add value through the selection process of a talented fund manager, or strict rules-based criteria, do you think the powers that be will want to charge more or less for this fund?

Obviously more. After all, these funds are being marketed as being "different" than the standard white vanilla indexes. This difference should come at a premium price, right?

But with closet indexing, the unfortunate reality is many investors are buying something that resembles a vanilla index far more closely than their desired factor – yet they're paying higher fees based on this alleged factor-value-add. Paying for filet, but getting bologna. In some cases, the fund companies don't even hide in the closet, it's even worse than that. They tell you they're tracking the same index and charge you way more…

As an example found in this Forbes article , if you wanted to track the S&P 500, you could buy SPY, which costs 0.09%…or VOO at 0.05%…or you could buy the Rydex S&P 500 fund, RYSOX, at 1.57% – that's 17 times as much as SPY. You can read the article to get the Rydex spokesperson's justification for the fee, but to me, it's back to filet versus bologna. (Here's another piece on the topic.) The C-share class (RYSYX) is even worse at 2.31%, and it has a load too (as we have repeatedly warned, you should never pay a load)! For the S&P 500! Over the last 10 years you'd expect this fund to underperform the S&P 500 by about 20%…and guess what? That's what it has done…

I did a very quick search for some other offenders, and wow this list is bad. These 10 funds all track the S&P 500 Index, which as a reminder you can get for 0.05%, and on average charge 1.31%. Even more embarrassing, these are not no-name fund companies, but rather the who's who of the investment space.

To be fair to these fund companies, if there is such a thing, these are the C share classes that get sold to investors. The "institutional" share classes are a more reasonable 0.55%, but realize that is still 10x the cost of SPY.

Name	SYMBOL	Fee
Rydex S&P 500	RYSYX	2.31%
State Farm S&P 500 Index	SNPBX	1.38%
Invesco S&P 500 Index	SPICX	1.32%
Deutsche S&P 500 Index	SXPCX	1.31%
Principal Large Cap S&P 500 Index	PLICX	1.30%
Nationwide S&P 500 Index	GRMCX	1.24%
BlackRock S&P 500 Index Investor	BSPZX	1.08%
Victory S&P 500 Index	MUXRX	1.02%
MainStay S&P 500 Index	MYSPX	0.70%

Stepping back, the summary is really quite simple:

If you want market beta, then buy a low-cost fund (mutual fund or ETF). But if you want to try for alpha, then buy a fund that is truly DIFFERENT. And by different, the more different from the index the better.

(By the way, the investment jargon for this is "active share." It's the measure of the percentage of a fund that differs from its benchmark index.)

I can hear the naysayers already… "Thanks, Meb, but we already know this. The challenge is how to identify which funds are apple juice and which ones are beet sugar."

Fair enough. Let me point you toward some tools to help.

First, here's a resource from The Wall Street Journal that compares many popular funds to their most similar benchmark, then identifies the percentage of the portfolio that differs from the benchmark.

Second, here's a link to Active Share, which enables you to type in a fund ticker then immediately determine its active share.

Third, here's another great tool – Visual Active Share – from our friend, Wes Gray at Alpha Architect. And don't miss Wes's article on the topic, here, and video here.

(If you can't get enough of the research on the topic, here are some additional great articles for you: Alpha Architect, Jason Zweig, Jake at Econompic, Patrick O'Shaugnessy, and a broad summary) ...

Like I've said a million times, all that matters is total return after all fees and taxes. If you're buying beta (a commoditized index like the S&P 500) you should pay as little as possible. You can justify paying more for potential alpha, but you better make sure they are not just a closet indexer and at least give you the chance to outperform. ...

Know what you're buying, know how much you're paying, and don't pay for a filet, and get bologna.

Our Thoughts

Within academia all Factors are judged on the historical returns to long/short portfolios. In 1992 Eugene Fama and Kenneth French published their three-factor (Market Beta, Size and Value) model, which explained over 90% of the difference in returns between diversified portfolios. The Value Factor was defined as the return on the 30% of stocks with the highest book-to-market minus that on the lowest 30%. As detailed on our website, subsequent research has shown that there are superior valuation metrics than book value and that portfolio construction matters, with top decile concentration and semi-annual rebalancing enhancing returns. However, as we have previously shared, Funds that are marketed as Value are often far removed from the academic studies that are referenced in their support.

