Strategic beta ETFs: New challenges in evaluation and adoption

In the early days of ETFs, these funds were known for their low cost, transparency, and simplicity. Investors could gain exposure to an entire stock index as easily as buying a single share of stock. As the vehicle grew more popular, however, products and strategies proliferated in an attempt to serve the varied goals of investors.

ETFs have evolved beyond seeking to deliver simple cap-weighted index returns for an asset class, sector, or geographic region and now aim to deliver on alternative indices seeking either higher returns, lower risk, or both. These index strategies—in which constituents aren't selected or weighted by market capitalization measures—are known as strategic beta, or smart beta.

Currently, Morningstar recognizes 11 strategic beta categories or "groups." The 11 groups by ETF assets appear in Exhibit 1. Given the number of categories and permutations possible within these attributes, one clear result has emerged: a crowded, confusing landscape of choices.

Key takeaways

- Strategic beta ETFs are based on indices that seek to improve the strategies' return profile, alter the risk profile, or do both.
- ETF methodologies are growing increasingly complex and, in some cases, less transparent
- Proliferation is rampant, especially in newer multi-factor ETFs.
- Strategic beta requires new dimensions of evaluation beyond what's commonly reviewed for traditional cap-weighted index ETFs.
- One of the most talked-about flavors of strategic beta is the multi-factor approach, which, in our view, involves additional complexities and unpredictability that deserve heightened due diligence.

An example of complexity

In just the last few years, the number of ETF providers has shot upward and the number of strategic beta ETFs has exploded. Approximately 700 strategic beta ETFs exist today and, in terms of category flows, they have been doing remarkably well.

Exhibit 1. Strategic beta ETF categories

Strategic beta group	AUM ($M)	% of strategic beta AUM	# of ETFs
Growth	211,061	25%	40
Value	205,178	24%	51
Dividend	198,198	23%	137
Risk-Oriented	75,542	9%	53
Multi-Factor	54,515	6%	179
Fundamentals	33,744	4%	32
Other	26,699	3%	68
Momentum	18,287	2%	39
Quality	18,173	2%	17
Fixed Income	9,596	1%	41
Commodity	5,713	1%	34

Source: Morningstar Direct, as of June 30, 2019.

ETFs have given investors and advisors the power to allocate among asset classes with ease and cost efficiency. But hundreds of choices and increasingly complex strategies have also created challenges for investors and advisors: What is the best way to use these funds? How do I choose among them? Can I assume that all of the strategic beta categories are created equally?

Let's take one of the most prolific new strategies—multi-factor ETFs—as a pointed example. Nearly 180 multi-factor ETFs exist today, comprising 26% of all strategic beta ETFs by product count—but only 6% of strategic beta ETF assets.[1]

A framework for evaluating these complex new funds is increasingly important. This article offers a series of questions and answers that illustrate the importance of carefully evaluating the various strategies before selecting among them.

An evaluation approach

Typically, traditional cap-weighted index ETFs are evaluated on exposure, costs, and liquidity. But strategic beta requires new dimensions of evaluation. Here are some key questions to begin your assessment (see Exhibit 2).

Is the index strategy understandable and transparent?
Does the index methodology use vague language? If the strategy can't be readily understood or easily explained, then it might be very difficult to stick with the ETF during periods of underperformance.

How does the strategy fit in a portfolio?
If a new strategy performs like the existing holdings in a portfolio, it isn't diversifying but rather is doubling down. It pays to understand how a strategic beta ETF differs in terms of size, sector and factor tilts, and whether the strategy is meant to complement or replace a traditional cap-weighted index ETF.

How much history does the index have in the market?
In the quest for alpha, providers may be tempted to mine past market results to find measures associated with market outperformance. This approach has several risks, including not knowing whether past outperformance was due to random chance or a valid strategy. This suggests strategies with actual time invested in the market should be viewed more favorably.

What is the ETF's closure risk?
Check the issuer's history of ETF closures and determine whether the ETF has enough assets and liquidity for long-term survival. The stakes are high. In previous cycles, high product launches have been followed by spates of fund closures years later. Indeed, in multi-factor ETFs as an example, fund closure risks are already elevated (see Exhibit 3).

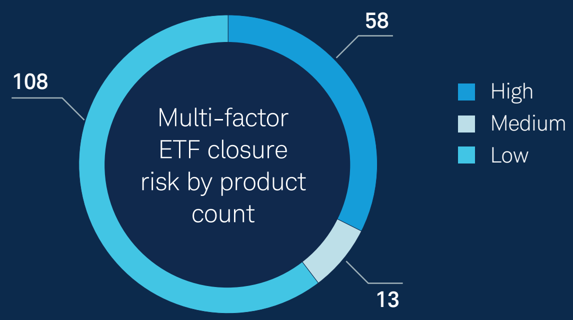
1 Morningstar Direct, as of June 30, 2019.

