MONEY

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Time to 'smarten' up portfolio

So-called "smart beta" investing requires some careful thought. Barry O'Neill, investment director with award-winning financial planning firm Carbon Financial Partners in Aberdeen, explains what it is

The smart beta investment approach to investments is starting to feature regularly in financial pages.

To understand just how smart it really is, we first need to go back to basics.

In investment terms, "beta" means the level of risk – or more accurately volatility – associated with an investment when compared to the market as a whole.

If an investment has a beta of 1, it should move up or down in value in tandem with the whole market. A beta of less than or greater than 1 means lower or higher volatility than the market respectively.

Traditional index tracker funds usually have a beta very close to 1 as they seek to deliver the risk and return characteristics of the market as a whole, at minimal cost. The most well-known mainstream index in the UK is the FTSE 100 Index.

Barry O'Neill

Passive funds that track this index should deliver a return very similar to that of the index, less the cost of running that fund, and have done so with broadly similar levels of risk.

Warren Buffett proclaimed index-investing as the most suitable way to invest for most investors.

However, one issue with tracking a mainstream index like the FTSE 100 is that a small number of very large companies account for a significant part of the index. Returns will, therefore, be skewed to those companies and will not provide exposure to the large number of mid-sized or smaller firms that make up the whole market.

Traditional index-tracker funds are also forced to buy overvalued securities and sell undervalued ones in order to continue to look like the index they are tracking. Actively managed funds claim to be able to beat the market by being clever at individual security selection, or timing entry to or exit from the market. But decades of academic research show very few such funds manage to consistently beat the index and trying to pick those that do in advance is near impossible. The smart beta approach is an attempt to overcome some of these perceived issues of traditional index investing, while still being cheaper than active management. Some of the methods employed are:

- Using indices that are not market cap weighted but based on some other fundamental, like book value or dividends.
- Employing greater flexibility as to when securities are purchased or sold.
- Targeting niche areas of markets that have higher expected returns or lower risk than the broad market.

If you are not sure how smart your portfolio is, now might be a great time to put it to the test.

POPULAR: The smart beta investment approach to investments is becoming more mainstream