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On this week's ***Consuelo Mack WEALTHTRACK*****:** when 'Smart beta' investing can be dumb! Financial innovator and thought leader, Research Affiliates' Robert Arnott warns about pitfalls with the popular strategy he helped create.

Robert Arnott
Chairman, CEO
Research Affiliates

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CONSUELO MACK: This week on WEALTHTRACK, financial innovator Rob Arnott of Research Affiliates warns that 'smart beta' investing, a popular alternative to index investing, which he helped create can go horribly wrong…next, on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Indexing is all the rage…more investors both institutional and individual are abandoning actively managed mutual funds for index funds and exchange traded funds, which are based on a managed index, the most popular being the S&P 500. Since 2009 these passively managed funds have exploded, from 11% of global assets under management, to 19% last year, a 73% gain, with no slowdown in sight.

Investors are switching for two reasons. The most important being that market based index funds have been outperforming the vast majority of actively managed funds for the last decade. According to the investment classic, "Winning The Loser's Game: Timeless Strategies For Successful Investing," by financial thought leader and frequent WEALTHTRACK guest, Charles Ellis:

"In round numbers, over one year, 70% of mutual funds underperform their chosen benchmarks. Over 10 years, 80% underperform."

The other major reason: index fund's fees are much lower than actively managed ones, and they are falling rapidly. Many of them now charge just 5/100ths of a percent! Traditional index funds have their critics, however, as they're weights based on market capitalization, which means the index is dominated by the companies with the largest stock market value. Investors end up owning the most expensive stocks, whereas smaller companies or those not appreciating as much or declining have much less of a share.

The top 10 companies by market weight in the S&P 500 for instance, account for nearly 20% of the index. They include three of the so called FANG stocks: Facebook, Amazon and Google parent Alphabet, as well as blue chip giants like Microsoft, Exxon Mobil and Johnson & Johnson.

This week's guest is Robert Arnott, chairman and CEO of Research Affiliates, which he founded in 2002 as a self-described: "…research intensive asset management firm that focuses on innovative products." Among the innovations that he has pioneered is what he calls Fundamental Indexation. Building indexes with stocks based on the size of their fundamentals, such as sales, profits, cash flow, book value and dividends, not their stock price.

His firm Research Affiliates has created a series of fundamental indexes for a variety of markets and asset classes around the world. The Rafi indexes were early entries in an approach to investing that has become extremely popular, known as Smart Beta. Smart beta is an umbrella term for multiple index strategies based on characteristics other than market price. As the *Financial Times* defines it: "…Smart beta strategies attempt to deliver a better risk and return

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trade-off than conventional market cap weighted indices." But have they and will they in the future? Arnott and his team have recently published a series of research articles on the future of Smart Beta. A link to them is available on our website.

I asked Arnott why the shared premise of all Smart Beta strategies is that market cap weighted investing is not the way to go.

ROB ARNOTT: It's actually really simple. If you capitalization weight the portfolio, if the share price doubles, your target weight in the portfolio doubles. Why should you want to own more of a stock after it's doubled than before it's doubled? If it's an efficient market and if the pricing was correct before it doubled and was correct after it doubled, shouldn't you want the same amount after as before? Doesn't that mean you should be rebalancing within the equity portfolio? People rebalance their asset allocation all the time. Why not rebalance within the equity portfolio?

CONSUELO MACK: Right. And the market capitalization formula does not call for rebalancing based on price appreciation or, right?

ROB ARNOTT: Correct. So the shared attribute of true smart beta strategies is that they break the link with price, and they earn an incremental return because they contra trade against the market's most extravagant bets. It's that simple. So, fundamental index obviously qualifies. Equal weight qualifies. Minimum variance qualifies if it doesn't anchor on the market sector weights or something like that if it's pure minimum variance. Even weighting a portfolio by the number of board members who have facial hair would be …

CONSUELO MACK: So it's anything but market capitalization.

ROB ARNOTT: Right.

CONSUELO MACK: Yes. So here's the rub. The market capitalization indices have done really well in recent years.

