

# Factor investing: It's a jungle out there, but it doesn't have to be

## Challenges of strategic beta

The world of strategic beta can be quite confusing for investors and advisors. Today, there are over 700 strategic beta ETFs (see Exhibit 1). Roughly 80% of them can be considered factor-based strategies. This large number has created a “factor jungle” for advisors to navigate.

Strategic beta ETFs are increasingly being viewed as a way to gain factor exposures. The lines between active and passive investing have become blurred as portfolios can now be constructed by overweighting or underweighting to a variety of factors.

As we travel throughout the country and meet with advisors, we are clearly seeing strong adoption and enthusiasm for ETFs. We also find that advisors have challenges evaluating and comparing strategic beta ETFs. With hundreds of products to choose from, advisors may find themselves bombarded with newer and increasingly complex strategies that have very little history. There is no standard playbook for evaluating and comparing strategic beta ETFs. For many advisors, this process begins with reading provider materials and then comparing an ETF's portfolio and historical performance. These are reasonable first steps, but they may not result in clear conclusions.

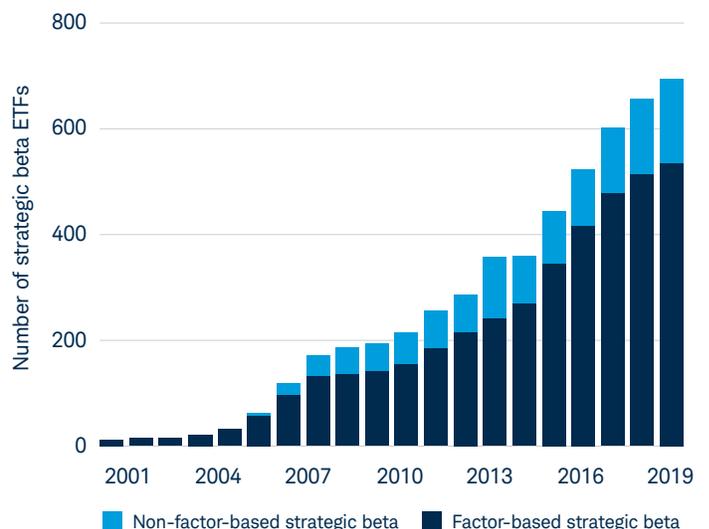
Evaluating strategic beta ETFs doesn't have to be difficult. In this article, we will discuss tools we've found very helpful in revealing the underlying factor exposures in ETFs. We believe that knowing what factor exposures are in a strategic beta ETF and understanding how they are expected to perform in different market environments is important when building an investment portfolio.

## Key takeaways:

- Strategic beta is becoming a channel for factor investing.
- Identifying factor tilts in strategic beta ETFs provides a new method for analyzing ETFs.
- Tools exist to help understand the magnitude of an ETF's factor exposures.
- Factor awareness can help advisors select the right strategic beta ETFs for integration into client portfolios.

## Exhibit 1: Proliferation of strategic beta ETFs

In the following chart, we can see that the number of strategic beta ETFs has grown significantly over the past 19 years.



Source: Morningstar as of 9/30/19

## What are factors?

Factors are basically attributes that drive the return and risk profile of a fund. For example, the momentum factor describes the portfolio characteristic of outperforming in an environment of rising stock prices. In the case of index funds, factors are often the output or result of the fund's underlying index methodology. Keep in mind that all ETFs, including cap-weighted, have factor exposures—whether the strategy intentionally targets them or not.

Identifying factors and factor tilts in ETFs has been recognized as an effective method of categorizing funds for comparison. A fund's factor exposures can also be key contributors to diversified portfolio construction. They allow advisors to move beyond traditional measures of size and style and into more differentiated attributes.

## Identifying factors

Identifying and defining factors can vary depending on the asset manager and index provider. Quality, for example, can be defined using a multitude of different measures. It's useful to have a standard definition of factors from an independent third party when evaluating fund strategies. MSCI's Factor Classification Standards (FaCS) is an example of a framework that does just that, in a simple, straightforward, and digestible manner.