Exhibit 2: Key questions for evaluating strategic beta

1. Is the index strategy understandable and transparent?
2. How does the strategy fit in a portfolio?
3. How much history does the index have in the market?
4. What is the ETF's closure risk?
5. How cost efficient is the strategy?

Exhibit 3: Closure risk for multi-factor ETFs

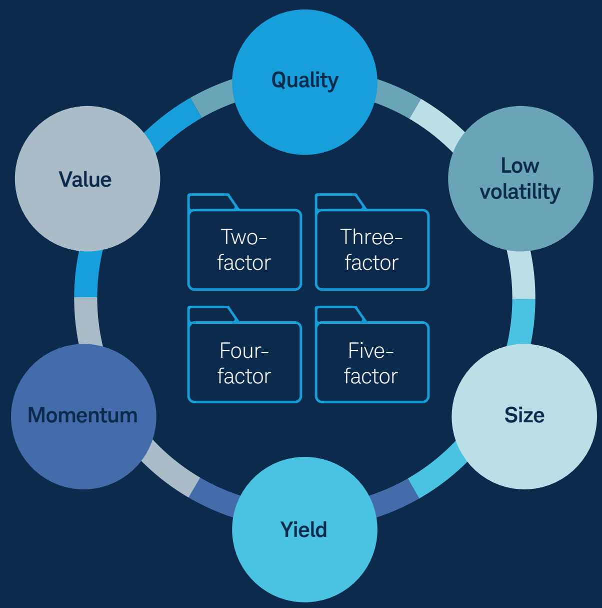
ETF.com estimates that nearly 40% of ETFs categorized as multi-factor by Morningstar are at medium to high risk of closure.



Source: ETF.com, as of June 30, 2019. ETF.com assigns fund closure risk based on a quantitative methodology that considers fund assets under management, issuer strength, fund rank in segment, and ADV, among other metrics.

Exhibit 4: Variable factor combinations

Among multi-factor ETFs, there is great difference in how many and which combination of factors are employed.



How cost efficient is the strategy?
To assess cost efficiency, compare the ETF's expense ratio to competitors with similar strategies from the same Morningstar strategic beta category. Also consider the fund's bid/ask spread and other transaction costs as well as the ETF's history of capital gains distributions.

Diving deeper: Multi-factor ETFs

Now let's consider the additional due diligence required for more complex multi-factor ETFs.

How is each factor defined?
Index providers often define factors differently. Even a traditional factor like value can be defined in many ways—book to price, sales to price, and earnings to price, among other metrics. Understand the metrics employed and whether they match your investment objectives.

How are factors combined?
How many factors does the model employ? Which factors does it combine? Two-, three-, four-, and five-factor models can be used to combine factors such as value, quality, momentum, size, low volatility, and yield (see Exhibit 4). Is it clear how these combinations will help you reach your goals? Make sure the combination of factors aligns with your objectives and provides the diversification you need.

How are factor exposures weighted?
Multi-factor indices may weight their factor exposures differently. Strategies may seek equal, customized, or even dynamically weighted factor exposures (see Exhibit 5). Seek to understand how much exposure is given to each factor in the strategy.

How is the index constructed?
Multi-factor indices are built using either an isolated (top-down) or integrated (bottom-up) approach (see Exhibit 6). An isolated approach involves several single-factor indices equally weighted to create a "master" multi-factor index. An integrated approach typically selects and weights the constituents based on an aggregated "factor score." Based on the index construction, overall factor characteristics—and performance—may differ, even among indices targeting the same combination of factors.

Exhibit 5: Factor weighting

Understand how much exposure (weight) is given to each factor in the index.