ROB ARNOTT: Oh, they sure have.

CONSUELO MACK: And so, for instance, I looked at the FTSE RAFI U.S. 1000, one of your fundamental weighted indexes, versus the Russell 1000, and over the last one- and three-year periods, your index has underperformed this market cap weighted Russell 1000. How do you explain that?

ROB ARNOTT: Very simple: you have value-driven markets and you have momentum-driven markets. If momentum is on a roll, then you don't add value by contra trading against the market's most extreme bets. You have to be patient. And if value is underperforming, anything with a value tilt, faces a headwind. Now, what's cool about fundamental index is we

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introduced the idea almost 12 years ago, FTSE started publishing the index almost 11 years ago, and it's beat the market by just under one percent per year compounded, which is fine. That's nice. But it's done that while value has underperformed growth by two percent per year. Oh my goodness.

CONSUELO MACK: So explain that. How did that happen?

ROB ARNOTT: That happened because fundamental index isn't a plain vanilla value strategy. It doesn't simply throw out the growth stocks and cap weight the value stocks the way a conventional value strategy might. And as a consequence of that, we're adding value from rebalancing. Fundamental size of a business is an anchor, a stable anchor that we trade towards. So if a stock soars in price and its fundamentals haven't changed much, then we'll say thanks for those lovely gains, I'm sure the company has a great outlook, but it's in the price, it's not going to help you, let me reweight it down to a second on my footprint.

CONSUELO MACK: Right.

ROB ARNOTT: And if a company is deeply out of favor trading very cheap, fundamental index will say, yes, the company is probably pretty troubled, but it's obviously in the price and it's a big company, so let's reweight it back up. And it's the contra trading against the market's most extreme swings.

CONSUELO MACK: That explains the points, right.

ROB ARNOTT: That creates the alpha. The average value tilt contributes very little. The dynamics shifts in the value tilt, that's where the alpha comes from.

CONSUELO MACK: Are we still in a momentum market? I mean, how long could the momentum-driven market last?

ROB ARNOTT: I think the value bear market which started in 2007, probably came to an end in January. The value has recovered all over the world. Fundamental index in emerging markets where value was hit most savagely in recent years, fundamental index in emerging markets has beat the cap weighted indexes by well over 1,500 basis points in well under a year. That's pretty cool.

CONSUELO MACK: So, do these trends, for instance, momentum being out of favor and value coming back, are these long-lasting trends?

ROB ARNOTT: They often are.

CONSUELO MACK: Are they multiyear trends often or?

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ROB ARNOTT: Think of it as a bull and bear market. Value has had a wrenching nine-year bear market relative to growth.

CONSUELO MACK: Right. Doesn't mean you've lost money in value, but you've underperformed relative to growth.

ROB ARNOTT: Right.

CONSUELO MACK: As I said in my introduction to you that you're a pioneer in fundamental indexation, and fundamental indexation is under what's called the Smart Beta umbrella, which is a very popular term, very popular strategies. And you and your research team, research affiliates have written a series of papers, of research papers that are on your website and we will link to them on our website, about smart beta. And the intriguing title of the first one was "How Can Smart Beta Go Horribly Wrong?" So my first question to you is can it go horribly wrong? And has it?

ROB ARNOTT: What I'm talking about is that users of smart beta can find that the strategies go horribly wrong for them if they engage in performance chasing. And performance chasing is rife in our business. What do you look at when you're thinking of embracing a strategy? You look at the trailing one-, three-, five-, ten-year results, and if three out of the four look good, okay, that's the strategy for me. Pardon me, but whatever is newly expensive and vulnerable to disappointing results, is highly likely to have been wonderful in the past.

CONSUELO MACK: Especially the recent past.

ROB ARNOTT: Right.

CONSUELO MACK: Last three years.