MSCI, via FaCS, offers a standardized approach and framework for identifying and analyzing factors. Akin to how the Global Industry Classification Standards (GICS) sets standards for the company's industry categorization, FaCS offers standards for fund factors.

The ETF industry has widely identified six common investment factors found in ETFs: value, low size, momentum, quality, yield, and low volatility (see Exhibit 2). The majority of single-factor and multi-factor ETFs today focus on one or more from these core factor groups. In other words, strategic beta can largely be viewed as a conduit for delivering one or more of these six factors.

MSCI has also developed an illustrative standard graphic that displays factor exposures called the MSCI Factor Box. Its straightforward visuals illustrate the direction and magnitude of an

Exhibit 2: Six common investment factors

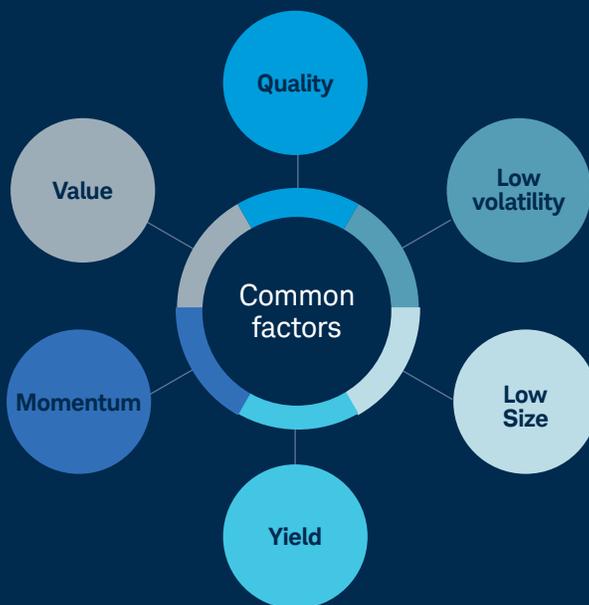
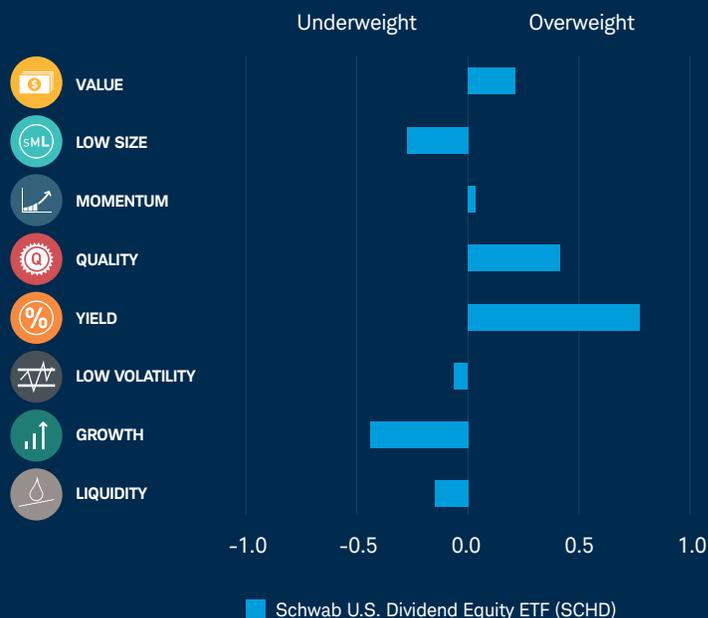


Exhibit 3: SCHD factor exposures<sup>1</sup>

The MSCI Factor Box highlights the Schwab U.S. Dividend Equity ETF's (SCHD) heavy factor tilt toward quality and yield.



