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Mind the gap! Scientific Beta highlights the importance of market risk in smart beta strategies

New research paper published in the *Journal of Portfolio Management*

In a new research paper entitled "Mind the Gap: On the Importance of Understanding and Controlling Market Risk in Smart Beta Strategies," published in a special 2018 issue of the *Journal of Portfolio Management* on factor investing, Scientific Beta argues that more attention should be paid to market exposure when conducting analyses of smart beta strategies.

Most research proposing new multi-factor investment methodologies essentially ignores exposure to the market factor, which is the most consensual among all factors and often the most influential factor for a strategy. Over the long term adjusting the market beta of a multi-factor strategy with that of a cap-weighted index corresponds to an annual gain in performance of more than 1%.

More generally, the authors demonstrate that different levels of market beta have a strong impact on the performance and risk of smart beta strategies in terms of long-term returns, volatility, and the dependence of performance on market conditions.

Commenting on the paper, Noël Amenc, CEO of ERI Scientific Beta, said, "The Multi-Beta Multi-Strategy Six-Factor High Factor Intensity Equal Weight offering has been Scientific Beta's flagship offering since last year. There are now two versions of this offering: with and without market beta control. This distinction, with and without Market Beta Adjustment (MBA), corresponds to a very straightforward approach since these two versions have the same Sharpe ratio over the long term. The version without the MBA risk control option has a defensive beta bias and as such has lower volatility than that of the market and given its low market beta bias, does not allow one to benefit from all the returns of the markets. The MBA version, whether it is implemented in the form of overlay or leveraged, logically has volatility that is quite similar to that of the market, since the strategy is 100% exposed to the volatility of the market, and therefore constructs its improvement in the Sharpe ratio over the long term on the excess return procured by factor premia.

Ultimately the version without MBA is probably the version that corresponds best to an absolute risk budgeting, and therefore cap-weighted benchmark substitution, approach. The version with MBA corresponds best to a relative risk budgeting (conditional relative performance, tracking error) approach and as such is surely recommended for investors who are concerned about replacing an active manager."

The paper can be downloaded from the following link:

Mind the Gap: On the Importance of Understanding and Controlling Market Risk in Smart Beta Strategies

Contact:
For more information, please contact: **Laure Barralis**
Tel.: **+33 493 187 863** – E-mail: laure.barralis@scientificbeta.com
To visit our web site: www.scientificbeta.com

About ERI Scientific Beta

ERI Scientific Beta aims to be the first provider of a smart beta indices platform to help investors understand and invest in advanced beta equity strategies.

Established by EDHEC-Risk Institute, one of the very top academic institutions in the field of fundamental and applied research for the investment industry, ERI Scientific Beta shares the same concern for scientific rigour and veracity, which it applies to all the services that it offers investors and asset managers.

The ERI Scientific Beta offering covers three major services:

- **Scientific Beta Indices**
  Scientific Beta Indices are smart beta indices that aim to be the reference for the investment and analysis of alternative beta strategies. Scientific Beta Indices reflect the state-of-the-art in the construction of different alternative beta strategies and allow for a flexible choice among a wide range of options at each stage of their construction process. This choice enables users of the platform to construct their own benchmark, thus controlling the risks of investing in this new type of beta (Smart Beta 2.0).

  Within the framework of Smart Beta 2.0 offerings, ERI Scientific Beta provides access to smart factor indices, which give exposure to risk factors that are well rewarded over the long term while at the same time diversifying away unrewarded specific risks. By combining these smart factor indices, one can design very high performance passive investment solutions.

- **Scientific Beta Analytics**
  Scientific Beta Analytics are detailed analytics and exhaustive information on its smart beta indices to allow investors to evaluate the advanced beta strategies in terms of risk and performance. The analytics capabilities include risk and performance assessments, factor and sector attribution, and relative risk assessment. Scientific Beta Analytics also allow the liquidity, turnover and diversification quality of the indices offered to be analysed. In the same way, analytics provide an evaluation of the probability of out-of-sample outperformance of the various strategies present on the platform.

- **Scientific Beta Fully-Customised Benchmarks and Smart Beta Solutions** is a service proposed by ERI Scientific Beta, and its partners, in the context of an advisory relationship for the construction and implementation of benchmarks specially designed to meet the specific objectives and constraints of investors and asset managers. This service notably offers the possibility of determining specific combinations of factors, considering optimal combinations of smart beta strategies, defining a stock universe specific to the investor, and taking account of specific risk constraints during the benchmark construction process.

With a concern to provide worldwide client servicing, ERI Scientific Beta is present in Boston, London, Nice, Singapore and Tokyo. As of December 31, 2017, the Scientific Beta indices corresponded to USD 25bn in assets under replication. ERI Scientific Beta has a dedicated team of 45 people who cover not only client support from Nice, Singapore and Boston, but also the development, production and promotion of its index offering. ERI Scientific Beta signed the United Nations-supported Principles for Responsible Investment (PRI) on September 27, 2016.