The Asset Manager's Dilemma: How Smart Beta is disrupting the investment management industry

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The ultimate goal of disruptive innovation in investment management is to deliver superior investment outcomes and meet investors' needs as opposed to requests. In the case of smart beta, the outcome is higher returns and/or lower risk, after fees and costs.

Smart beta strategies have elements of both passive and active management. They are passive in that they are simple, rule based and transparent. They are active in that they require periodic balancing to maintain the desired exposure.

The expected return on any investment product can be broken down into 3 components:
1) Index/benchmark returns
2) Return from static exposure to smart beta factors
3) Return above and beyond static exposure to smart beta factors, also called alpha

Smart beta is a disruptive innovation because it provides value to investors at a lower cost. Many active managers deliver a significant portion of their returns via static exposures to smart beta factors while charging fees applicable to active management. Smart beta fees are significantly lower than active fees.

Smart beta strategy takes ideas already in use in active trading strategies and delivers them more cheaply and transparently. The innovation lies in cost and packaging, not in doing anything which is radically different. Managers who offer a mix of smart beta and pure alpha but charge pure alpha fees face a real threat from smart beta investment managers. All active managers need to carefully examine what they are doing and then conclude where their comparative advantage lies; smart beta or alpha.