The demand for fundamental index funds, also known as "smart beta," continues to grow at a rapid pace. Unlike traditional index funds, which weight components based on market capitalization, these funds utilize fundamental factors such sales, earnings, dividends and book value. In doing so, proponents of fundamental indices argue that they are avoiding the pitfalls of a market capitalization approach, namely that such an approach overweights stocks that have advanced the most (and are overvalued) and underweights stocks that have declined the most (and are undervalued).

By ignoring price in their weighting methodology, the argument is essentially that they have built a better mousetrap. And at first blush, by looking at the historical outperformance of a fundamental index approach, it appears that they have. But a deeper dive reveals the dirty little secret of "smart beta," which is that it is simply benefitting from two factors already known to have enhanced performance in the past: value and small-cap tilts. As James Montier of GMO wrote in his December 2013 white paper, "When these strategies are corrected for their exposure to 'value' and 'small,' they exhibit no statistically significant outperformance compared to the cap weighted benchmark." Montier adds that isn't even a guarantee that value (cheap price to book) and small caps will "outperform independent of their pricing," and that now is a particularly inconvenient time to use smart beta as "both value and small have very unattractive expected returns in the U.S. on our data."

We can see this in looking at the year-to-date performance of one of the more popular fundamental index exchange-traded funds, the PowerShares FTSE RAFI U.S. 1000 Portfolio. This ETF is up 32.3 percent year to date, versus a 29.6 percent gain for the S&P 500. But as the components of PowerShares FTSE RAFI U.S. 1000 display a small-cap and value tilt, a better benchmark is the Russell 2000 index, which is actually outperforming PowerShares FTSE TAFI U.S. 1000 and is up 33.5 percent year to date.

The reality, then, is that "smart beta" is simply a rebranding of the age-old concept that small caps and value stocks have tended to outperform over time. But if this is the case, why not invest directly in these factors with lower-fee, traditional passive index funds? The expense ratio on many popular small-cap ETFs is around 0.10 percent and significantly lower than PowerShares FTSE RAFI U.S. 1000's expense ratio of 0.39 percent. You are essentially paying an additional fee for the construction of an index that is substantially similar to the traditional value and small-cap indices.

Another issue with fundamental indices, given their value and small cap bias, is that they are relying on the relative attractiveness of these factors. In 2000, both value and small-caps were particularly cheap relative to large-caps and growth and over the subsequent years, significantly outperformed. Fast forward to today, and you have the opposite situation, particularly in small-caps, which are among the most overvalued asset classes globally. This suggests fundamental indices, which are currently biased toward small-caps, are more likely to underperform in the coming years.

Rick Ferri, founder of Portfolio Solutions, pointed out that according to the inventor of the investing term "beta," William Sharpe, the term "smart beta" doesn't really mean anything and is simply a marketing ploy.

"According to its inventor, beta is neither smart nor intelligent, and there isn't a better beta or an alternative beta … The attention-grabbing spin on beta is a creation of investment firms that seek to funnel money into products that may have greater risk and higher fees than low-cost index funds that track markets," Ferri wrote on his website.

In summary, we should drop the "smart" from so-called "smart beta." While fundamental index funds have done a great job marketing their products, in the end, they are simply just beta to value, small-caps or some combination of the two. If you want just beta, though, you can achieve a similar result with lower fees by going directly to the source, namely value and small-cap index funds. But keep in mind that, like anything else, the relative attractiveness of value and small-cap beta can vary significantly over time. Given small-cap overvaluation, a strong case can be made today that you should actually be tilting your portfolio in the other direction, in favor of large-caps.