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Investment strategy can increase your returns

Smart Beta is the new buzz word in investing, but what is Smart Beta and how can you use it to maximise your returns?

Shaun Levitan, executive director at Colourfield, says Smart Beta is a rules-based strategy that deviates from the traditional indices that you would usually invest in via an exchange-traded fund (ETF). Typically, most investment strategies aim to track or outperform a market index, which is constructed based on the market cap or size of the stocks within that index.

"For example, Naspers would have a bigger weighting since it has a large comparative market cap. The problem with this approach is that you find that a small percentage of the top 40 stocks on the JSE account for a larger weighting in the Top 40 Index based on their market cap alone. A Smart Beta investment strategy aims to break the link between the stock's market cap and its weighting in your investment portfolio," Levitan says.

"There are a number of sources of equity returns or characteristics that drive performance. Smart Beta is concerned with identifying and selecting those characteristics that best compensate an investor for taking on risk."

He says the motivation for deviating from an established index (such as the All Share Index or the Shareholder Weighted Index) is to improve the chances of outperforming the benchmark by having greater exposure to those securities with higher expected returns, a strategy that requires strong empirical research and a good rationale.

It is important to understand the difference between Smart Beta, which is an investment strategy, and an ETF, which is an investment vehicle. A good analogy would be that the ETF or unit trust fund would be the car you use to get to your destination, and Smart Beta is the route or the map that you use to get there.

Different characteristics contribute to outperformance, and Levitan notes that academic research has provided insight into why and how particular stocks outperform over time, taking into account factors such as the size and value, the momentum of the stock and the profitability.

"There are many criteria one can choose from, but common characteristics should include a stock that has shown persistent performance across time periods, is pervasive across markets and is robust to alternative specifications."

Levitan notes that there are a number of pitfalls when choosing the right Smart Beta solution.

"Not all Smart Beta strategies are created equally. For example, we believe that Smart Beta strategies that do not consider a security's price are flawed. Valuation models and intuition suggest that expected returns depend on the profits. As a result, investors cannot ignore the share price - it may seem fundamental, but the price of a share is hugely important.

"You could use a number of different factors to inform your strategy, for example, giving a higher allocation to smaller market capitalisation or relatively high-value stocks. Smart Beta is a middle ground between active and passive investing. The fund manager's portfolio construction aims to outperform the benchmark, but without requiring the capitalisation of short-term trading that is normally typical of active management," he says.

Levitan says the fees for a product that uses a Smart Beta strategy should theoretically be between the fees you would pay for active and passive investing.

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