

The Strategic Factor of Smart Beta

By Ben Johnson

Morningstar lays out a sensible approach to so-called “smart beta,” including a name change.

“Smart beta,” “alternative beta,” “enhanced indexes,” “quantamental indexes”—at this point, the list of monikers describing the fast-growing middle of the active-to-passive spectrum extends long enough to put it just a few syllables shy of making a lunar landing. It’s an arena that has further blurred the lines between active and passive management (Exhibit 1), and one which is at the leading edge of the most recent wave of product proliferation within the global exchange-traded products (ETPs) landscape.

What Morningstar is deeming *strategic beta* is a broad and rapidly growing category of benchmarks and the investment products that track them. The common thread among them is that they seek to either improve their return profile or alter their risk profile relative to more traditional market benchmarks. In the case of equity products, which account for the overwhelming majority of assets in this arena, the result is typically one or more factor tilts relative to standard market indexes (see “Factors 101 on Page 41).

As new products have continued to roll off asset managers’ assembly lines, their sales and marketing departments have been working tirelessly to position these new models within an increasingly competitive field. The result has been a ratcheting up of the level of complexity of the indexes that form the

raw stuff of these benchmark-based investment products and, in some cases, a growing disparity between how they are pitched by their sponsors and the actual investment results that they produce. Investors are faced with a complex task as they navigate this landscape, and Morningstar is working to provide the compass they need to do so.

A Brief Historical Detour

The proverb “there is nothing new under the sun” applies to this “new” corner of the asset-management arena. Academics distilled investment returns into their component factors decades ago. And others, most notably the eponymous founder of Barr Rosenberg Associates, had recombined these basic drivers of investment returns into investable products. In fact, Rosenberg’s “bionic betas” landed him on the cover of the May 1978 issue of *Institutional Investor* magazine.

So why is this time different? First, there have been major advances in information and investment technology since the mid-1970s that have given asset managers the horsepower necessary to efficiently manage more complex index strategies, to repackage them into the newest generation of strategy-delivery vessels (such as ETPs), and to deliver them at a low cost to investors. The past four decades have also been marked by steady secular growth in index investing. Since the

first index fund was launched in 1975, the portion of U.S. mutual fund and ETP assets accounted for by index-tracking products has grown from nothing to nearly 30% today. All told, the investment world of today is far more ready for these sorts of strategies than it was 40 years ago, when some people, as John Bogle has reported, were calling the concept of indexing “un-American.”

What’s in a Name?

The need to define this space, to measure it, and to police it has grown and will continue to grow with time. At Morningstar, we are positioning ourselves to meet these needs, all with the goal of helping investors make better-informed investment decisions. For our part, we have decided to tag this realm with the label *strategic beta*. Why *strategic beta*? First and foremost, we are eager to do away with the positive connotations inferred by the *smart* in *smart beta*. Not all of the strategies included in this arena are smart, per se. The term *strategic* is meant to draw attention to the fact that the benchmark indexes underlying the ETPs, mutual funds, and other investment products in this space are designed with a strategic objective in mind. These objectives primarily include attempting to improve performance relative to a traditional market-capitalization-weighted index or altering the level of risk relative to a standard benchmark.

As for the *beta* in the name, it is not meant to imply beta in the strictest, most academic sense of the term (a measure of a security or portfolio's sensitivity to movements in the broader market). Instead, it is to highlight the fact that this is a group of index-linked investments, all of which have the goal of achieving a beta equal to one as measured against their benchmark indexes. *Strategic beta* may not roll off the tongue as easily as *smart beta*, but we believe it is a more accurate descriptor—one that doesn't imply that this universe is the index world's equivalent of Lake Woebegon.

