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An Expert View:

MSCI's Altaf Kassam On What To Consider When Investing In Smart Beta

Altaf Kassam
Head of Equity Applied Research, MSCI

MSCI has been a market leader in indexes for 45 years, but it was the acquisition of Barra, seven years ago, that brought MSCI to the forefront of factor investing. Barra brought its analytical and pure factor modelling pedigree, which includes ways of isolating and analysing the drivers of stock risks and returns. This, combined with MSCI's long history of creating equity indexes, has produced investible factor indexes, or what people increasingly term "smart beta".

MSCI has since taken those factors that outperform over the long term, and through their factor indexes, given investors a transparent, systematic way of investing in them.

Altaf Kassam, Head of Equity Applied Research at MSCI, explains what differentiates MSCI in the "smart beta" field and what investors should look at when investing in these factor indexes.

Why does MSCI offer smart beta indexes?

It suits our strengths, as we are unique among index providers in being able to provide both risk modelling and index creation. Smart beta in an investible index form gives the market something that was previously only accessible through active managers. We have been doing it for several years now and some of our products—high dividend yield index and minimum volatility, launched in 2006 and 2008, respectively—are well known now and have several years of live track record, showing that they are more than just a backtest.

What does MSCI do that is unique in this sphere?

We have been creating and publishing indexes for over 45 years, and so could create 40 years of index factor history across our products, which certainly differentiates us from our competitors. We also put a lot of resources into our research, with a large team conceptualising, designing and testing new types of indexes. So, we are not just a research house, but a research house that has an industrial investible index creation process and a sophisticated risk model.

We cover many bases.

Has the market come up with a definition for 'smart beta' yet?

I don't think that the market has agreed on what to call it, or even what's in it. But I think that everyone agrees that it is not market cap.

Apart from non-market cap, MSCI's view is that it is a way of weighting stocks differently than market cap, and it specifically takes into account their [stocks] characteristics. For some users, it can be based on different ways of weighting stocks, while for others, it is purely based on stock selection and other things.

The only thing people agree on is what sits outside the market-cap bucket.

Has it not been defined because the market is still immature?

We have seen some standardisation of the market as it has matured, but the market may be gravitating towards including certain types of indexes within the factor investing definition, and this will, at certain times, move outside and remain outside the definition.

At MSCI, we have been talking about factor indexing and writing papers on it for 10 years, and have also had products out there for over seven years. It reminds me of the early days in the European ETF market, when there was a massive amount of fragmentation, which more recently has started to coalesce.

Do smart beta indexes need more management than market cap?

Not necessarily, but there are some operational considerations that investors need to be aware of. When you go from a market cap index to a factor index, you are naturally going to increase turnover because factors tend to move between stocks. A stock that was "value" six months ago might not be "value" in six months' time, so when you rebalance these indexes, you tend to add an extra layer of turnover, which can increase costs. We aim to minimise turnover wherever it is sensible while staying "true" to the factor—it's an ongoing trade-off.

At MSCI, we try to make our factor indexes *operationally* look as much like market cap as possible, with the same parent universe selection, corporate action adjustment, similar rebalance schedules and so on. We are ultimately about making indexes that are investible, so while you can use academic theory, you have to be able to turn it into something investible if people are going to launch commercial products based on it.

How do you keep costs down in your smart beta indexes?

We focus on capacity and concentration; that is, how much money you can actually put in these indexes and, as mentioned, turnover. We were approached by the Norwegian Ministry of Finance, which are one of the world's largest investors. They asked us to look at the feasibility of investing $100 billion or more into our factor indexes, so we started to address the issue of scale, asking the question: "Can our Factor Indexes support large scale investments without significantly diluting factor returns?"

And the answer was an emphatic "yes!" given that the scale of investment in factors is still relatively small compared to the overall market.

So, factors can accommodate the largest investors in the world, and the trickle-down effect is that smaller investors—from institutions, retail, private wealth—benefit from the index becoming a lot more tradable and investible, which should help bring the total cost of investment down for all.

While being aware of potential capacity constraints, we also realise that the industry is a long way from reaching these constraints. At the moment, we conservatively estimate that there is about $120 billion invested in, or tracking, MSCI factor indexes. Compare this to $9 trillion tracking MSCI market cap indexes, and that only 1 percent of money tracking all MSCI indexes is in "smart beta".

How does MSCI backtest its products?

We look for factors that outperform over the long term. Most institutional clients evaluate performance over three to five years or more, while retail investors typically can have shorter time horizons.

We find that factor indexes do generally outperform market cap over the long term, and as you increase the holding period, the chance they will outperform market cap clearly increases. It means that we see them as a strategic tilt, not necessarily something that is that suitable for timing, for example, on a monthly basis.

In short, our backtesting shows that all of our factor indexes have outperformed the market cap indexes in the long term, and the longer you hold them, the more likely the outperformance.

How does MSCI see smart beta being accessed?

At MSCI, we provide the factor indexes and are agnostic about the implementation. But we see people accessing them through funds, ETFs, mandates, asset managers, segregated mandates, swaps, etc.

Currently, most of the flows are in mandates, but our business licensing ETF providers is growing at a rapid rate in terms of capturing factor index flows.

How does MSCI launch a smart beta index?

A lot of demand comes from mandates. But there is also a combination of push from us and pull from clients.

We are very open to creating new products as well. So, for every index we create, there can be a dozen customised versions that cater to a particular investor-client need.

Most of the demand we see at MSCI comes from institutional investors—sovereign wealth funds, pension funds, large asset owners, insurance and so on, but we are now seeing more interest from retail investors. This is a consequence of the increasing level of sophistication of investors globally.

What are the real benefits of smart beta strategies for investors?

These strategies have taken something that was previously only available through active management and made it accessible in a transparent, simple and very cost effective way.

We are not saying this is the end of active management, which still has a considerable role to play in delivering purer alpha. But for investors who have views on certain factors, and either don't want to or can't select active managers—yet still want lower costs and some of the benefits of active management—factor investing gives them a tool to access this.

It provides investors long term risk adjusted return versus market cap and lets them access characteristics and risks in ways not previously available.

What are the key things investors need to know about smart beta?

One thing that we are at huge pains to make clear is that no single factor outperforms market cap all the time. Different factors perform differently. You can't just put all your investment into one factor and watch it outperform; there will be periods of underperformance.

Factor indexes also have higher turnover than market cap. This will translate into transaction costs and will take away from outperformance, so investors should ensure that the outperformance you are seeing isn't eaten up by turnover. When we design indexes, we make that an explicit goal.

Finally, you need to make sure that the factors you're investing in aren't just data mining. There should be some compelling reason why a factor exists and persists; for example, value, momentum and size have all been well documented in academic literature.

How and where do smart beta strategies fit in investor portfolios?

They sit between active and passive. They don't replace active management and they don't replace market cap passive.

If you don't have a view on the performance outlook for a specific factor, then we still think that market cap passive is the best way to invest in equities.

This is a third way for people to invest. It is for those who believe that they want to take a tilt away from market cap passive and for many reasons don't want to do that via active management.

What is the future for smart beta?

It is important to have a sense of scale. Factor indexing makes up only 1 percent of our business, but it is growing rapidly. We anticipate a trickle-down effect from the larger institutional investors to retail via ETFs. There is also likely to be some level of standardisation around certain families of factors—and that is what we have seen in some market cap.

At the moment, we see smart beta as a developed market phenomenon, but this will broaden into emerging and frontier markets. This broadening of the client universe, together with downward pressures on costs as investors become more accustomed to these types of strategies, will be the main drivers for smart beta growth.

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