This week marked the 10-year anniversary of the Great Recession's Bear Market, which ran from 10/10/07 to 3/9/09. As shown by the Total Returns (%) from Tuesday's Bespoke chart, the Size Factor has clearly prevailed over the last 5 and 10-years, with both the Russell 2000 (93.32% and 103.56% respectively) and the S&P 500 Equalweight (96.82% & 116.52%) ETFs outperforming the S&P 500 (93.03% & 97.92%). However, as we have previously shared, the superior index to capture the Size Premium with is

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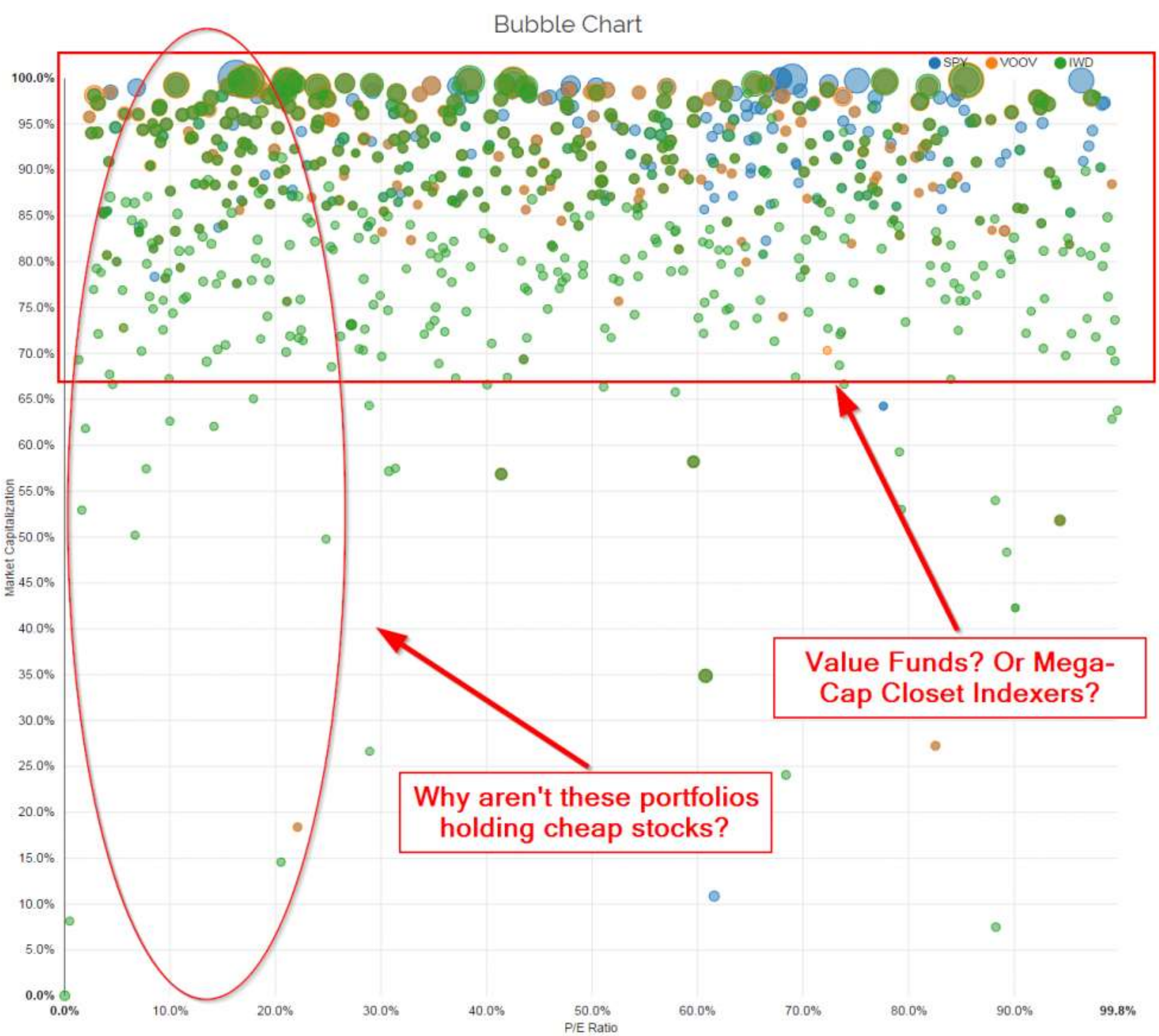
ETF	**Description**	**Last 5 Yrs**	**Bear Mkt Low**	**Last 10 Yrs**
SPY	S&P 500	93.03	341.80	97.92
DIA	Dow 30	86.77	322.19	103.15
QQQ	Nasdaq 100	129.79	517.57	199.17
IJH	S&P Midcap 400	96.37	400.68	126.14
IJR	S&P Smallcap 600	108.81	451.28	131.39
IWB	Russell 1000	93.32	347.35	99.62
IWM	Russell 2000	93.32	389.04	103.56
IWV	Russell 3000	92.73	348.23	98.99
IVW	S&P 500 Growth	99.92	352.90	130.31
IJK	Midcap 400 Growth	92.78	397.59	134.68
IJT	Smallcap 600 Growth	111.15	466.25	140.11
IVE	S&P 500 Value	82.88	326.39	64.89
IJJ	Midcap 400 Value	96.14	390.58	112.28
IJS	Smallcap 600 Value	103.84	428.31	118.64
DVY	DJ Dividend	89.43	385.02	88.94
RSP	S&P 500 Equalweight	96.82	430.26	116.52