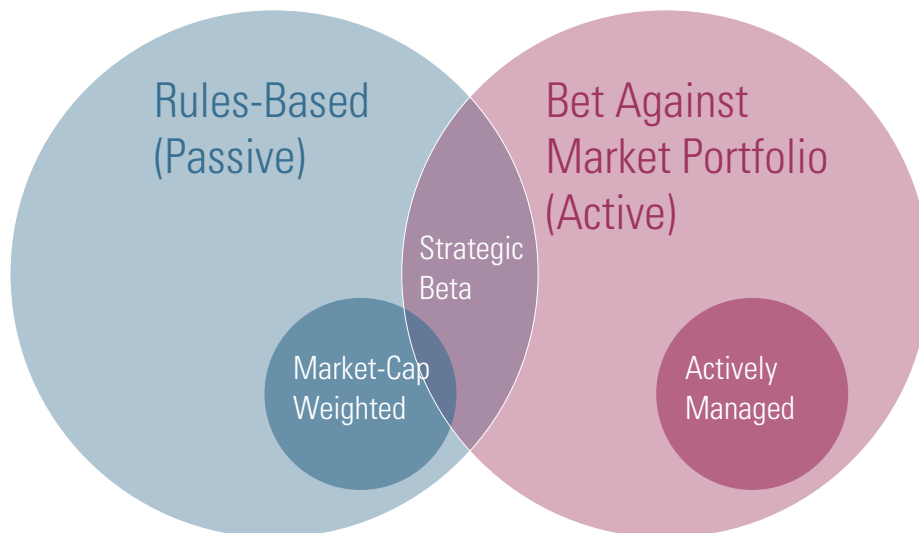
It should be noted that these are merely attribute tags and not new fund categories, just as we do not have a "passive" or an "active" category. The portfolios of strategic beta funds exhibit a variety of investment styles. Our purpose in creating these descriptions is to help investors rigorously analyze this breed of funds, facilitating comparisons between those with similar strategies as well as within the context of their traditional Morningstar category.

A Motley Crew

In delineating the boundaries of the strategic beta space, we have tried to be as inclusive as possible, including products that may have a variety of different processes, but yield fairly similar end products, and all of which deviate in some meaningful way from their traditional broad-based index peers.

Also, it is important to note that our definition differs from some others' in that we include products tied to benchmarks that first screen candidates for a variety of attributes (value, growth, and dividend characteristics, for example) and subsequently weight the eligible securities by their market capitalization (Vanguard Dividend Appreciation Fund VIG, for example). Others have adopted a more narrow definition that excludes any products based on benchmarks whose constituents are market-capitalization-weighted.

Exhibit 1 Part Passive, Part Active: Strategic beta lives in the middle of the active-to-passive spectrum.



Our resulting universe includes a diverse range of products, spanning from the iShares MSCI All Country World Minimum Volatility ETF ACWW to the YieldShares High Income ETF YYY.

The common elements among them:

- ▶ They are index-based investments.
- ▶ They track nontraditional benchmarks that have an active element to their methodology, which typically aims to either improve returns or alter the index's risk profile relative to a standard benchmark.
- ▶ Many of their benchmarks have short track records and were designed for the sole purpose of serving as the basis of an investment product.
- ▶ Their expense ratios tend to be lower relative to actively managed funds.
- ▶ Their expense ratios are often substantially higher relative to products tracking "bulk beta" benchmarks, like the S&P 500.

Better Returns, Less Risk?

Having defined the strategic beta space in very broad terms, Morningstar makes a second cut of the universe, tagging products on the

basis of the overarching strategic objective of their underlying benchmark. These objectives fall into three buckets: return-oriented strategies, risk-oriented strategies, and a catch-all *other* classification.

Return-oriented strategies look to improve returns relative to a standard benchmark. Value- and growth-based benchmarks are prime examples of return-oriented strategies. Other return-oriented strategies seek to isolate a specific source of return. Dividend-screened or weighted indexes, such as those followed by the iShares Select Dividend DVY and SPDR S&P Dividend SDY ETFs, are the chief examples of this type of return-oriented strategy.

Meanwhile risk-oriented strategies look to either reduce or increase the level of risk relative to a standard benchmark. Low-volatility and high-beta strategies are the most common examples of risk-oriented strategies.

Lastly, the *other* classification encompasses a wide variety of strategies. These range from nontraditional commodity benchmarks to multiasset indexes. This second cut allows

