Smart Beta Investing Has Underlying Problems

By Ben Broadwater
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Whether markets are up or down, investors are always looking for ways to beat the odds. Everyone wants to feel like their investing strategy is as solid as it possibly can be, regardless of the market conditions. One such strategy is a smart beta investing approach.

What is Smart Beta Investing?

Roughly fifteen years ago, a professional services firm called Towers Watson coined the term “smart beta.” However, the term was around long before that, dating back to the 1970s. It took more than 30 years for the first beta ETF to launch in 2003. Since then, smart beta fund managers have been tweaking and refining their investment strategies and methodologies.

According to ETF.com, with 1,209 ETFs traded on the U.S. markets, Smart Beta ETFs have total assets under management of $1,574.77B. The largest Smart Beta ETF is the Vanguard Value ETF VTV with $101.00B in assets.*

Smart beta refers to enhanced indexing strategies that seek to exploit certain performance factors in an attempt to outperform a benchmark index. Smart beta investing is essentially a combination of both active and passive investing. Taking the best of the two for the most optimal outcome.

Smart beta aims to give investors an edge by lowering risk, increasing diversification and decreasing overall cost. All this while creating the most optimal portfolio possible. Efficiency and value are the two main points of interest. At least one or more of these factors are rolled up into customized indexes or ETFs. However, as IJU Einstein and Quantitative Expert Nicholas Vardy explains...often the instant a smart beta strategy is introduced through an ETF, it stops working.

The Underlying Problem

Just last month, Nicholas Vardy wrote an article for Liberty Through Wealth called "The Underlying Problem with Smart Beta ETFs". In it he explains some of the less noted issues with the investing approach.

*These smart beta ETFs bet on factors like momentum or the Dividend Aristocrats to beat the market. Each of these strategies is backed by research conducted at the world's leading investment firms and business schools. Yet I've been disappointed by the real-world performance of smart beta ETFs. It seems that the instant a strategy is introduced through an ETF, it stops working.*
Nicholas goes on to reference an essay from Stanford Medicine professor John Ioannidis, called ‘Why Most Published Research Findings Are False’. In it, Ioannidis reveals how the “results published in many medical research papers cannot be replicated by other researchers.” Ioannidis’ financial counterpart, Campbell Harvey, a professor of finance at Duke University, estimates that “at least half of the 400 market-beating strategies identified in top financial journals over the past years are worthless. He challenges academics to take any so-called winning strategy and ask a different set of researchers to replicate it. And chances are about 50-50 that they can’t. Even worse, Harvey argues that his fellow academics are in complete denial about the problem.”

**Data Manipulation**

Vardy then goes on to talk about how smart beta data can be manipulated...

> “In statistics, a p-value represents the probability that a finding is statistically significant – attributable to an actual factor and not pure chance. For example, it will show whether a particular drug works or whether value stocks outperform over time.

*The problem is this:* Researchers twist the data – blatantly or subconsciously. They may cherry-pick the metrics used or adjust the time period studied to obtain a statistically significant result. We can blame “the system” for this problem.

Young finance professors can publish a paper with an eye-catching find in a prestigious journal – and they just might get tenure. As a result, investment strategies that look terrific on paper often flop in the real world.”

**Smart Beta Investing – Summarized**

As Nicholas and others have pointed out, many of the strategies surrounding smart beta investing are quite impressive. However, now that the term smart beta has been around for more than a few decades, it has lost some of its magic. The real world performance of smart beta ETFs has often missed the mark.

To learn more about smart beta investing, value investing, insider trading and more... sign up for one of our free e-letters today. Just visit our best investment newsletters page and select a free mailing that fits your investing style. If you’d like to follow more of Nicholas Vardy’s work, sign up for Liberty Through Wealth today.

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**About Ben Broadwater**

Ben Broadwater is the Director of Investment U. He has more than 15 years of content creation experience. He has worked and written for numerous companies in the financial publishing space, including Charles Street Research, The Oxford Club and now Investment U. When Ben isn’t busy running Investment U, you can usually find him with a pair of drumsticks or a guitar in his hand.

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[2/4]