MSCI FaCS provides absolute factor exposure relative to a broad global index: MSCI ACWI IMI.<sup>2</sup> Neutral factor exposure (FaCS = 0) represents MSCI ACWI IMI.

MSCI Factor Box data as of 9/30/19

ETF's factor exposures. By viewing an ETF's factor tilts in the MSCI Factor Box, advisors can assess some important questions, such as, "Does the fund deliver what it describes in its name or slated strategy?" Or, "Does the fund have the attributes that match your portfolio's objectives?"

As an example, let's take a look at the factor exposures of the Schwab U.S. Dividend Equity ETF (SCHD; see Exhibit 3). SCHD's index places an emphasis on dividend quality and yield through fundamental screens. As the factor box shows, SCHD has a heavy overweight to the quality and yield factors.

## Selecting strategic beta ETFs

Traditionally, portfolio diversification was achieved through combining different asset classes. By identifying and managing factor exposures among strategic beta ETFs, another level of portfolio diversification can be achieved within the asset classes.

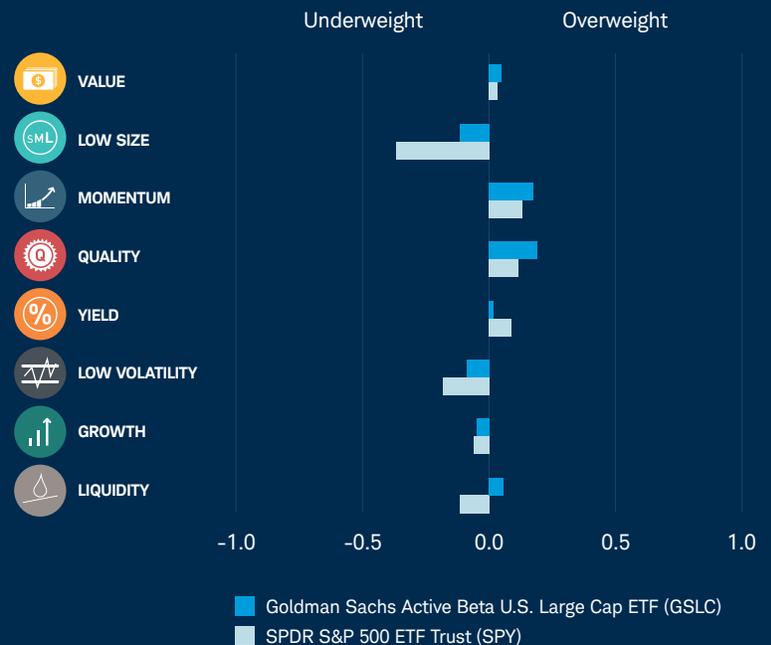
Looking at fund factor exposures is key in selecting the right strategic beta ETFs, based on your client's existing exposures in their portfolio. For example, if your client is looking for a strategic beta ETF to complement existing cap-weighted ETFs, it's important to understand the existing factors and those of the potential strategic beta ETFs. If you pair a strategic beta ETF with a cap-weighted ETF that has similar factor exposures, there may be fewer diversification benefits.

As an example, the Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF<sup>3</sup> (GSLC) targets four factors: value, momentum, quality, and low volatility. When comparing GSLC to the SPDR S&P 500 ETF Trust<sup>4</sup> (SPY), you can see the magnitude of GSLC's factor exposures relative to SPY. In this example, as of the end of Q3 2019, GSLC provided slightly enhanced momentum and quality exposures, though its value exposure seemed to be similar to SPY. GSLC also exhibited an underweight to the low-volatility factor, along with SPY (see Exhibit 4).

Now let's take a look at the Schwab Fundamental U.S. Large Company Index ETF<sup>5</sup> (FNDX). As the factor box shows, FNDX had significantly different and thus complementary factor exposures to SPY (see Exhibit 5). Specifically, FNDX enhanced value and yield factor exposures relative to SPY.

