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INVESTMENT STRATEGY: SMART BETA INVESTING

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A SMART WAY TO ACCESS MARKET FACTORS

Smart Beta is an investment approach that manages to combine characteristics of active and passive investment strategies. At a first glance, smart beta strategies take the form of an active investing in that they aim to capture factor exposures; but, as opposed to traditional "alpha-seeking" strategies, they do so in a rules-based, transparent and cost-efficient manner, i.e. through index investing. ETFs are the financial vehicle most widely adopted to make these strategies operative.

THE "PASSIVE SIDE": INDEXING

Smart beta strategies are several, hardly classifiable, since they very much depend on the specific needs behind investors' allocations. A common feature, however, can be detected: all (or almost all) of these strategies consist of tracking an index (usually referred to as "underlying index"), which deviates from a reference, usually market-capitalization-weighted index (referred to as "parent index"). Indeed, the former isolates some of the securities included in the latter or modifies their weights in the index, in order to take exposures on one or more areas of the broad, "parent" market. These "areas" (later on, it will become clearer what these "areas" are), under the investor's view, offer opportunities of extra-return.

Notice, however, that the ETF management company and the index provider are two separate and independent entities. What the manager does is picking a market factor and identifying an index which best isolates that factor, with respect to a broader market index; it then sets a replicating strategy of the identified index and keeps it fixed over the life of the fund, trying at the same time to minimize the turnover, so as to keep running costs low. The index and its composition rules (set and executed by the index provider and not by the portfolio manager) represent what previously labelled as "rules-based and transparent" approach.

Before going into details over the most common investment strategies, an example is provided so as to clarify the relation linking the underlying and the parent index. Take the *iShares Russell 1000® Growth ETF* (IWF). The Underlying index, in this case, is the *Russell 1000 Growth Index*. Such index is built by, first, taking as a reference the broader *Russell 1000 Index* (Parent Index), which measures the performance of the large and mid-cap sector of US Equity market and, second, by isolating the growth sector of this market according to a composition and weighting rule established by the index provider only (Russell). As can be clearly understood from the ETF prospectus, the investment objective of the fund is to "track the investment results" of the underlying index, through a "passive or indexing approach". Notice that this leads to annual operating expenses as low as 0.19%.

THE "ACTIVE SIDE": INVESTMENT STRATEGIES

It is now clear what the main role played by Smart Beta ETFs is, i.e. a new and cheaper way to access market factors. How precisely this is done may vary across investors and investment companies. The main Equity Smart Beta strategies can be synthetically classified as follows:

- **Factor-based**: stocks are weighted based on specific factors (value vs. growth, size, momentum, quality, sustainability etc.). An example of this has already been proposed (iShare IWF)

- **Fundamentally weighted**: companies are selected and weighted according to fundamental metrics (earnings, profits, revenues, financially driven measures etc.). It is hard to neatly distinguish this category from the previous one: one way to disentangle it could be considering that the first refers to the factor, defined as investment characteristic, while the second specifies the accounting drivers that best describe the factor. The choice of the drivers selected to proxy the factor may vary across index providers and investment firms.

A few considerations on this are pointed out through the following example. Take the *iShares Edge MSCI Multifactor Intl ETF* (INTF). First, the very name of the fund makes it clear that smart beta funds can be managed either with single or with multiple weighting factors, depending on the single, as opposed to multiple, factor weighting rule adopted by the underlying index provider. If multiple, the factors can be equally-weighted or not.

Second, by the prospectus of the fund, we acknowledge that the underlying index (*MSCI World ex USA Diversified Multiple Factor Index*) is designed to select equity securities from *MSCI World ex USA Index* (the Parent) that have high exposure with four (and not a single one) investment style factors: value, quality, momentum and low size. Each factor is synthetized through a score. Value score, e.g., is derived from a list of company's valuation ratios. These are the fundamentals looked at, when measuring the value score for each company. Value is, instead, the factor being described.

A sub-category of the fundamentally based approaches is represented by those ETFs focusing on company's dividend yield and dividend yield growth. An example of this is represented by *Vanguard Dividend Appreciation Index ETF* (VIG).