ROB ARNOTT: So that particular paper was hugely controversial, and I found the controversy amusing, because all we were saying is look at the price. When you buy a car, you look at the price. If you're sensible when you buy a stock, you'll ask, what are the valuation multiples and how does that compare with what I think is reasonable? If you buy a strategy, whether it's fundamental index or minimum variance or you name it, anything, you should ask the question, is it trading richer relative to the market than its own historic norms? A quality strategy is always going to trade at a premium. Sometimes it'll trade at a 20 percent premium to the market, sometimes an 80 percent premium to the market. If you're paying 20 percent above the market, go with quality. It's cheap. If you're paying 80 percent above the market, watch out. There might be mean reversion.

CONSUELO MACK: So which Smart Beta strategies, or which factor tilts now look really expensive to you?

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ROB ARNOTT: When you look at low volatility and minimum variance and low beta strategies, if they anchor on beta to choose their portfolio, they today are trading at very high valuations relative to historic norms. So that strikes me as, I mean, they're wonderful strategies, don't get me wrong. But buy them now and you might be in for disappointment. Their recent results have been wonderful, and that's why people are pouring money in.

CONSUELO MACK: Exactly, yes.

ROB ARNOTT: So what our work suggests is quite simply look at the price. The other controversial thing we pointed out is equally obvious and should be equally uncontroversial, and that's that when people have found factors, or Smart Beta strategies, chances are they found them because they performed well.

CONSUELO MACK: Yes.

ROB ARNOTT: Chances are they found them because they had gotten more expensive. Cam Harvey wrote a survey paper in which he looked at published factors and anomalies and smart beta strategies.

CONSUELO MACK: And Cam Harvey is?

ROB ARNOTT: He's a Professor at Duke. He found that 316 factors had been identified by the end of 2012, and 30 to 50 more were being identified each year. So we're probably at 500 factors by now. Okay, I asked him how many of the 316 had added value? He laughed. He said 316. Okay, so was there data mining involved in finding these factors? Of course there was. Was there selection bias: you only pay attention to the best ones you find? Of course there was. Was there anything evil or nefarious about this? No, but it does mean that the forward-looking returns are likely to be worse than the past returns. I then asked Cam, how many of these authors ask the very simple question: did my strategy get more expensive during the test period? Did that contribute to the wonderful past results. And he said zero, not one out of 316 papers had asked that very simple fundamental question.

CONSUELO MACK: Simple. Right.

ROB ARNOTT: And that was viewed as a highly controversial thing to point out. Well, why is it controversial? All we're saying is when you find a strategy, why don't you ask how much of the alpha is revaluation, and what's left might be structural alpha. If what's left is large, then you found something really nice. With low volatility and with most quality strategies, revaluation has been the dominant source of return and you take that away and there is no value add left. I would also posit that if you're paying twice as much a price for low beta as high beta, your downside risk is not lower. It's higher. Now, there are low vol strategies that anchor on the volatility of companies, not the beta. It's a subtle difference but an important difference. Three of the four FANGs, Facebook, Amazon, and Netflix, early this

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year dropped into the low beta portfolio.

CONSUELO MACK: Really?

ROB ARNOTT: Yes.

CONSUELO MACK: That's surprising.

ROB ARNOTT: So those became three of the 20 largest holdings. All right, so …

CONSUELO MACK: Why did they drop into the low volatility portfolio?

ROB ARNOTT: Here's what's interesting about beta. Beta measures your sensitivity to market movements.

CONSUELO MACK: To markets, mm-hmm.

ROB ARNOTT: So if you have a stock that tracks perfectly with the market, it's going to have a beta of one. Market goes up one, you're going to be up one. Suppose we have a stock that's very volatile but doesn't necessarily track with the market. Suppose the market's down one percent on a particular day and Facebook's up five percent because of some news. That looks like a minus five beta at least for the day. Average it across enough days, and you wind up with, oh, Facebook's now all of a sudden low beta because of a few anomalous days when it swung the other way, when it zigged when the market zagged. So if three of the four FANGs are among your larger holdings, I would suggest that you aren't buying a portfolio with reduced downside risk. You're buying a portfolio with increased downside risk.

CONSUELO MACK: Right, because they're expensive.

