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Are smart beta funds a better alternative to large-caps?

These funds have outperformed large-caps over the past year, but need to build a longer track record to rely on.

by **Sanket Dhanorkar**

Investors don't have to restrict themselves to choosing between active and passive investment strategies. They can also opt for a smart beta strategy—a meeting point of active and passive investing. Funds following this strategy are growing in numbers. But are smart beta funds the right fit for you?

Where smart beta fits in

In active investing, fund managers seek to deliver higher returns (alpha) compared to their funds' respective benchmark indices. They take active positions in select stocks by investing in them in proportions that are different than that of the benchmark index. They may also invest in stocks not part of the index. Actively-managed funds charge a higher fee because the manager invests time and resources in identifying winning stocks. Passive schemes, such as index funds and exchange traded funds, just aim to mimic the return of their underlying indices by investing in the same set of stocks and in the same proportion as the index. They charge investors a lot less as there is no active management involved.

There are limits to both active and passive investing strategies. "If you merely track the index with a passive fund, you will miss out on outperformance, whereas active funds promise alpha but few actually deliver, after accounting for expenses," says Vikas Gupta, CEO and Chief Investment Strategist, OmniScience Capital.

Funds based on the smart beta strategy offer a middle path to investors. This strategy seeks to enhance returns from the base index by buying a larger proportion of stocks compared to their share in the underlying index, based on factors that a fund manager thinks will lead to outperformance. "Smart beta adds certain quantitative filters to pure passive strategies that can induce outperformance over time," says Prateek Pant, Head, Products and Solutions, Sanctum Wealth Management. For instance, a smart beta strategy focusing on quality will allocate more to companies with higher earnings growth, stable cash flows and low debt. A low-volatility ETF's portfolio will comprise companies with more stability in earnings and stocks with low volatility in price. By allocating to select stocks and rebalancing occasionally based on predefined parameters, smart beta funds can potentially offer better risk-adjusted return than a traditional index fund. While smart beta funds charge higher fees than vanilla index funds or ETFs, they are far cheaper than actively-managed funds.

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Several smart beta funds have outperformed...

FUNDS	1-YEAR RETURNS (%)	EXPENSE RATIOS (%)
Reliance ETF NV20	8.59	0.16
Kotak NV 20 ETF	8.50	0.05
ICICI Pru NV20 ETF	8.26	0.45
Edelweiss ETF Nifty 100 Quality 30	5.89	0.27
ICICI Pru Nifty Low Vol 30 ETF	5.82	0.42
Large-cap fund category average	**0.20**	

...but some schemes have fared poorly

FUNDS	1-YEAR RETURNS (%)	EXPENSE RATIOS (%)
Sundaram Smart NIFTY 100 Equal Wt	-7.7	1.5
DSP Equal Nifty 50	-5.93	0.9
Principal Nifty 100 Equal Wt	-4.35	1

Data as on 23 Nov 2018

Source: Value Research

Complementary play at best

Over the past one year, even as active large-cap funds have severely underperformed, smart beta funds have fared well. In fact, the table toppers from the large-cap category are all smart beta funds. However, as these are new entrants, it remains to be seen if they can deliver in the future as well. To be sure, there are limitations to smart beta investing. There is an element of cyclicality as funds, based on different factors, may perform well at different times. So, a smart beta fund based on 'low volatility' may contain losses better during a market slide but will likely underperform during a momentum-driven market rally. Gupta points out that investors need to be patient with smart beta strategy as it takes a longer time to deliver outperformance. "Investors should have a clear understanding of the factors driving the smart beta fund. Typically, such funds are introduced when the underlying factor has already been outperforming for a while," he says. Besides, most current smart beta funds are ETFs with poor liquidity, which may hinder investors from exiting.

Experts insist that active funds continue to be the best bet for building wealth over the long term, while smart beta can be a better alternative to traditional passive funds. Pant argues, "Smart beta funds are more relevant in the large-cap space where active funds are finding it difficult to outperform. Over time, the saving on costs will allow healthy compounding in returns." Ankur Maheshwari, CEO, Wealth Management, Equirus Capital, reckons that smart-beta funds can complement the existing portfolio. "These are a good proposition, if you are keen to invest in a specific theme not typically represented in active funds," he says and suggests limiting smart beat exposure to 10% of the portfolio.

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