



A seat at the table

Make room for strategic beta
and the elusive potential it offers



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KEY TAKEAWAYS

Strategic beta² bridges the gap between traditional passive investing and active management:

- > Provides a disciplined, active approach to indexing in a cost-effective manner
- > Allows for transparent exposure to a portfolio of preferred factors
- > Acts as a tactical tool that may enhance passive allocation and counterbalances some of the limitations of cap-weighted indexing

1 A basis point is one hundredth of a percent; often used in reference to a fund's annual expense ratio.

2 Strategic beta refers to rules-based investment strategies that do not use traditional market capitalization weights. Rather, a strategic beta ETF uses alternative weighting schemes based on measures such as volatility or dividends.

3 Factors are isolated components of an investment that influence performance and risk characteristics.

IN CASE YOU HAVEN'T NOTICED, there is a seismic shift underway in the asset management business. Investors of all ilk are becoming increasingly focused on fees and relative performance, and rightly so. This is having repercussions across the product spectrum, from hedge funds and their "two-and-twenty" fee structures to the most rudimentary passive strategies that charge just a handful of basis points.¹

Investors will no longer stand for the status quo, and their heightened consciousness has given rise to new products and strategies. Perhaps the current belle of the ball is strategic beta, that hard-to-define approach that is garnering media attention and a bucketful of assets to boot.

Investors have been eating up strategic beta, but is this the financial industry's latest flavor of the day—or is it a substantive approach with staying power? Given that strategic beta offers the elusive potential of attractive returns with potentially less risk and reasonable costs, it just might deserve a place in an investor's portfolio. But as with every "next great thing," details matter and caveats apply.

What's the fuss?

Strategic beta—often called "smart beta"—refers to a set of indexes and their corresponding investment products. Typically, these strategic beta indexes are rules based and

constructed differently than traditional market-capitalization-weighted benchmarks, whereby the largest index components are owned proportionally and thus hold greater sway over performance.

"The challenge with traditional market-cap weighting is it can lead to concentrations that erode the benefits of diversification," explains Mannik S. Dhillon, Head of Investment Solutions, Product, and Strategy with Victory Capital. "While cap-weighted benchmarks can effectively measure a market, they are not always the best investment solution. That's why I think there's a definitive role for strategic beta ETFs in most investors' portfolios."

In contrast to traditional cap-weighted indexes, strategic beta offers alternative weighting approaches that can potentially minimize or eliminate some of the inherent limitations of passive investing. Moreover, strategic beta is designed to take elements of active portfolios, seeking to capture exposure to certain investment factors³ or otherwise exploit market inefficiencies in an attempt to deliver better risk-adjusted outcomes, all while retaining the benefits of passive investing.

One simplified way to consider strategic beta is that it bridges the gap between traditional passive investing and active management. Another way is to view it as a disciplined, "active" approach to indexing done

cost effectively. Investments in strategic beta can be made via a variety of investment vehicles, though the transparency afforded by strategic beta and the potential cost-efficiency works well in an ETF wrapper.

Fundamentally based indexes were launched in the early aughts, circa 2004, though it's fair to note that the price-weighted DJIA was first published in 1896, long before anyone cleverly coined the name strategic beta. Today, this has emerged as a mega-trend of investment sponsors launching new indexes (and their corresponding tracking products) that aim to exploit specific investment factors, such as value, small size, low volatility, high yield, quality, and momentum.

Filling the void

According to ETF.com,⁴ an industry authority providing news, analysis and education on ETFs, there are now hundreds of smart beta products that aim to deliver better risk-adjusted returns compared to traditional cap-weighted indexes and hundreds of billions of dollars benchmarked to them. The growth of this category has been nothing less than explosive.

“Academic studies have demonstrated that certain investment factors can be used to explain investment returns, isolated in a passive way, and exploited to outperform traditional cap-weighted benchmarks,” says Dhillon. “This can help replicate components of active strategies.