ROB ARNOTT: Right. Now …

CONSUELO MACK: They know them really well. Mm-hmm.

ROB ARNOTT: There is nothing wrong with low vol. Low vol generally does what it purports to do: reduce your risk, reduce your downside risk. Watch out if it anchors on beta. Minimum variance strategies, for instance, anchor on beta. S&P's low vol strategy anchors on volatility. Facebook, Amazon, Netflix won't get into the portfolio. Okay, that helps. But also look at the valuation and ask, is the market pricing low vol cheap or rich? And no matter how you construct it, right now it's trading rich. Why? Flight to safety.

CONSUELO MACK: Right.

ROB ARNOTT: People in the U.S. and all over the world have been repositioning to what

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they think are less risky, higher quality portfolios with the result that low volatility companies now trade at a premium multiple to high volatility companies, very anomalous, and that high quality companies trade at a premium, as they always have, but a larger premium. The revaluation is to a new normal and is based on totally justifiable reasons. That's how smart beta goes horribly wrong: if you pile into a strategy because it has brilliant ten-year results, and it's priced to have horrible ten-year results in the future, uh-oh, it's nothing stupid about smart beta. It's just using smart beta in a careless way.

CONSUELO MACK: So Rob, listening to you as an individual investor, I'm saying to myself, this is way too complicated for me. And a lot of Wall Street firms and investment advisors are trying to sell me as an individual on these Smart Beta strategies and I'm saying, listening to you, I'm saying, whoa, this is way too complicated, and also, I'm probably chasing performance, and it might be what they're saying is low risk is going to be higher risk. So what's my strategy as an individual? I mean, do I just avoid these new vehicles and …

ROB ARNOTT: No.

CONSUELO MACK: No. Okay.

ROB ARNOTT: No. Smart Beta is an umbrella that's expanding. It's been expanded to encompass all sorts of ideas. Some of them are good and some of them are bad. Some of them are good ideas that are temporarily expensive. So what you want to do is first break the link with price in your own behavior. Don't buy a strategy just because it has great five- or ten-year results. Buy it because it's cheap now relative to its past. Now, what's newly cheap is likely to provide wonderful forward returns and it's likely to have inflicted pain and losses getting to cheap. The last time we got together, I was talking about emerging markets deep value, fundamental index and emerging markets. Okay, since January, that's up about 60 percent. Oh my goodness.

CONSUELO MACK: What do we do? So you are rebalancing out of, right?

ROB ARNOTT: I still like the asset class. It's gone from unbelievably cheap to pretty decently cheap.

CONSUELO MACK: And you were early …

ROB ARNOTT: So I still like it.

CONSUELO MACK: … in emerging markets and …

ROB ARNOTT: I was.

CONSUELO MACK: … it hurt your relative performance.

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ROB ARNOTT: Until they turned.

CONSUELO MACK: Right.

ROB ARNOTT: So the idea in contrarian investing is: if you like something because it's cheap and it gets cheaper, buy more. That's the only way to assure that when it turns, you have your maximum exposure at the turn, and it's the only way to assure that in any mean reversion, any rebound, you get back the entire shortfall really fast.

CONSUELO MACK: What's cheap now? You just said, so emerging markets stocks?

ROB ARNOTT: Emerging markets stocks are still cheap.

CONSUELO MACK: Still cheap. Relative to their historic …

ROB ARNOTT: Yeah.

CONSUELO MACK: …Range and relative to how they trade to developing markets, for instance?

ROB ARNOTT: Right.

CONSUELO MACK: All sorts of measures, yes.

ROB ARNOTT: And emerging markets deep value, best exemplified by fundamental index and emerging markets, is also trading cheap. It's trading at what's called a Schiller P/E Ratio, price relative to long-term ten-year earnings of eight-and-a-half, and that's after rising 60 percent. So that means that back in January, it was trading at five-and-a-half times earnings. You could buy half the world's GDP at five-and-a-half times earnings.

CONSUELO MACK: It's no longer January but you still think?

ROB ARNOTT: It's still relatively cheap. There are other things that are cheap today.