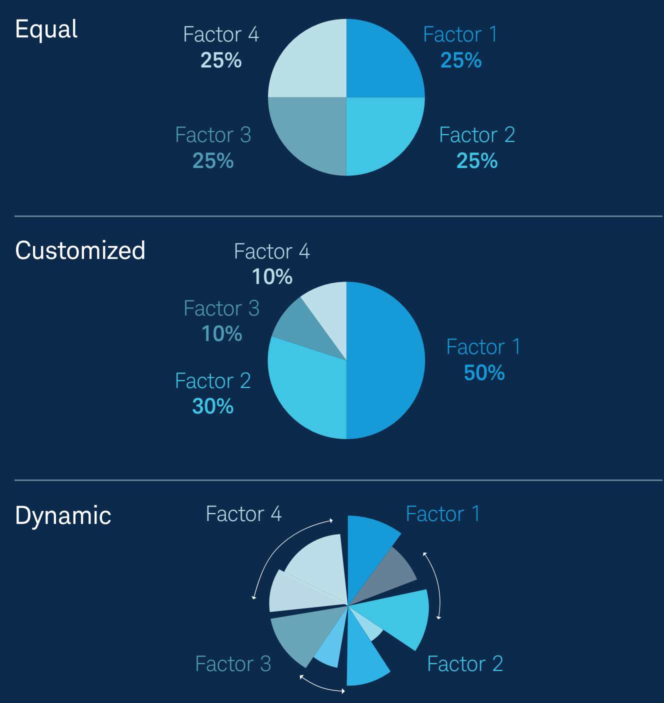
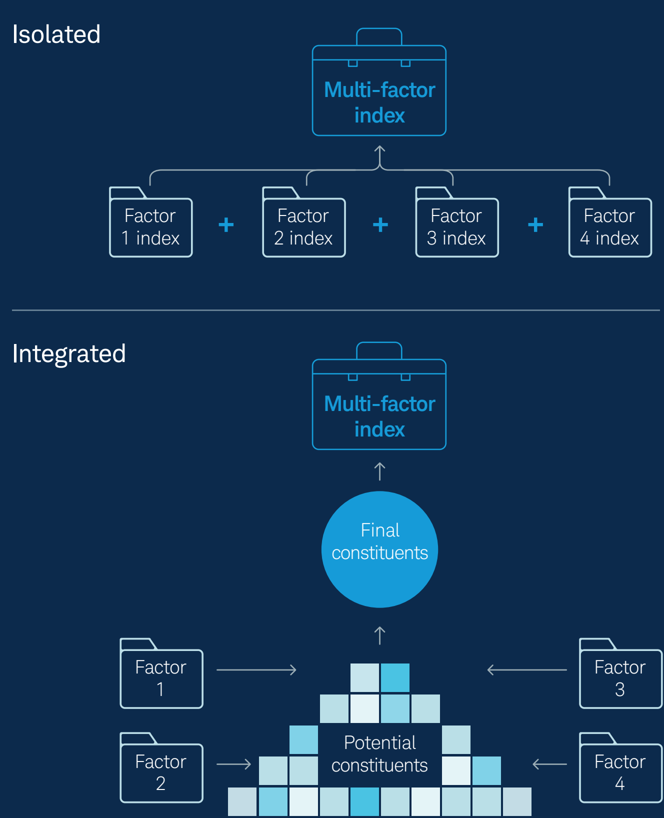


Exhibit 6: Multi-factor index construction

Multi-factor indices are constructed using an isolated or integrated approach.



Among the nearly 180 multi-factor ETFs, what is the optimal strategy to implement in a portfolio? That may be the most difficult question of all. The four "how" questions in this section can help advisors understand the differences in how these strategies are constructed, but may not ultimately help them determine which multi-factor ETF is implementing the optimal combination of factors.

Bottom line: Take a closer look

ETF strategies are growing increasingly complex and, in some cases, less transparent. Proliferation is rampant, especially in newer multi-factor ETFs.

The strategic beta ETF landscape has become quite broad, offering a range of strategies from simple and transparent to complex and opaque. Unpredictable returns are an unavoidable characteristic of investing. However, strategies that increase unpredictable outcomes via elaborate approaches may not necessarily be attractive. Simplicity and transparency are positive attributes that we believe will help you feel confident in attaining your long-term investment goals.

About the authors

D.J. Tierney is a Managing Director and Client Portfolio Strategist at Charles Schwab & Co supporting Charles Schwab Investment Management, Inc. In this role, he represents Schwab ETFs™ to sales channels, clients, and the media. He also works with CSIM's product team to optimize Schwab's ETF offerings. Mr. Tierney assists in managing relationships and communications for Schwab ETFs with authorized participants, broker-dealers, and regulatory agencies. Prior to joining Schwab in December 2016, Mr. Tierney spent 16 years with Morgan Stanley as a senior institutional sales, trading, and relationship management professional. Mr. Tierney earned a BA in economics from the University of California, Los Angeles, and an MBA from the University of California, Berkeley, Haas School of Business.

Dennis Hudachek is a Director at Charles Schwab & Co supporting Charles Schwab Investment Management, Inc. In this role, he is responsible for product management of Schwab's index mutual funds and ETFs, and he provides analysis of product construction and attributes for proprietary and third-party funds. Mr. Hudachek joined Schwab in March 2015 after leaving ETF.com, where he spent five years as a senior ETF analyst responsible for creation of the firm's ETF analytics and classification tools. In this role, he helped build the firm's ETF scoring system and supported the publications and sales teams with ETF education, research reports, and whitepapers. Prior to ETF.com, he spent six years in the Global Wealth Management divisions at Merrill Lynch and Banc of America Investments. Mr. Hudachek earned a BA in economics from the University of California, Davis.

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