ESLICK FINANCIAL GROUP
How wealth works.

M WEALTH PERSPECTIVE

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Eslick Financial Group, Inc. provides sophisticated insurance and wealth management services to families, business owners, corporate executives, professionals, and other successful high income and high net worth individuals. Our team of professionals utilizes a customized process of defining, understanding, researching, evaluating, and informing our clients of innovative and uniquely integrated solutions tailored to their diverse financial goals. Our desire is to help make the otherwise complex, more understandable as it applies to your unique situation.

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Smart Beta

There has been much recent debate about the term smart beta, which is sometimes referred to as strategic beta, alternative beta, or intelligent beta to describe an investment strategy that provides an alternative to market capitalization weighting.

Today's investors are familiar with the passive management approach of index-based investing, in which a fund will track a given index that allocates its holdings based on each company's market capitalization. This strategy captures the performance of that market index (also known as beta). Critics of index-based investing highlight that this strategy forces its investors to buy more shares of high-priced stocks and fewer shares of lower-priced stocks that are underpriced. On the other hand, active management strives to strategically deliver returns that beat the market. Critics will quickly point out the inability of most active managers to deliver market returns and when they do, at a much higher cost. Smart beta acts as a hybrid between the two investment styles, by combining the strategic advantages of active management and implementing the lower investment costs offered through index-based investing.

While a smart beta strategy may fall between the two investment styles, there are numerous ways to develop a smart beta strategy. Some may lean toward a more passive style and others may be more active in nature. Regardless, there are a few basic smart beta approaches based on desired outcomes that investors should understand.

- ❖ The simplest approach is to give each stock equal weighting in the portfolio. If there are 100 stocks, then each stock would be equally weighted at 1%. This approach will tilt the allocation towards smaller stocks relative to a market cap weighted index.
- ❖ A second approach, known as "Fundamental Indexing," weights each stock based on the company's financial statistics. For example, the portfolio could be weighted based on a company's revenues, earnings, dividends, or book value. This approach ignores stock prices, which leads to an allocation heavier in value stocks.
- ❖ A third approach is to weight the index based on each stock's volatility, with the least volatile stock being more heavily weighted. The company's volatility is measured either by historical standard deviation or by the company's beta. This approach is based on research that shows it has both lower risk and higher long-term returns than the index-based approach. It is often referred to as the low-volatility strategy.
- ❖ A fourth approach uses price momentum, also known as the momentum effect, to buy stocks that have recently risen in price, and to sell stocks that have recently fallen in price. This approach is based on research showing stocks that have recently outperformed will continue to rise in the short term, and those that underperform will continue to lag.

The concept of smart beta can sound appealing, but there can be downsides to these strategies. One of the main concerns is the cost of rebalancing. Typically, smart beta portfolios will have higher transaction costs than index-based portfolios. A smart

beta portfolio will often have to realign or rebalance its holdings as prices fluctuate, whereas an index-based portfolio does not need to trade any holdings. These incurred costs can make a smart beta portfolio more expensive than an index-based portfolio, but typically still cost less than an actively managed portfolio.

The equal weighted approach takes advantage of smaller stocks outperforming large stocks in the long run. Fundamental indexing capitalizes on value stocks outperforming growth stocks. While this explains why certain smart beta portfolios perform better than index-based portfolios, it is not a "free lunch" as smaller and value stocks are typically more volatile (i.e., riskier).

M Wealth's investment philosophy has much in common with these smart beta approaches. We believe that risk and return are related. Therefore, we intentionally tilt toward small company and value stocks in order to strive for higher long-term returns. We utilize mutual funds, which include trading rules that take into account the momentum effect. Lastly, whereas we do not see the benefit of a low-volatility stock strategy—stock investors should be focused on the long-term and not annual volatility—we do see the benefit of reducing volatility in portfolios. We do this by using bonds to balance stock risk and to fund short-term goals.

While the investment industry will always be generating buzzwords in order to make new products and concepts more marketable, M Wealth continues to believe in a well-diversified strategic asset allocation that focuses on disciplined long-term portfolio management based on a client's goals and fundamentals.

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