CONSUELO MACK: Yes.

ROB ARNOTT: EAFE international stocks has gotten cheaper, and value in international stocks has gotten cheaper.

CONSUELO MACK: Right, value stocks in the international space.

ROB ARNOTT: Correct. Not as cheap as emerging but still pretty good. So I've been called

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a perma bear sometimes in my career. I'm a bear when things are expensive. I'm a bull when things are cheap. If you buy international stocks, they're cheap. Emerging markets stocks are cheaper.

CONSUELO MACK: And when you talk about international stocks, these are in developed countries.

ROB ARNOTT: Correct. Emerging markets' currencies have gone from 25 percent rich relative to purchasing power parity back in 2010, to 30 percent cheap back in January. And people worry that Trump's protectionism is going to be devastating to emerging economies of the world. Bet against the conventional wisdom. He is not likely to do anything wildly stupid. He is not likely to impose 70 percent tariffs on emerging markets countries, because trade works both ways. You'd stifle your own exports if you do that.

CONSUELO MACK: So you think he will be, and I was going to ask you, as far as the Trump Presidency, how you figured that in, or does it figure into your investment outlook?

ROB ARNOTT: When the media thinks a particular outcome is highly likely, Trump will be a disaster. Bet against the media because that captures the conventional wisdom.

CONSUELO MACK: Again, you're speaking like a true contrarian.

ROB ARNOTT: Right.

CONSUELO MACK: You're saying if everyone is saying one thing, be highly suspicious and skeptical.

ROB ARNOTT: So we've seen a flight to safety, which has meant a flight to the U.S., which has meant a flight to the dollar, the dollar is newly high, what a wonderful time to move money out of the dollar into some cheap currencies. The challenge is staying the course because unless you can pick the bottom tick, you're going to go through periods of time where you look and feel stupid for months or even a year or two.

CONSUELO MACK: Right, because you're underperforming again …

ROB ARNOTT: Right.

CONSUELO MACK: … relative to your benchmark or whatever.

ROB ARNOTT: And if you look and feel stupid for two years and you flinch and pull back, you've just locked in your losses. If you underperform for a couple of years and you rebalance into a larger position, you get it all back astonishingly fast. So emerging markets currencies, I would also say, represent a very interesting opportunity.

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CONSUELO MACK: And that might lead me to the one investment for a long-term diversified portfolio, would be emerging market currencies, right?

ROB ARNOTT: Yes.

CONSUELO MACK: Is that your choice?

ROB ARNOTT: Yes, yes. PIMCO's got a great record and a great reputation in bonds and in emerging markets, and so, the PIMCO emerging markets currency portfolio. You're not buying Tibot and stuffing them into a mattress. You're buying Ti short maturity debt which has a beautiful premium yield.

CONSUELO MACK: Not hedged.

ROB ARNOTT: Unhedged.

CONSUELO MACK: Unhedged. Right.

ROB ARNOTT: So that if the currency doesn't take away the entire yield premium, or better still, if the currency recovers, then you get high yield with rising valuation from the currency rising. And emerging markets' currencies are broadly very, very cheap.

CONSUELO MACK: Rob Arnott, always a pleasure to have you on *WEALTHTRACK*. Thanks so much for joining us.

ROB ARNOTT: Thank you so much. This has been fun.

CONSUELO MACK: At the close of every *WEALTHTRACK* we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is: **act like a contrarian and systematically rebalance your portfolio**. That means periodically adjusting your investments back to the appropriate allocations pre-determined by you and your financial advisor. By trimming big winners and adding to substantial laggards.

Arnott adjusts some of his fundamental indexes annually and others quarterly. You don't have to do it frequently; just have a plan to do it at least once a year to have a disciplined approach to buying low and selling high.

Next week, we will have an exclusive interview with Wall Street's top strategist François Trahan. Why has this bull just turned bearish? We'll find out.

In the meantime to hear why Rob Arnott chases solar eclipses in his spare time, go to the Extra feature on our website, wealthtrack.com.

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Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.

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