LMCG INVESTMENTS®

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Smart Beta: What It Is and How It's Incorporated in Global MultiCap May 4, 2018

The *Financial Times* reported last December that there was approximately $1 trillion tracking smart beta strategies. Most of these strategies are housed in exchange traded funds. With this proliferation of smart beta strategies we thought it was an appropriate time to write a follow-up piece to our earlier smart beta *Unfiltered*. Smart beta strategies have played a significant role through the history of LMCG's Global MultiCap management, and the explosion of the Smart Beta ETF business has opened up new opportunities for enhancing our management process.

Let's start with a definition of Smart Beta. If you Google Smart Beta you will get a number of different definitions. We believe the most accurate definition is perhaps the simplest: *Smart Beta is a rules-based discipline method of constructing a portfolio*. Here are two examples:

- **The iShares Select Dividend ETF (DVY):** *The iShares Select Dividend ETF seeks to track the investment results of an index composed of relatively high dividend paying US equities.*
- **State Street SPDR – Russell 1000 Momentum ETF (ONEO):** *The specific focus on momentum potentially captures the excess returns of stocks that have enjoyed higher recent price performance compared to other securities due to the tendency for stock prices to form trends over certain time horizons.*

These definitions fit neatly into a rules-based construct. There is no judgment applied. These weighting schemes stand in contrast to index funds (pure passive), which simply invest according to the weight of the companies' outstanding equity. The great advantage of capitalization weighting is that there is very little cost in managing a portfolio to match an index – a portfolio will automatically adjust to changes in capitalization weights every day as prices change within the index. Capitalization weighting also accommodates large companies since smaller and less liquid companies are accorded proportionally lower weight. Smart beta strategies can be viewed as falling somewhere on the spectrum between index funds and active strategies. It also follows that fees for smart beta ETFs typically fall between index fund fees and active managers' fees.

It's worth noting that while the first smart beta ETF emerged in 2003, investors were employing smart beta strategies decades earlier – even though the term had not been coined yet. Equal-weighted index funds were used by institutional investors in the early 1970's, and institutional investors exercised sound investment judgment in the late 1980s/early 1990s by underweighting Japan in global portfolios to avoid the distortion created by the market cap weighted index. The bubble burst badly in Japan in 1991 – when the Nikkei Index had reached its zenith of 39,000 – a level that has never been re-traced (as of May 4th the Nikkei sits at 22,473).

How We Employ Smart Beta Strategies within Our Global MultiCap Investment Approach

We use smart beta strategies in market segments where we believe the opportunity for active management to add significant value relative to the benchmark is challenging, e.g., US and Foreign large cap. In these market segments, we actively tilt the portfolio's exposure toward specific themes, sectors or countries using this rules-based smart beta approach.

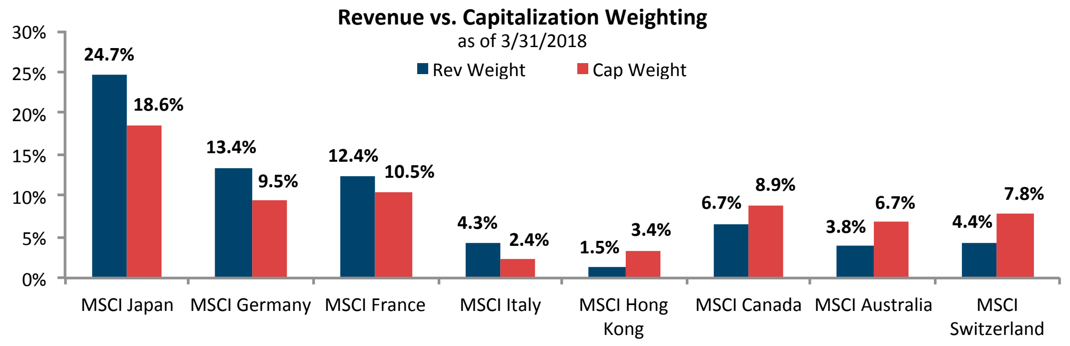
Additionally, the LMCG Global MultiCap strategy is unique in that we complement our smart beta methodology with active stock selection in the portfolio construction process. In those market segments where we believe inefficiencies exist – such as US small cap – we leverage the investment acumen of our active institutional investment teams here at LMCG.

Just like there are different styles of active management, there are different options or choices of smart beta constructs. Here are a few examples:

- **Example 1: Revenue/Valuation Weighting**
  One of the most useful cross-border investment disciplines has been to measure the valuation of a market relative to some less volatile and more objective measure of a country market's economic significance. Simple metrics like capitalization relative to Gross Domestic Product of a country

This edition of *Unfiltered* is a follow-on to a smart beta piece we did in March of 2016. We thought it would be helpful to dig a little deeper into how the Global MultiCap team incorporates smart beta in the management of the strategy. But more importantly, we believe the last few years of strong equity returns dominated by a handful of names – most notably the FAANG stocks – amplify the need for smart beta applications. Let's face it – index funds have been tough to beat in the past few years – concentrated exposure to technology names has been a performance winner. But oftentimes the risk aspect is overlooked. We have recently been reminded of these risks as Facebook and Amazon experienced sharp sell-offs for different reasons. We think that smart beta tools can help investors sidestep some of these risks – which may be particularly helpful given the current equity environment.

has been extremely useful in identifying long-term mis-valuations of country stock markets. While widely credited for moderating investments in Japan in the 1990s, large stock market valuations relative to country GDP has been an early warning signal for relative decline over subsequent years in markets as diverse as Malaysia, Taiwan and South Korea.



Source: MSCI and FactSet

Revenue weighting replaced GDP weighting for investors because the size of stock market listings is not necessarily proportional to GDP around the world for many historical reasons. Italy has a very small stock market compared to its GDP because many companies avoided becoming public for tax reasons. Emerging stock markets have evolved at very different rates as many smaller market companies still rely on private lending rather than stock listing for capital.

- **Example 2: Thematic-Based Smart Beta**
  There may be certain market environments where a certain sector, region or theme offers a favorable risk/reward relationship in the opinion of our GMC portfolio management team. In the days following the Trump election, US financial stocks soared, while their European counterparts languished. At this time, the GMC team added European bank exposure to the portfolio, with the belief that this trade had run too far and that European banks were better positioned for global reflation.

- **Example 3: Fundamentally-Based Smart Beta**
  In the US large cap arena, dozens of industry analysts publish research on the companies in the index – such that the ability to glean any unique insight into a particular company that would lead to a differentiated opinion on the stock – is extremely challenging. The academics would use the term *efficient* to describe this type of segment of the market. In the US large cap portion of the portfolio we use a complement of fundamental inputs, e.g., capital deployment, earnings trends and valuation levels to construct exposure that we believe should outperform over time. The other significant drawback to simply capitalization weighting is the lack of risk control. We have written in previous versions of *Unfiltered* about mitigating exposure to FAANG stocks – smart beta provides us with robust alternatives to these types of concentrations.

Putting It All Together

Hopefully, this *Unfiltered* gives you a better understanding of how we incorporate smart beta tools in our Global MultiCap strategy. Smart beta is an important component of our overall portfolio construction method. In addition, dynamic asset allocation, active stock selection and overall portfolio risk management help to deliver what we believe to be an attractive global equity solution.

John J. Harrington, CFA | Managing Director, Investments
200 Clarendon St. | Boston, MA 02116 | T. 617-380-5661
jharrington@lmcg.com | www.lmcg.com

Christopher Sabo, CFA | Portfolio Manager
200 Clarendon St. | Boston, MA 02116 | T. 617-380-5680
csabo@lmcg.com | www.lmcg.com

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