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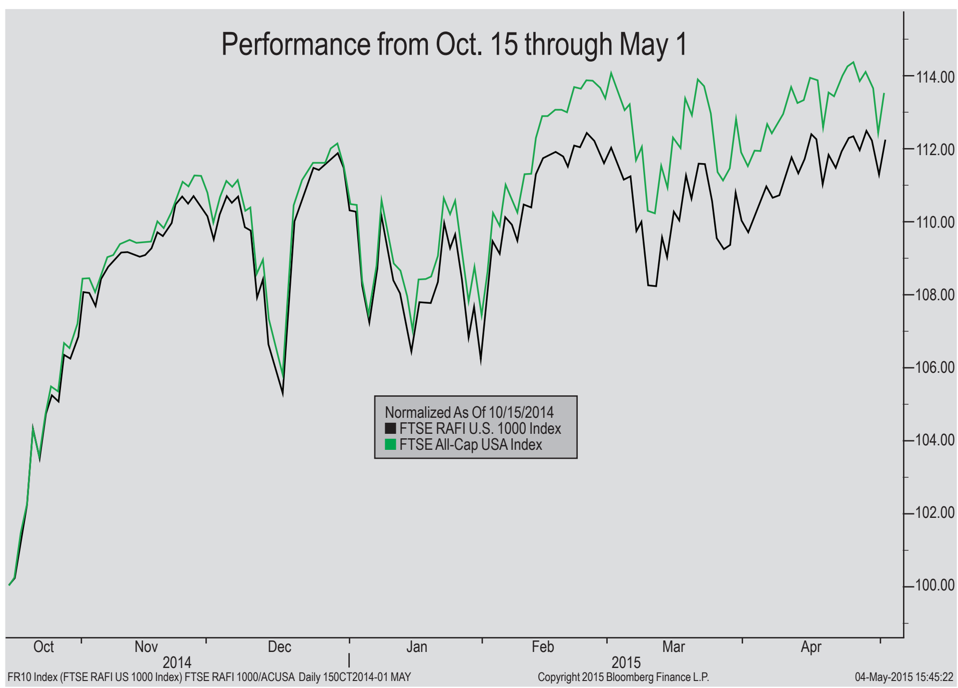
Smart Beta Doesn't Look That Smart to Some U.S. Stock Investors

Investments linked to alternative stock indexes aren't "a magic formula for increasing returns while reducing risks," according to Bruce I. Jacobs and Kenneth N. Levy, principals of Jacobs Levy Equity Management Inc.

Jacobs and Levy drew this conclusion in a paper on smart beta strategies, built around indexes that use criteria other than market value to determine each company's weighting. This approach can't "be expected to perform consistently in all market environments," they wrote.

The attached chart shows this by comparing this year's performance of the FTSE RAFI U.S. 1000 Index, which calculates weightings based on sales, cash flow, asset values and dividend payments, and the market-value-weighted FTSE USA All-Cap Index.



The RAFI U.S. 1000, compiled by Research Affiliates LLC, gained 12.3 percent from its second-half low on Oct. 15 through the end of last week. The USA All-Cap, a broader indicator that includes all the stocks in the RAFI gauge, climbed 13.6 percent in the period. By contrast, the RAFI U.S. 1000 has performed better since the current bull market began in March 2009.

Criteria, or factors, used in smart beta investing can produce returns that vary significantly, Jacobs and Levy wrote. They mentioned strategies favoring smaller companies and value stocks, or shares trading at relatively low multiples of asset values, as examples.

"A constant exposure to a factor regardless of underlying conditions leaves a portfolio vulnerable when that factor underperforms, as it inevitably will," the Florham Park, New Jersey-based investors wrote. The latest version of their paper was posted last week on the Social Science Research Network and is due for July publication in Ernst & Young LLP's Journal of Financial Perspectives.

By David Wilson