

Decoding Smart Beta



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There is a lot of debate about the term “smart beta” these days. Sometimes known as intelligent beta, alternative beta, or strategy beta, Morningstar uses “strategic beta” to describe indexes that implement rules-based strategies, often by means of non-market-cap weighting schemes. In the beginning, indexes were a way to represent broad markets by capitalization. Now the industry continues to evolve and offer specialized “smart beta” indexes.

Two Ends of the Spectrum Meet

Smart beta is blurring the line between active management, which relies on a human element to manage a portfolio and strives to deliver returns that beat the market, and passive management, which captures the performance of a market index, or beta. Smart beta often refers to rules-based strategies that attempt to beat the market, typically by tilting toward one or more factors that capture anomalies or market inefficiencies. Simply put, these strategies attempt to unite the best qualities of active and passive management to meet specific investment objectives.

Smart beta indexes take a passive approach, but are designed around a specific investment thesis and display characteristics of active strategies. Some of these strategies try to explicitly enhance returns, while others target a desired outcome like minimum volatility or dividend income. Smart beta indexes can draw from a range of approaches, some of which borrow more heavily from passive investing and some of which are more active in nature.

Built to Last

As alluring as it may sound to combine the best of passive and active management, there will always be some “not-so-smart” ideas packaged under the label “smart beta.” It’s not always easy to evaluate the quality of these strategies, but we believe

a strategy should begin with a strong, evidence-based story that justifies the proposed effect. While statistical and economic significance is necessary to develop strategy rules, they alone are not adequate to predict the future. We believe that the strategies that are built to last must be backed by substantial evidence from independent sources. At Morningstar, we take a measured, disciplined approach to developing new index products that clearly defines the outcomes we want to achieve.

Smart Beta Opportunities

We have dedicated this publication to smart beta. We’ll take you behind the scenes to hear from a few individuals at Morningstar who play a role in transforming ideas into indexes that marry active with passive concepts. Each article is an example of the research that’s essential to our work and demonstrates the rigorous process that leads us to create distinct indexes.

There’s no doubt that smart beta is quickly reshaping passive portfolio management. Although it’s not a cure-all, it does offer possibilities to deliver better outcomes for investors when used appropriately. In our view, the firms that create and own superior intellectual capital will lead in this space. At Morningstar, we see smart beta as an opportunity to blend our passion for investing with our knowledge of indexing. We are excited about the framework and process we have put in place to build strategic beta indexes that offer innovative market views to investors. We invite you to join our conversation by contacting us at indexes@morningstar.com.

A Smarter Approach

At Morningstar, strategic beta is about cultivating a strong investment thesis and objective from the rich ideas that emerge from the Morningstar Investment Research Ecosystem. It's about testing those theories using high-quality global investment data. And it's about creating transparent, rules-based methodologies that deliver these investment strategies in indexes designed to accomplish them. We understand the science of building traditional, passive indexes, and we connect this with the art required to create strategic beta indexes.

How We Build Strategic Beta Indexes

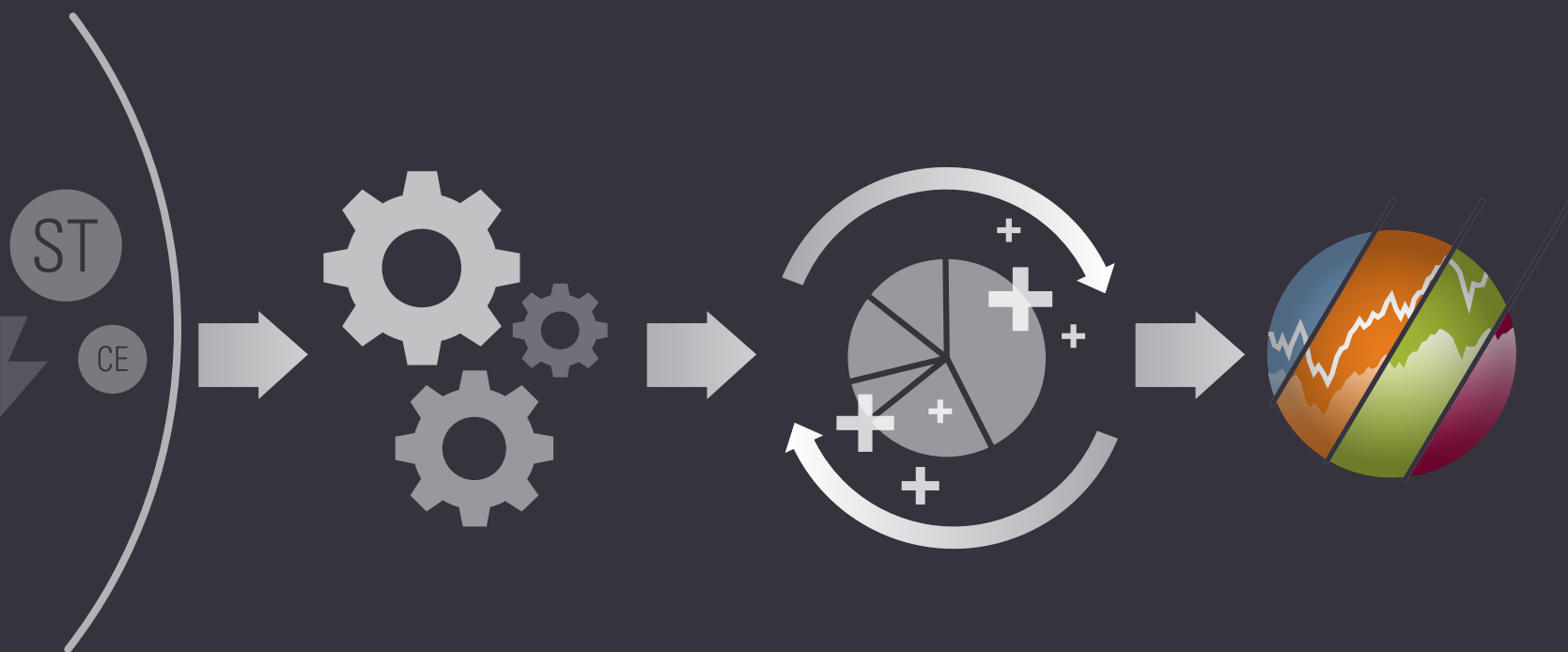


Start With a Strong Investment Thesis

We distill each thesis into an evidence-based strategy that justifies the proposed effect we wish to achieve.

Draw From the Morningstar Investment Research Ecosystem

We back each thesis with our extensive high-quality data and the body of research that emerges from the Morningstar Investment Research Ecosystem.



Design a Transparent, Rules-Based Methodology

Complex models often underperform simple ones. We look to capture each process in a rules-based, transparent manner that is easy-to-replicate, scalable, and representative of the underlying opportunity set.

Conduct Intellectually Honest Back-Tests

We conduct back-tests using extensive, high-quality data to stress-test each model in different economic cycles. During the testing process, we fine-tune the details of our investment thesis and adjust our models to distinguish “signals” from “noise.”

Strategic Beta Indexes

The success of a strategic beta index depends on how it’s executed and whether the factors it aims to capture persist in the future. Because of the rigor of our process, we are in a position to build indexes based on factors that are likely to endure.