Investment Fund Construction

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The terms “Alpha”, “Beta” and “Smart Beta” are now an ingredient in the Wall Street and Pension investment language lexicon.

Alpha is defined as the skill required of the fund custodian or investor, to successfully identify, select and choose specific investment assets that will hopefully outperform the market. It’s a value added fund portending positive tactical investment bets.

Beta is defined as the rate of return received or achieved from those selected assets and their respective allocation.

Smart Beta is a strategic deviation from the standard investment approach strategies that attempt to enhance the return even more than prevailing standard expectations.

What then is the standard benchmark? The most common one is the Cap-Weighted approach. This is where the custodian or investor buys stocks and/or bonds in proportion to their market value at the time (i.e. 60% stocks and 40% bonds prevalent mostly within index funds where stocks have 90% of Volatility and Bonds have 10%).

This cap-weighted fund approach is still the norm however because of the current (2013) pension <u>underfunding</u> issue with many *investor groups*, smart beta is becoming an investment matrix to be aware of. This phenomenon is coming to the forefront because these underfunded (cash shortfalls) have to be made-up achieve the funds’ ultimate investment objectives for the future.

Here are a few of the *smart-beta* approaches some are using to achieve the catch-up funding goals:

Smart Beta

1. <u>Fundamental Indexing</u>: This process requires weighting of each stock (or bond) as to it’s fundamental financial characteristics as a investment measurement. For example, the fund can be strategically weighted as to its sales, dividends, assets, diluted earnings or it’s cash flows. This approach depends on large cap value stocks to beat small cap growth stocks since small caps can be perceived to be illiquid and risky.

2. <u>Volatility Weighting</u>: The custodian or investor weights the index balance based upon the past and anticipated volatility of the stock or other targeted asset. For example, large cap-value or small cap growth stocks or bonds. The heaviest favored weighting goes to the <u>least</u> volatile and more stable stocks (or bonds). This approach empirically and historically does very well over the long term

(10-20 years_. Nonetheless, there isn't always a free lunch here. If you push down on one risk, another pops up elsewhere (utility stocks in an increasing interest rate environment are an example).