Another category that more neatly departs from the previous two is:

- **Volatility-based**, usually low-volatility: a real-world example will clarify how this works. For the *Invesco S&P 500® Low Volatility ETF* the prospectus states that the investment objective is to track the underlying index (*S&P 500® Low Volatility Index*, by S&P DJ Indices LLP), made up of "100 securities from the *S&P 500® Index* that have the lowest realized volatility over the past 12 months, as determined by S&P DJI" (another clear sign of the strict separation of roles between the investment company and the index provider; furthermore, the 100 securities are selected "strictly in accordance with its guidelines and mandated procedures").

Besides Equity smart beta, other asset classes are targeted. Mostly,

- **Fixed-Income**: targets exposure to historically rewarded factors in fixed income securities. For the sake of completeness, see for example the *iShares Edge U.S. Fixed Income Balanced Risk ETF* (FIBR), though the discussion on these ETFs is beyond the purpose of this paper.

However, this classification is accurate, but far from being complete: many different hybrid strategies are developed in the industry. What is common and important to keep in mind are the building blocks: the portfolio manager passively tracks an index; the index is constructed (by an independent index provider) so as to take a view on one or more factors, with respect to a broader market.

As a consequence of the way smart beta funds work, beyond the risks common to any financial investment and those shared with purely passive mutual funds, smart beta funds are subject to an "investment style risk": the risk that stocks selected according to a specific criterion will trail returns from the overall reference stock market.

A REAL WORLD EXAMPLE

The following analysis on *iShares Russell 1000® Growth ETF* (IWF) performances, compared with the ones of two indexes, the underlying *Russell 1000 Growth Index* (RLG) and the broader *Russell 1000 Index* (RUI), allows the reader to concretely spot how the smart beta ETF in question succeeded in capturing the extra-return of the US equity growth sector, in 2019, at a competitive, passive-wise, cost.

Figure 1 shows how the return on the growth index in 2019 was 29.52%, as opposed to the broader Russell index which recorded a 25.01%. The smart beta ETF in question perfectly succeeded in tracking this overperformance and

closed the year with a 30.55% return. These are all log returns.

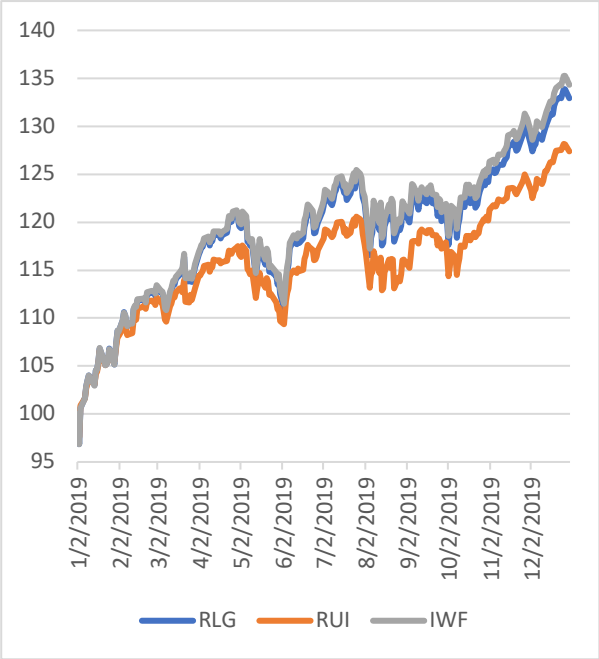

Figure 1 – iShares Russell 1000® Growth ETF (IWF), Russell 1000 Growth Index (RLG) and Russell 1000 Index (RUI) cumulative daily performance over 2019

As previously said, smart beta investing implies a passive management approach with respect to the reference index. IWF provides a clear example of this since it captured the overperformance, keeping the tracking error volatility at a low level. The daily TEV between the fund and its direct benchmark was 0,047%. In other terms, when the smart beta ETF and the growth index are compared to the broader index, they show TEVs equal to 0,223% and 0,217% respectively (almost equal). It happens only 6 days (out of 251) that the ETF did worse than the broader market, when the benchmark did better. The number of days rises to 17 (still very low) if you also consider the other side of the mismatching (the good one, from an ETF investor's perspective).