THE NAME GAME

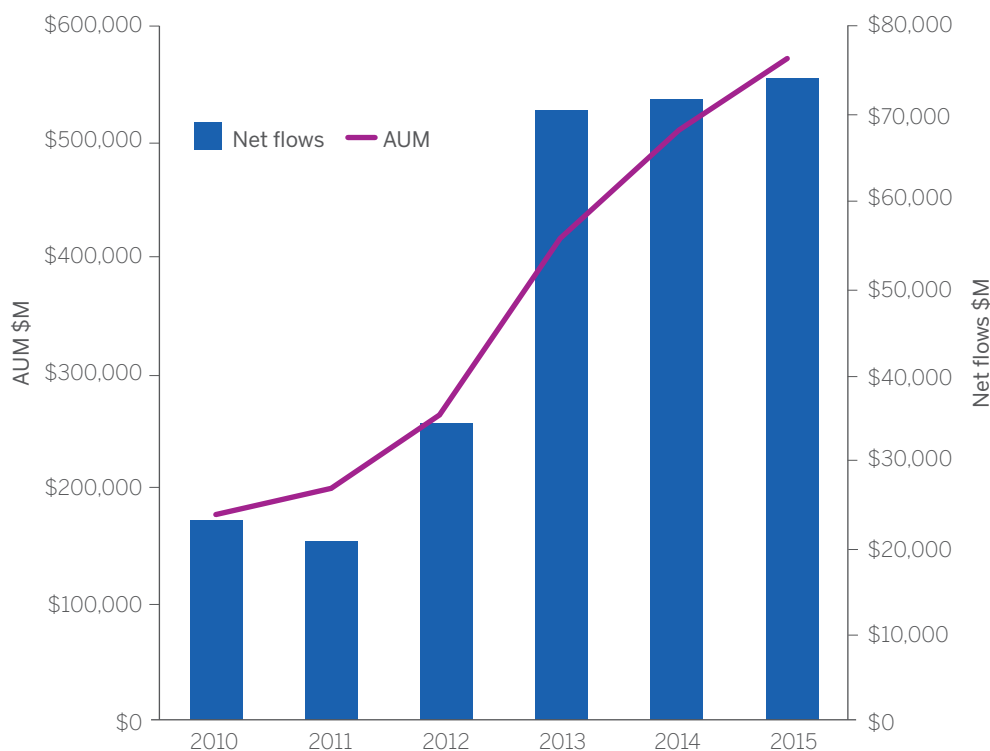
As the FT lexicon astutely points out, “Smart beta is a rather elusive term in modern finance. It lacks a strict definition and is also known as advanced beta, alternative beta or strategy indices.”

But the name game doesn't end there. Scientific beta, enhanced indexing, factor investing, alternative-weighted, and active beta are also among the many monikers used for these strategies. Investors should be savvy to these names and, more importantly, to the underlying rules and approach used by each index and corresponding product.

⁴ Source: <http://www.etf.com/channels/smart-beta-etfs>

IT'S NOT A FAD




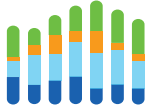
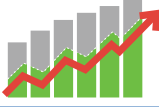

Growth of strategic beta products



Source: FUSE, Morningstar, as of December 31, 2015.

JUST THE FACTORS

Listed below are well-known systematic factors from academic research. Today, investors can easily access these factors.

FACTORS	WHAT IT IS	COMMONLY CAPTURED BY
Low volatility 	Captures excess returns to stocks with lower-than-average volatility, beta, and/or idiosyncratic risk	Standard deviation, ⁵ downside standard deviation, beta ⁶
Dividend yield 	Captures excess returns to stocks that have higher-than-average dividends	Dividend yield
Quality 	Captures excess returns to stocks that are characterized by low debt, stable earnings growth, and other “quality” metrics	ROE, ⁷ earnings stability, dividend growth stability, strength of balance sheet
Momentum 	Reflects excess returns to stocks with stronger past performance	Relative returns, historical alpha ⁸
Value 	Captures excess returns to stocks that have low prices relative to their fundamental value	Price-to-book, ⁹ earnings to price, book value ⁹
Low size 	Captures excess returns of smaller firms relative to their larger counterparts	Market capitalization

5 Standard deviation is a statistical measure of volatility and is often used as an indicator of risk.

6 Beta is a measure of the volatility, or systematic risk, of a security or portfolio in comparison to the market as a whole.

7 Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. ROE measures a company’s profitability by comparing profit to the money shareholders have invested.

8 Alpha is a measure of the excess return of a fund relative to the return of a benchmark index.

9 Price-to-book ratio (P/B ratio) compares a stock’s market value (price) to its book value (the net asset value of an asset, calculated as total assets minus intangible assets and liabilities). A lower P/B ratio could mean a stock is undervalued.

And if investors can gain exposure to a portfolio of preferred factors in a cost-effective manner, you can see the appeal. The asset management business has recognized this and moved quickly to meet demand.”