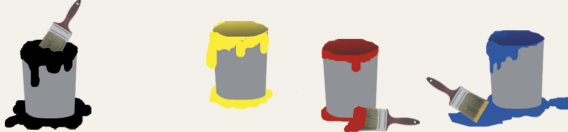


Exhibit 2 Classifying Strategic Beta Strategies

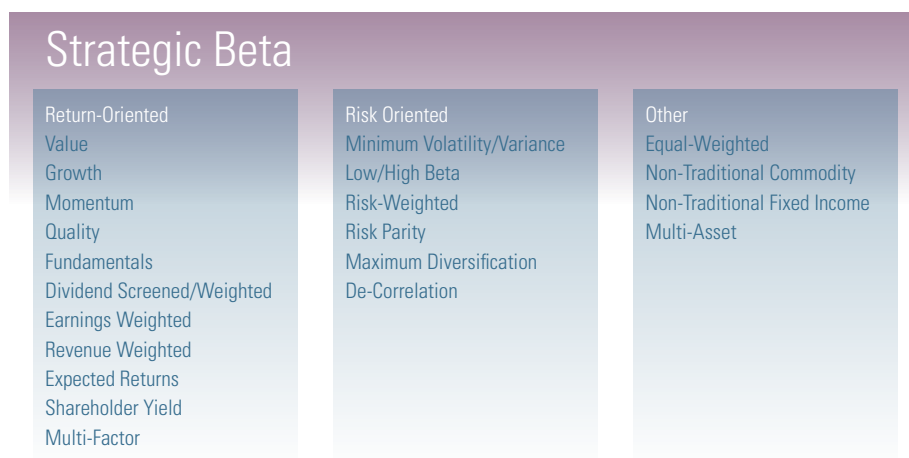


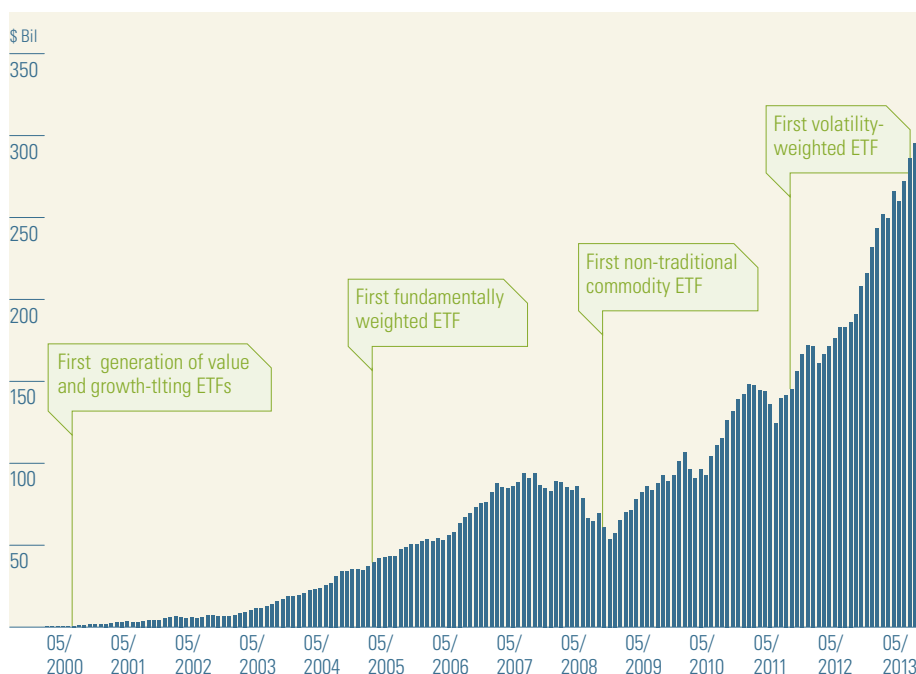
Exhibit 2 outlines our strategic beta taxonomy in full detail.

A Look at the Numbers

Overlaying our taxonomy on the U.S. ETP market yields some interesting results.

First, this universe has seen tremendous growth over the past decade (Exhibit 3). The rate of growth has only accelerated in the past five years. At the end of 2013, Morningstar counted 342 strategic-beta ETPs in the United States. These products had collective assets under management of \$291 billion, representing nearly 18% of total ETP assets. Assets grew 59% in 2013 alone; net new cash inflows accounted for more than 34 percentage points of that figure, and asset appreciation accounted for the remaining 25 percentage points.

Exhibit 3 Total Net Assets in Strategic Beta Funds



Also, this is a category that has been punching above its weight. While strategic beta ETPs accounted for 18% of total industry assets as of year-end 2013, they garnered 35% of total net cash inflows into all ETPs for the year.

Exhibit 4 shows the breakdown of strategic beta ETP assets and their share of flows for 2013 along the lines of the secondary strategy attributes outlined above. ETPs offering access to dividend-screened or weighted strategies are the largest class of strategic beta ETPs. It should come as little surprise in the context of what has been a yield-starved market environment that dividend strategies have grown to account for nearly one third of assets in this space.

investors to classify strategic beta instruments along very broad lines.

The Devil Is in the Details

The third and final cut involves classifying products with similar strategic objectives at a more granular level.

