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(James Saft is a Reuters columnist. The opinions expressed are his own)

SAFT ON WEALTH — World too complex for smart beta

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Nov 12 (Reuters) — Ironically, the simple truth may be that the world is more complex and less stable than popular smart beta strategies assume.

Smart beta strategies have enjoyed rampant growth, being funds which are a sort of hybrid; passive in nature but with active management tweaks.

But smart beta's weakness is that the performance factors it is based on are less bedrock and more shifting soil, argue well-known quants Bruce I. Jacobs and Kenneth N. Levy of Jacobs Levy Equity Management.

"Smart beta strategies assume a stock market in which a few chosen factors produce persistent returns," Jacobs and Levy write in a forthcoming piece in the November/December 2014 Financial Analysts Journal. "This assumption is not a good approximation of what is observed in reality."

While a classic index fund attempts to capture beta, or market return, by holding all shares in proportion to their market capitalized weight, smart beta funds try to beat the market by making adjustments. Those adjustments are based on 'factors,' anomalies, like for example the outperformance of stocks with certain characteristics such as small size which managers hope will persist.

James Montier of fund managers GMO has criticized smart beta for, in what he says is the vast majority of cases, simply giving investors extra exposure to value and small-capitalization shares, but at a higher price.

Jacobs and Levy, who more than 25 years ago were early to catalog and study factors, go a bit beyond, and to the side, of Montier, in their critique. They argue that not only are these factors, on which a smart beta fund must depend, not stable, but also that managers would do better to spread bets across more types of shares, and be willing to adjust these over time as needed.

It may well be, contrary to some of the marketing of smart beta, that there is no such thing as being "a little bit active" in investment management, just as it is impossible to be a little bit pregnant.

While most smart beta funds over-weight stocks with a few criteria, such as small capitalization, low volatility, momentum and value, these are far from the only characteristics which can lead to outperformance. A recent study by Jeremiah Green, John Hand and Frank Zhang found 24 factors with statistically significant outperformance, but further that size and price-to-book, both popular in smart beta, were not among the leading group.

SHIFTING SANDS AND DRAWDOWNS

One of the key problems is that a factor which is an outperformer today may not be one tomorrow, or quite the opposite. Take price momentum, the tendency often seen that shares will carry on trading in the same direction, be it up or down. When the market bottomed in 2009, momentum strategies were hit hard, suffering significant drawdowns for investors.

Another problem, especially with smart beta exchange traded funds alone accounting for $350 billion, is too much money crowding into too few factors. Get a forced deleveraging, as happened with a sudden market move in August 2007, and stocks with commonly used factors can be particularly vulnerable.

Similarly, given the fairly static nature of smart beta, front running can be a problem as outside investors try to get in ahead of a planned re-balancing of an index.

Now to be sure, the advantage of a fairly simple and static smart beta approach is that costs are kept down, and perhaps over time will fall further.

In contrast, a proprietary and less transparent approach to capturing and moving among factors will cost more, though it obviously brings with it more opportunity to outperform if the manager gets it right. Diversification too will come with less reliance on a few factors like small cap or value.

The other thing to remember, and this is true for all forms of index investing, is that ultimately someone needs to decide when to get in or out of a given fund or asset class.

"Smart beta strategies shift the decisions about the selection of factors and the timing of factor exposures from the investment manager to the asset owner," according to Jacobs and Levy.

Under a multi-dimensional approach, with more active switching and managing of factors, "managers, in contrast, take responsibility for investment decisions."

All of this is nothing more than acknowledgement that the world is much more complex than smart beta would seem to imply.

Things change, and an investment strategy that fails to take this into account will inevitably come to grief.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.) (Editing by James Dalgleish)

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