It’s fair to say that ETFs are not a fad, and strategic beta strategies are growing as investors continue to gravitate toward lower-cost passive strategies that can be tweaked for

exposure to specific factors that can, potentially, improve outcomes. Additionally, these approaches provide the opportunity to use well-known, objective criteria to select and weight securities in a way that not only offers potential advantages to cap-weighted indexing but is also more cost-effective than higher-cost active funds.

Dhillon explains that an active manager’s return can be broken down

into three components. There's beta, defined as simple market exposure, and true alpha, which is the result of manager skill or some information advantage. "And then there's that slice in the middle that comes from exposure to certain characteristics or factors, such as high dividends, or growth," Dhillon points out.

That's the appeal. Of course when any strategy quickly grows in popularity, investors would be wise to consider what typically happens when too many managers begin relying on the same insights or deploying similar philosophies. In other words, do investors need to worry about if and when the crowds head for the exits?

This question may be particularly relevant for one enticing strategic beta approach—low volatility—that is generating significant buzz from investors and financial media alike. Nobody wants to relive the 2008/09 drawdowns of the Global Financial Crisis or even those of the 2001 tech bubble. And now seven-plus years into a bull market, some investors are wondering how much longer equities can grind higher before a significant pullback. Against that backdrop, it's no surprise that low-vol strategies are appealing to investors.

Several indexes and corresponding low-volatility products have emerged. For example, the S&P 500® Low Volatility Index¹⁰ screens for the 100 least-volatile stocks in the S&P 500® Index,¹¹ and the funds typically tracking this benchmark offer investors the lure of equity exposure with, presumably, less turbulence. It's

a sound theory with a strong pitch, but as with most strategies it requires a closer look.

If a product focuses on a very narrow segment of the equities universe, what are the hidden ramifications? For one, there may be unintended sector risk. A portfolio that loads up exclusively on the lowest-volatility stocks, for example, may feature elevated allocations to utilities. But in a hypothetical rising rate environment, such a portfolio heavy on utilities, which historically are considered interest rate-sensitive businesses, may be poised to underperform.

"And don't forget the importance of valuations," Dhillon reminds us.

"With so much capital crowding into a single factor, investors need to ask if these funds are chasing a narrow group of equities at the top of a cycle. In other words, at current valuations, low-vol stocks may not be positioned to deliver on their promise of smoother returns going forward."

Dividend-focused strategies are yet another example of a popular factor-based approach attracting investor interest. That's no surprise during a time when 10-year Treasuries have been depressed and investors are reaching for yield and income alternatives. But as always, there are potential problems with simply rounding up all the highest-yielding dividend payers.

For one, there's a similar potential sector risk in building a portfolio reliant on real estate investment trusts (REITs), consumer staples, and master

"At current valuations, low-vol stocks may not be positioned to deliver on their promise of smoother returns going forward."

10 The S&P 500® Index is a market-capitalization-weighted index generally considered to be representative of U.S. equity market activity. The index consists of 500 stocks representing leading industries of the U.S. economy.

11 The S&P 500® Low Volatility Index measures performance of the 100 least volatile stocks in the S&P 500 which are weighted relative to the inverse of their corresponding volatility, with the least volatile stocks receiving the highest weights.

limited partnerships (MLPs). And it's important to remember that equity dividend yields are, by definition, a percentage of share price. Thus if a company's price per share plummets and the quarterly payout remains the same, the yield will increase. So while a rules-based and transparent strategic beta index can identify the highest-yielding stocks, it does not necessarily mean those companies are healthy and poised for outperformance going forward.

Dhillon suggests that a more thoughtful way to capture the appeal of high-dividend stocks may require some combination of fundamental criteria and risk weighting. Selecting the highest dividend-yielding stocks and then weighting them based on standard deviation or some measure of volatility could add an important layer of risk management and, ultimately, provide a viable alternative to traditional beta approaches.