When the time horizon is widened to the past 5 years, the story repeats. Figure 2 shows the cumulative annual performances of 10.000 USD invested in the ETF, compared to the same amount invested in the two indexes, based on monthly data. Figure 3 shows the dispersion of the results, confirming the aforementioned behavior in terms of TEV.

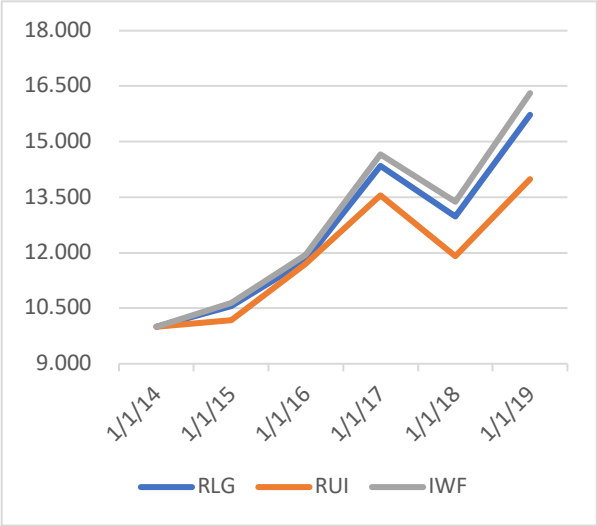

Figure 2 – iShares Russell 1000® Growth ETF (IWF), Russell 1000 Growth Index (RLG) and Russell 1000 Index (RUI) cumulative annual performance (2014-2019)

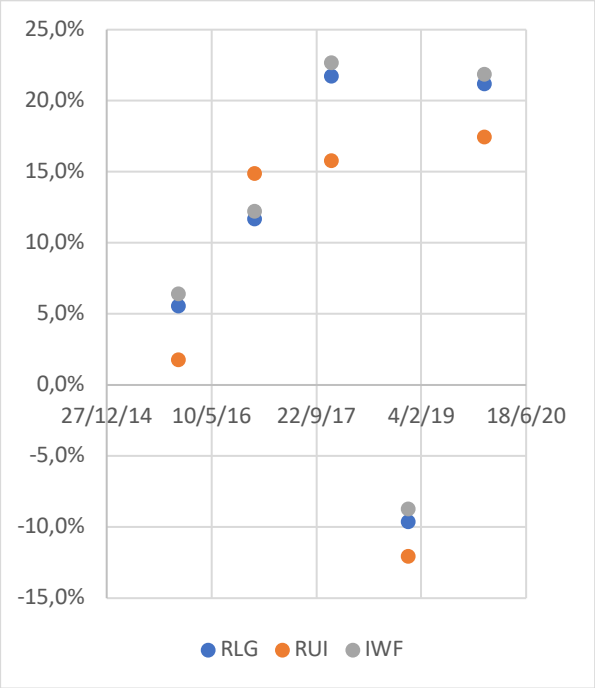

Figure 3 – iShares Russell 1000® Growth ETF (IWF), Russell 1000 Growth Index (RLG) and Russell 1000 Index (RUI) annual return dispersion (2014-2019)

Last but not least, the cost profile. A smart beta ETF manages to capture the overperformance offered by a factor at a cost of a passive fund. The net expense ratio (ER) of an index tracking the broad *Russell 1000* (take the *iShares Russell*

1000® ETF (IWB) to be consistent) is **0.15%** by prospectus. The extra-price you have to pay to access the growth factor (i.e. the ER of our IWF ETF in excess of 0.15%) is only **0.04%.**

Therefore, if one is willing to isolate one or a set of factors or fundamentals keeping a passive management strategy, Minerva IMS believes smart beta is an invaluable tool to keep into account.