

Smart Beta Funds

Nicola Borri

LUISS University

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Mutual funds

- A mutual fund is an investment vehicle that pools money from multiple investors to buy/manage a diversified portfolio of stocks, bonds, or other securities.
- Mutual funds are commonly classified into two categories
 1. active
 2. passive

Active funds

An active fund

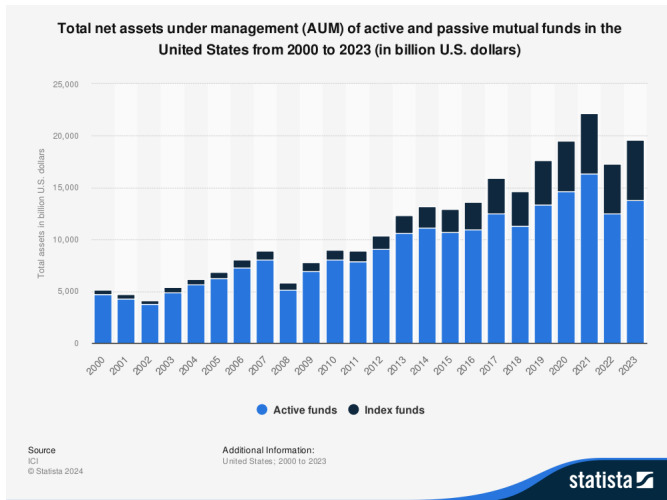
1. follows *active strategies* (e.g., stock picking) designed by the fund managers
2. indicates a benchmark to help investors understand the set of assets and/or strategies they might follow (e.g., North-America equity, short-term U.S. government bonds, etc.)
3. charges relatively high fees (both fixed and performance fees) to remunerate the *investment skills* of their managers and to cover the overall operational costs.

Passive funds

A passive fund

1. is often called an *index fund* because it buys-and-hold an index (e.g., the components of the S&P 500)
2. charges low fixed fees as it requires a relatively small budget to run

The share of AUM of passive funds is trending up



The structure of mutual funds

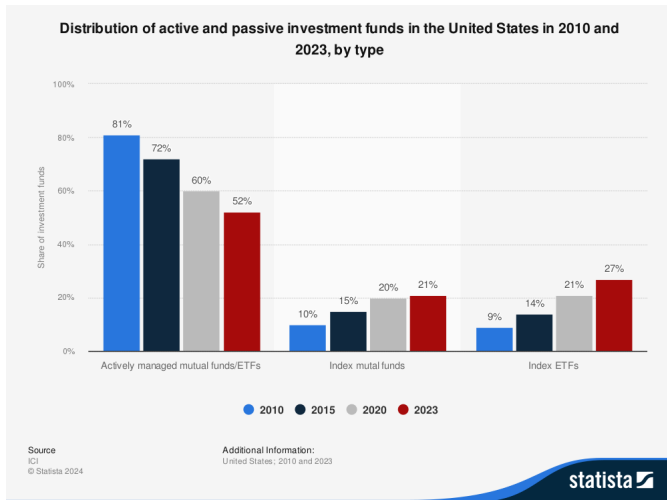
Mutual funds can be

- **open-end:** A type of mutual fund that issues and redeems shares on demand at the fund's net asset value (NAV). The number of shares can fluctuate as investors buy or sell shares directly from the fund.
- **closed-end:** A fund that issues a fixed number of shares through an initial public offering, and these shares are traded on the stock exchange. The market price of shares may differ from the fund's NAV.

Exchange traded funds

- Exchange Traded Funds (ETFs) is a type of investment fund that holds a basket of assets with the objective of passively replicating an index (e.g., the S&P 500).
 - Like passive funds, they offer lower fees than active mutual funds.
 - Like a closed-end fund, ETFs can be traded throughout the day at market prices as they are listed on a stock exchange.
 - Only some authorized participants can redeem/create shares of ETFs. This mechanism is designed to keep the ETF price close to index they track through arbitrage.

The share of ETFs and passive funds is trending up



Smart beta funds

- Smart beta strategies funds (or strategies) are a type of funds that blends elements of passive and active management (→ **systematic active management**)
 - Unlike traditional passive funds, smart beta funds aim to capture specific factors or investment styles to generate performance and “beat” the market
 - Unlike traditional active funds, smart beta funds offer a rule-based, transparent, and cost-efficient way to access these factors

Smart beta ETFs

- Smart beta strategies have become popular in the ETF space, with several ETF providers (e.g., Blackrock) offering smart beta (also called “style” or “factor”) ETFs
- Morningstar introduced the terminology of strategic-beta exchange traded products (ETPs) to denote smart beta ETFs
 - the “beta” denotes the sensitivity of a given strategy to a given factor (e.g., value, momentum, etc.)

Popular smart beta strategies in equity space

Some popular smart beta strategies for equities are

- dividend yield
- volatility
- liquidity
- quality
- value
- size
- momentum

Risk vs inefficiencies

- Investors and fund managers typically associate smart beta strategies to *alpha*
 - “*I think [markets] are probably less efficient than I thought 25 years ago*”, Clifford Asness (manager of the prominent systematic hedge fund AQR)
- Financial economists associate smart beta strategies to exposure to multiple risk factors
 - “*He’s trying to take advantage of different risks, and maybe he interprets that as inefficiency*”, Eugene Fama (Nobel economics prize winner and father of the efficient market hypothesis, see the recent “**Lunch with the FT**” column)

Takeaways

- Passive investment is gaining importance due to low fees and doubts about performance of active funds
- Smart beta funds invest in systematic strategies, blending elements of active and passive investing