

Smart Beta Portfolio Optimization

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Abstract : Traditionally, portfolio managers have been discouraged from timing the market. This means, for example, that equity managers have been forced to adhere strictly to a benchmark with static or relatively stable components, such as the SP 500 or the Russell 3000. This means that the portfolio's exposures to all risk factors should mimic as closely as possible the corresponding exposures of the benchmark. The main risk factor, of course, is the market itself. Effectively, a long-only portfolio would be constrained to have a beta 1. More recently, however, managers have been given greater discretion to adjust their portfolio's risk exposures (in particular, the beta of their portfolio) dynamically to match the manager's beliefs about future performance of the risk factors themselves. This freedom translates into the manager's ability to adjust the portfolio's beta dynamically. These strategies have come to be known as smart beta strategies. Adjusting beta dynamically amounts to attempting to "time" the market; that is, to increase exposure when one anticipates that the market will rise, and to decrease it when one anticipates that the market will fall. Traditionally, market timing has been believed to be impossible to perform effectively and consistently. Moreover, if a majority of market participants do it, their combined actions could destabilize the market. The aim of this project is to investigate so-called smart beta strategies to determine if they really can add value, or if they are merely marketing gimmicks used to sell dubious investment strategies.

Keywords : beta, alpha, active portfolio management, trading strategies

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