the S&P Smallcap 600 (108.81% & 131.39%), as it also screens for the Quality Factor.

Unlike Size, Value ETFs have underperformed. Part of the reason is provided in a critique of the academic paper "Facts about Formulaic Value Investing". Updated on April 24th, Alpha Architect's Wesley R. Gray, PhD gives an example of 2 such ETFs using their Visual Active Share tool referenced in Meb's post above:

"The authors cite the Vanguard Value Index Fund (VOOV) and the iShares Russell 1000 Value ETF (IWD, at $37.6 billion the largest Value ETF) as examples of so-called simple "value funds" with enormous asset bases. Let's first examine the claim that these are value funds. If a simple value fund is the type outlined by Graham — concentrated and focused on the "cheapness" characteristic — there are actually very few value funds in the marketplace. Below is a graphic from our new visual active share tool, which allows an investor to visualize the holdings of these two "value" funds across two stock characteristics – cheapness and size. The X-axis maps all holdings on the simple price-to-earnings metric. The y-axis is market capitalization. (Note: price-to-book shows a similar pattern)



Source: Visual Active Share

A Graham-style investment portfolio would have ~30 dots clumped towards the left section of the chart, and probably sit across the market cap spectrum (likely more small/mid relative to mega-cap).

VOOV (orange) and IWD (green, while SPY, the S&P 500, stocks are blue) do not appear to be value investing funds at all. There is little relationship between their holdings and "cheapness." The holdings seem to be spread out across the cheapness spectrum, with no clear characteristic tilt that would even capture the value premium. The only relationship that is painfully obvious is that these portfolios are strongly correlated with the "size" characteristic.

To claim that simple value investing based on fundamental/price ratios are "ubiquitous" doesn't seem to be supported by an analysis of the construction of the specific portfolios the authors cite as examples, such as VOOV, IWD .... These so-called "value" funds are not value funds at all. If they were, we would see more evidence of that. Instead, these funds are mega-cap closet-indexing funds with holding characteristics that show no relationship to the value anomaly that Ben Graham would recognize as "systematic value investing." In the author's defense, these sort of funds do represent what many in today's marketplace consider to be "value" funds, so it is reasonable to use them in their discussion. Our point is more of a rant on the state of what is appropriately defined as a "value" investing fund. Having the word "value" in your fund title doesn't make you a value fund, at least based on how Ben Graham and generations of academics have defined value…"

From an April 29, 2017 WSJ article, titled **'Godfather of Smart Beta': "**Smart-beta funds, which try to beat standard index funds' returns by allocating money based on factors ... attracted record inflows of $55 billion last year. According to BlackRock Inc., which operates several of the biggest smart-beta exchange-traded funds, they are headed toward $1 trillion under management globally by 2020." So how does an investor make sure they are actually getting what they are paying for? It helps to have a solid foundation in the pertinent academic studies, keep on top of the relevant new studies that are released weekly and be able to dig deeply enough into the process underlying each Factor based "Smart Beta" Fund to know if "Filet" is being offered.