



Best Practices in Smart Beta Indexing

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SMART BETA INDEX DEVELOPMENT

Developing a Superior Fund-Ready Smart Beta Index

- Step 1: Begin with an investment objective and strategy
- Step 2: Match it to the best benchmark universe for construction and comparative purposes
- Step 3: Match the strategy with a research-based security selection process (the “Alpha” file)
- Step 4: Determine the desired trade-offs between performance goals and risk control (the weighting scheme)
- Step 5: Develop construction and maintenance rules best suited to achieve goals while minimizing market friction and implementation costs

A Superior Smart Beta Index Must Be Designed to Achieve a Superior Return-Per-Unit-Risk Ratio to Its Benchmark Index

CHOOSING THE APPROPRIATE UNIVERSE BENCHMARK INDEXES



US Benchmarks

- S-Net US Equity 3000
- S-Net US Equity Large Cap 500
- S-Net US Equity Mid-Cap 500
- S-Net Large/Mid-Cap US Value
- S-Net Large/Mid-Cap US Growth
- S-Net US Equity Large Cap 1000
- S-Net US Equity Small Cap 2000

International Benchmarks

- S-Net Europe 500
- S-Net Pacific 500
- S-Net Developed Intl 1000
- S-Net Emerging 1000
- S-Net Emerging Investable 500

Alternative Benchmarks

- Closed-End Funds
- Master Limited Partnerships
- US REITS
- International REITS
- Pass-Thru Securities
- Global Commodity Stocks
- Global Alternative Energy
- Global Water
- Global Agriculture

Best practices benchmark universe indexes should have disclosed, transparent, and deterministic construction and maintenance rules with point-in-time data determining historical constituent sets

The “Alpha” File:

1. Stocks must be scored or rated by an algorithmic process that has plausible rationale for superior performance
2. Potential sources of superior rating methodology:
 - a. Data not in the 3 standard financial statements
 - b. Under-utilized metrics from the 10-K and/or market-related metrics
 - c. Conditional metrics with trigger function
 - d. Proprietary research and data sets

A Smart Beta Index Can Only Add Value In Periods When Its Alpha File Generates Positive Information Coefficients

WEIGHTING SCHEME

The Weighting Scheme:

1. Objective: Absolute return vs. Information ratio
2. Constraints: Sector, Industry, single-stock and other
3. Total universe inclusion (re-weighting) vs security selection / exclusion
4. Question: Does merely equally weighting the securities in a benchmark index actually qualify as Smart Beta?

The Weighting Scheme Is The Single Biggest Factor In The Portfolio's Ability To Control For Market and Idiosyncratic Risk

CONSTRUCTION AND MAINTENANCE RULES

Requirements for a Fund-Ready Smart Beta Index:

1. Best practices in “clean” back-testing PLUS
2. Stress-testing regarding liquidity and volatile market environments
3. Additional stress-testing considerations for global and international portfolios
4. Tax considerations: RIC requirements and other income treatment issues

A smart beta index should provide for real-world market contingencies to qualify as following best practices

THANK YOU

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