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THE BETA LESS TRAVELED: FINDING AN ALTERNATE ROUTE

INTERVIEW BY EMILY WELLIKOFF

Strategic beta, smart beta, alternate beta, factor-based investing—each term has its champions. Despite the differences in nomenclature, they all refer to a particular kind of investment strategy that's been capturing the attention of investors globally. We recently sat down with Vinit Srivastava and Tim Edwards to get their perspectives.

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InSIGHTS: Why do you think there has been so much interest recently in alternate beta strategies?

VINIT: Alternate beta strategies can be appealing because they allow you to essentially bet on risk factors, which have associated premia. It's not a new concept though; active managers have long tried to get enhanced returns from different risk factors. Indexing passivizes these strategies and index-based products make them widely available. An index can be the most efficient way to represent a particular risk factor.

TIM: Yes, these concepts have been around for quite some time, and yet their adoption by a broad cohort of investors is fairly recent—particularly in the institutional space. There is certainly an increased availability in terms of products (such as ETFs) giving access to these strategies, which is obviously important, but in my view this is only part of the story. Better education, thought leadership from leading institutions and (not least of all) proof of concepts via real world live performance have also played significant roles.

InSIGHTS: Which risk factors are investors looking to access, and how do indices represent these factors?

VINIT: The primary factors are size, momentum, volatility, value and quality. For a long time, we've offered a way to access the size factor through our size indices (global and U.S.) and equal-weight indices, including the S&P 500® Equal Weight Index. In terms of volatility, we offer a global suite of low volatility indices, incorporating two approaches that either tilt (S&P Low Beta Indices) or provide a pure (S&P Low Volatility Indices) exposure to the factor. With value, we have the traditional style indices (either tilt or pure) and an intrinsic value approach that, in addition to book value, looks at some forward-looking metrics. We recently launched the S&P Quality Indices as a way to access the quality factor.

TIM: It's also important to note that investors are not, typically, accessing these factors as an end in themselves. There is a material shift towards what you might call "outcome-based" investing, structuring a portfolio to deliver certain outcomes such as lower volatility, greater diversification, a better risk/return profile or a more stable income stream. The desired outcomes determine which factors are germane to the portfolio construction, and our indices are designed in part to provide tools to suit those needs.

InSIGHTS: What drives the performance of alternate beta indices?

VINIT: By definition, since these are risk factors, investors capture the premium associated with that factor when they access it. These excess returns manifest over time and can lag market returns depending on the market cycle and the factor being considered. The premium associated with these factors is explained by various reasons. For example, the low volatility anomaly has been shown to have behavioral roots—leverage-constrained investors and a preference for lotteries have historically caused high volatility stocks to be overvalued, and as a result, less volatile stocks have outperformed them on a risk-adjusted basis.

TIM: In the majority of alternate beta indices, the most significant driver of absolute performance is the market that is being represented, that is to say, the "beta." The relative performance, compared to a standard benchmark such as the S&P 500, is typically dependent on the factor that is being captured by the "alternative" nature of the index. For example, if the goal is to provide less volatility than the parent index, as is the case with the S&P Low Volatility Index Series, then one should expect fewer losses in bear markets (and also fewer gains in bull markets) precisely as a result of the lower volatility.

InSIGHTS: How can alternate beta indices be used?

VINIT: In many ways. We offer single-factor indices, which can be used as building blocks to customize an alternate beta strategy. We also offer multifactor indices, in which we pre-combine factors in one index. As we mentioned before, different factors work differently in market cycles. As such, some factors work well together based on historical correlations and other efficiencies, and investors are looking to access the combinations of such factors. Notable combinations include quality and value, value and momentum, and low volatility and value. The S&P GIVI® family of indices is one such multi-factor global index family that is constructed to provide access to the low volatility and value risk premiums while maintaining characteristics similar to the underlying benchmark.

TIM: We've mentioned the use of alternate beta indices to target certain investment outcomes, which is certainly the primary application. However, alternate beta indices can also be used for benchmarking. For example, comparing the performance of a small-cap value manager to a small-cap value index allows one to better understand the manager's sources of return beyond and above their exposure to the value and small-cap factors. Lastly, they can also be used in macro-analysis. For example, if stocks with higher momentum or lower dividends, or value stocks, etc. are behaving notably differently, that can provide a valuable insight into the evolving dynamics of the market.

InSIGHTS: Why might an alternate beta index outperform an active manager's comparable alternate beta strategy?

VINIT: Alternate beta indices, and the products associated with them, don't entail active management fees and are transparent with the exposure that they provide. The latter appeals to institutional investors who are looking to make specific factor bets or want to correct for certain inadvertent bets in other parts of their portfolio.

TIM: Strictly speaking, there is not a massive difference between the investment strategies incorporated by some active managers and those replicated by some alternate beta indices. There are two important differences: the fees traditionally associated with active management play their inevitable role in performance, and it is important to note that index methodologies don't tend to suffer from style drift in the way that some managers do. There is very little reason to believe that alternate beta indices are predestined to select better performing stocks than active managers following similar principles; instead, a preference for low cost structures, transparency and liquidity tends to differentiate the investor tracking alternate beta indices, as opposed to those investing with active managers.

It is not possible to invest directly in an index, and index returns do not reflect expenses an investor would incur to replicate an index.

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