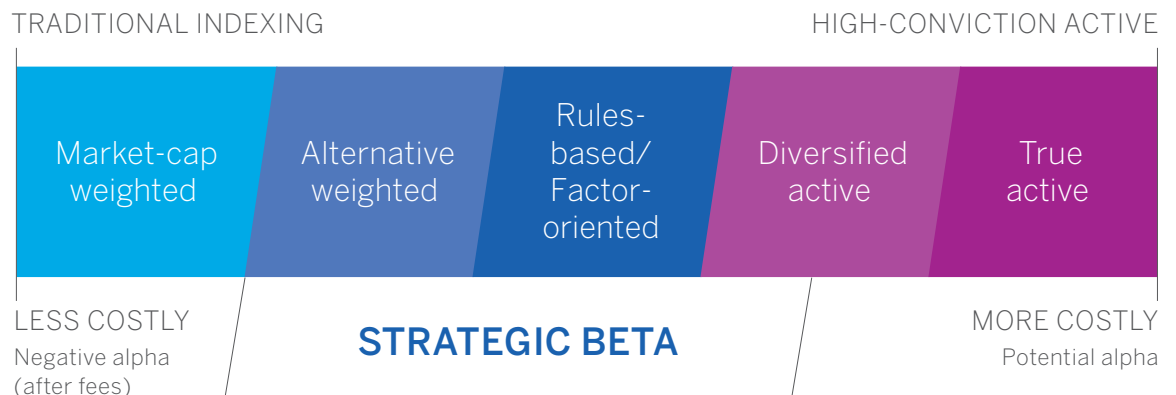
“One simplified approach might be to use traditional passive funds as the base of the portfolio.”

Bridge the gap

If investors have begun to recognize the potential benefits of enhanced passive strategies, the next logical question is: What role should strategic beta play in an investor's portfolio?

Above all else, advisors and investors should realize that strategic beta is not an all-or-nothing proposition, and it should not attempt to completely replace a passive—or active—allocation. Anyone arguing that position likely has a hidden agenda. Rather, it may be effective as a tactical tool that enhances a passive allocation and acts as a counterbalance to some of the limitations of cap-weighted indexing.

If the aim is to build a better portfolio, one simplified approach might be to use traditional passive funds as the base of the portfolio. Investors can use these building blocks to access very broad and liquid segments of the equity market for just a handful of basis points.



GET SMART ON STRATEGIC BETA

As with any investment concept that grows rapidly in popularity, it's critical to read the fine print before making an allocation decision. That can be tricky with nuanced products in a category as broad as strategic beta, which can differ significantly from traditional passive strategies that track a market-cap-weighted index. Here are a few tips that advisors and investors should discuss before allocating to strategic beta:

- > Understand the investment objectives and, importantly, the methodology behind the index construction.
- > Consider the potential unintended ramifications of an allocation in different market environments and inflation regimes.
- > Confirm the true cost of the investment. Typically, strategic beta is priced higher than traditional cap-weighted indexing and lower than actively managed funds, but not always.
- > Focus on liquidity, especially with new products that rely on a single factor or a narrow section of the equities universe. Thin trading can result in heightened volatility and bid-ask spreads.
- > Recognize that simpler is sometimes better. An easily understood methodology may have broader appeal.

"Strategic beta can then be used to enhance traditional indexing," explains Dhillon. "It's a cost-effective way to incorporate something a little different, such as volatility weighting, or to gain exposure to quality, value, small size, or any other factors that are missing from an existing portfolio."

Strategic beta can also help investors use their risk and fee budget judiciously. Typically, these strategies are a little more expensive than traditional beta but less costly than most active strategies.

"That frees you up to use the majority of your risk budget for active

managers who chase true, differentiated alpha, such as concentrated, high-conviction approaches or niche sub-asset classes that might be a little more costly from a fee perspective but are generally less efficient and areas where active can win," he adds.

Adding specific factor exposures might also help capture those elusive uncorrelated returns, improve diversification, or even act as a vehicle to tilt a portfolio based on the macro environment or an investor's risk profile. Considering strategic beta as a way to bridge the gap in a portfolio that straddles active and passive just might be a smart approach after all. **VS**

"Strategic beta can also help investors use their risk and fee budget judiciously."



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Investing involves risk, including the potential loss of principal. Diversification and asset allocation do not guarantee a profit or protect from loss in a declining market. There is no guarantee that a strategic beta strategy will be successful. There can be no assurance that performance will be enhanced or risk will be reduced for funds that seek to provide exposure to certain quantitative investment characteristics ("factors"). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses. The annual management fees of ETFs may

be substantially less than those of active mutual funds. Buying and selling shares of ETFs will result in brokerage commissions, but the savings from lower annual fees can help offset these costs. Active funds typically charge more than index-linked products for the increased trading and research expenses that may be incurred.

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