Smart beta ETFs: Why not all strategies are created equally

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WisdomTree
Contributor

Exchange-traded funds, or ETFs, are gaining momentum in Europe and showing few signs of slowing any time soon. Not the least of which is smart beta, which represents around 27% of the $4.1 trillion global ETF market1. Despite smart beta's growing popularity, however, the nuances present within the different smart beta strategies warrant a closer look.

Firstly, smart beta is not a single strategy, but an all-encompassing term to describe a multitude of strategies ranging from simple to complex. Secondly, smart beta strategies are rules-based, that is, they aim to achieve better risk-adjusted returns in a systematic way. The difference between smart beta funds are the ways in which each fund selects and weights specific securities or investment objectives.

Some of the smart beta strategies that are attracting attention are listed in Table 1. A range of products are offered within each of these categories, ranging from those weighted by a single factor, such as dividends, to those skewed towards multiple factors within a single ETF.

Table 1: The range of smart beta strategies

Smart beta strategy

Description

Fundamentally-weighted indices

Components are selected to provide broad exposure to an equity market, but companies are weighted by a fundamental factor, such as aggregate dividends or earnings, rather than market capitalisation.

Equal-weighted indices

Components are based on established indices like the S&P 500, but are equally weighted so that all components have identical weights when rebalanced.

Factor-based indices

Components are selected and weighted, based on one or more fundamental factors.

Low-volatility indices

Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility.

Some investors believe that smart beta strategies have only performed well because money has flowed into them. In other words, investor enthusiasm would have driven returns by bidding up valuations. We find this unlikely given the short history of smart beta and the relatively small scale of investment. In fact, this may be applicable to more traditional market capitalisation-weighted indices that assign more weight to a stock as its price rises. This contrasts with how we here at WisdomTree weight companies in our fundamental ETFs—which is by their annual cash dividends in a proprietary methodology called Dividend Stream®2.

This is because we believe dividends offer the most objective measure of a company's health, value and balance-sheet strength and, therefore, this weighting serves as the foundation for most of our European ETFs. And, because stocks owned by smart beta strategies could become overvalued or no longer representative of the factor(s) under consideration, we also rebalance to a measure of fundamental value annually.

Different strokes for different folks

Ultimately, transparency and education is the key to the future success of smart beta ETFs. Investors therefore need to take a closer look at providers' smart beta strategies: the approach, what it invests in, whether it complements what they already own and what type of exposure it gives. It can certainly be challenging to distinguish all that is out there. When it comes to identifying truly smart beta strategies, we believe investors should seek the following:

- A rules-based, repeatable methodology that offers broad, representative exposure to an asset class.
- Alternative weighting methods that allow for ample investment capacity.
- High correlations to established benchmarks.
- An established track record on a total return and risk-adjusted basis.
- Regular rebalancing.

1 ETF Strategy, as of 01/08/2017

2 The Dividend Stream is the sum of the cash dividends of all the constituents in the index. A company's weight in the index is defined by its cash dividend as a proportion of the Dividend Stream.

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