Here, we group products tracking dividend screened or weighted, value, low/minimum volatility/variance, nontraditional commodity, and a variety of other benchmarks together. This is intended to facilitate more precise comparisons between products with very similar underlying methodologies.

It is also important to note that more than 45% of assets in strategic beta ETPs are tied to what we would deem to be the first generation of such benchmarks—those that tilt or otherwise seek to isolate stocks with value and growth characteristics.

There are also some notable up-and-comers in the space. Fundamentally weighted strategies have been gaining traction as many of the ETPs tracking them now have track records of

Exhibit 4 Strategic Beta Assets by Secondary Attribute

Secondary Strategy Attribute	% of Category AUM	% of 2013 Flows
Dividend Screened/Weighted	32.7%	41.5%
Value	23.9%	18.8%
Growth	21.7%	10.5%
Fundamentally-Weighted	6.3%	11.1%
Low/Minimum Volatility/Variance	3.7%	6.8%
Non-Traditional Commodity	2.9%	−1.9%
Equal Weighted	2.7%	4.4%
Non-Traditional Fixed Income	1.7%	0.3%
Momentum	1.2%	2.2%
Shareholder Yield	0.9%	3.3%
Earnings Weighted	0.7%	0.4%
Multi-Asset	0.4%	0.3%
Multi-Factor	0.4%	1.1%
Revenue Weighted	0.2%	0.2%
Quality	0.2%	0.5%
Low/High Beta	0.2%	0.4%
Expected Returns	0.1%	0.1%
Risk-Weighted	0.0%	0.0%

Data as of Dec. 31, 2014

three-plus years, a fact which has bolstered some investors' confidence in their merit. Low/minimum volatility/variance ETPs have also attracted substantial investor interest as investors that are still feeling the sting of the 2008 downdraft in global financial markets adopt these strategies as a way to smooth their stock returns a bit.

What's Next?

What comes next in the land of strategic beta is more complexity. The latest wave of new products hitting the market is of the multifactor variety, which combine a range of factor tilts or exposures into one fund.

Factors 101

By Alex Bryan

Academics and investment practitioners have identified a number of factors that can be used in combination to explain investment returns. Here, we provide a high-level overview of a few core factors.

Value

Value investing has been around long before index funds. Historically, stocks that have traded at low multiples of earnings, book value, and other valuation metrics have outperformed their more expensive counterparts in nearly every market studied over long time horizons. There are two possible explanations. Value stocks could be riskier than more expensive stocks and offer higher returns as compensation, or investors may have extrapolated past growth too far into the future and systematically mispriced them. It is also possible that both of these effects are at work. While there is still a vigorous debate about which story is more credible, if the risk-based explanation is correct, the value premium is more likely to persist. While investor behavior will not change overnight, systemic mispricing resulting from behavioral biases will likely diminish as more investors exploit it.

Momentum

Momentum describes the tendency of recent performance to persist. Stocks that have recently outperformed continue to do so in the short term, and those that have underperformed often continue to lag. Behavioral finance researchers argue this effect may arise because investors may underreact to new information. While it is difficult to articulate a risk-based explanation for momentum, the strategy does not work well when volatility spikes. It can also be expensive to exploit in practice because it requires high turnover.

Quality

Quality stocks—those with high profitability and stable earnings—have historically outperformed their less profitable counterparts. But there isn't a compelling risk story for this effect. Instead, investors may have underestimated the long-term persistence of these companies' profits. The low volatility anomaly may be related. Low volatility stocks have historically offered better risk-adjusted returns than their riskier counterparts. This may be because investors are unwilling or unable to use leverage to meet their objectives. Consequently, they may tilt toward high-beta (volatile) stocks, which should, in theory, outperform their less-risky counterparts. Their collective bet on these stocks can cause them to become overvalued relative to their risk, while neglected low volatility stocks become undervalued.

During the writing of this article, J.P. Morgan Chase filed with the SEC to launch a suite of ETFs tracking multifactor equity benchmarks. These products are peeking over the fence that stands at the border between active and passive—mimicking active strategies in a rules-based, transparent, tax-efficient, and low-cost manner.

This layering of complexity adds to the due-diligence burden for investors. Investors' due-diligence processes for these funds need to be every bit as rigorous as those they would undertake in scrutinizing active managers. Morningstar believes that

its taxonomy is an important first step in the direction toward helping investors to better understand the strategic beta universe. ■■■

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