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SMART BETA:

A USEFUL MISNOMER

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While widely used by investment professionals across the industry, the term *smart beta* is one of the more difficult concepts to understand in the asset management profession. There are many explanations, but the most likely source of confusion stems from the name itself. Assuming beta is a proxy for risk or level of market exposure, the name facially implies that the strategies included under this investment header are "smart risk" or "smart market exposure" strategies. Considering different strategies and asset classes experience market cycles, it is imprecise to label one passive strategy of investing as more intelligent than others. While misleading, smart beta vehicles still provide value to investors if used properly as part of a diverse allocation.

What is Smart Beta? A Quick Explanation

Essentially, smart beta is an index based strategy that uses an alternative weighting scheme to the traditional cap weighted indices. Widely reported indices, such as the S&P 500 and Russell 1000, are often traditional market capitalization weighted indices. By contrast, smart beta indices are weighted by an alternative scheme such as style (growth or value), a factor (momentum, low volatility, quality, etc.) or some other metric. An alternative explanation is that these are "strategy" indices which offer investors the transparency and lower fees of a passive experience coupled with common elements (i.e. factors and styles) that theoretically drive active managers' alpha. Given the nature of the product, Morningstar more appropriately categorizes these products as "strategic beta" as opposed to smart beta.[1] At the inception of these indices, this was an alternative name given to smart beta that more accurately describes the investment.

Utilizing Smart Beta & Criticisms

As noted above, smart beta strategies offer a transparent investment vehicle with exposure to factors that can translate to outperformance for top-performing active managers. However, these investments by themselves present some issues which investors should note. First, smart beta strategies often come with higher risk and higher fees than cap weighted indices.[2] Furthermore, factor strategies typically go through long cycles that can lead to underperformance.[3] These criticisms are not unique to smart beta, and a simple disciplined investment philosophy can help mitigate many of the risks and criticisms. When utilizing smart beta vehicles, the formula is simple: invest for the long-term to mitigate cycles, use smart beta strategies in a core/satellite approach in order to enhance returns, beware of correlation among factors and always pay attention to fees.

[1] *A Global Guide to Strategic-Beta Exchange-Traded Products. September 2014. Morningstar. https://corporate.morningstar.com/US/documents/Indexes/Strategic-Beta-Landscape.pdf.*

[2] *Ferri, Rick. The Dark Side of Smart Beta. Forbes. January 2014. https://www.forbes.com/sites/rickferri/2014/01/30/thedarksideofsmart-beta/print/*

[3] *Kaissar, Nir & Rani Molla. Is Smart Beta Investing Really Smarter? Bloomberg Gadfly. February 2017. https://www.bloomberg.com/gadfly/articles/20160526/issmartbetainvestingreallysmarter*

Multi-Factor Smart Beta – Proceed with Caution

Popular subcomponents of smart beta strategies are multi-factor vehicles. For example, a hypothetical strategy might blend momentum, growth and mid-cap companies. There are a couple of risks to these strategies to note. First, the allocation between factors is set by the strategy. A way around this is creating a custom separately managed account with a blended benchmark. Also, some factors have a high degree of correlation between one another. While a strategy may appear to have multiple factor exposures, sometimes the return can more simply be expressed by one driving factor or style (value/growth). Another aspect is these strategies typically have higher fees because they use proprietary research and allocations. Finally, as with other smart beta strategies, the multi-factor strategies are not customizable. This makes it difficult for investors to achieve socially responsible or ESG goals or mandates.

Alternatives to Traditional Smart Beta Vehicles

For institutional investors, a custom separate account offers an alternative to traditional smart beta mutual funds or ETfs. It allows the advisor, consultant and/or client to customize an allocation between cap-weighted strategies and factor based indices within the same account. This results in fewer overall positions and costs by reweighting securities that cross over between the multiple mandates. Furthermore, this approach is customizable. It allows for screening that helps a client meet socially responsible and ESG mandates. As values based investing grows in popularity, customized screening will become an important feature to any smart beta investment and present the greatest challenge to the current popular investment vehicles, which do not offer customization. While ETFs took the lion's share of smart beta mandates over the past decade, it seems plausible that separately managed custom accounts will gain ground over the next decade because they offer an investor more allocation flexibility while meeting an investors values.

About Crossmark's 30 Year History

Crossmark, previously Capstone Asset Management Company, is an independent investment advisor headquartered in Houston, Texas. Founded in 1987, Crossmark is in its 30th year of providing portfolio solutions for financial advisors and institutional investors with values-based, SRI and ESG values and factor-based strategies. Additionally, Crossmark is the exclusive manager of the Crossmark Steward Funds, which is a fund family that applies an overarching values-based screening methodology to its suite of equity and fixed income funds, including its award-winning Global Equity Income Fund- named Lipper's "Best Global Equity Income Fund" for the last three consecutive years. Crossmark manages approximately $5 billion in assets with clients nationwide.

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