## Exhibit 4: GSLC & SPY

In the example below, you can see the Goldman Sachs ActiveBeta U.S. Large Cap ETF (GSLC) was the most overweight to the momentum and quality factors.

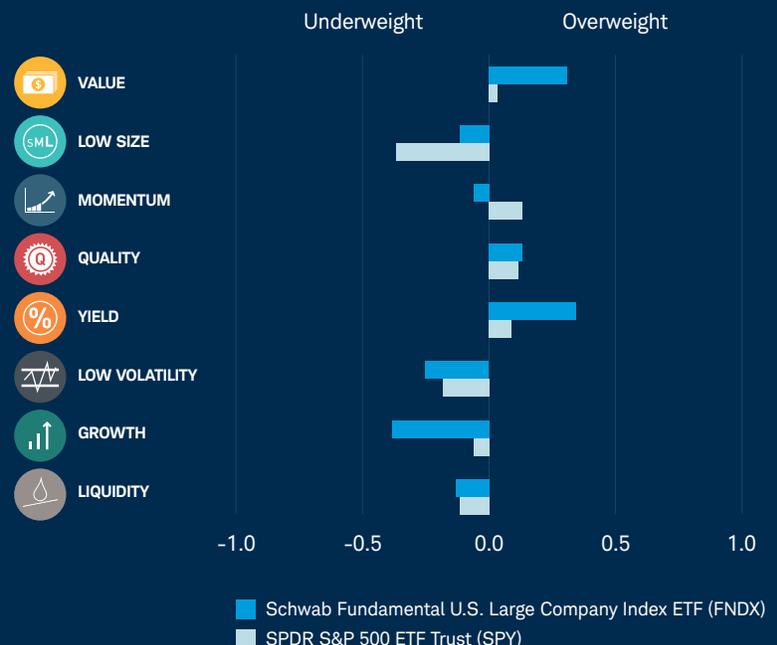


MSCI FaCS provides absolute factor exposure relative to a broad global index: MSCI ACWI IMI.<sup>2</sup> Neutral factor exposure (FaCS = 0) represents MSCI ACWI IMI.

MSCI Factor Box data as of 9/30/19

## Exhibit 5: FNDX & SPY

In the example below, you can see the factor diversification obtained by combining SPY with the Schwab Fundamental U.S. Large Company Index ETF (FNDX).



MSCI FaCS provides absolute factor exposure relative to a broad global index: MSCI ACWI IMI.<sup>2</sup> Neutral factor exposure (FaCS = 0) represents MSCI ACWI IMI.

MSCI Factor Box data as of 9/30/19

## Summary

As the number of strategic beta ETFs continues to grow, it has created a complex landscape for advisors to navigate when evaluating and comparing funds. Many ETFs can have very similar names or stated objectives—especially factor-based strategies. Using an illustrative tool, such as the MSCI Factor Box, can be very helpful in ETF evaluation and portfolio construction. This ultimately helps advisors select the right strategic beta ETFs to integrate into their clients' portfolios.

## About the authors



**D.J. Tierney** is a Senior Client Portfolio Strategist at Charles Schwab & Co., supporting CSIM. In this role, he represents the Schwab ETFs to sales channels, clients, and the media. He also works with CSIM's Product Management and Marketing teams to produce educational and market strategy content for indexed products and ETFs. Prior to joining Schwab in December 2016, Mr. Tierney spent 16 years with

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Mr. Hudachek joined Schwab in March 2015 from 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 white papers. Prior to ETF.com, he spent six years in the global wealth management division at Merrill Lynch and Banc of America Investments. Mr. Hudachek holds a Bachelor of Arts in economics from the University of California, Davis.

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<sup>1</sup> Factor definitions, sourced from MSCI Factor Classification Standards (FaCS): Value—relatively inexpensive stocks; Low Size—smaller companies; Momentum—rising stocks; Quality—sound balance sheets; Yield—cash flow paid out; Low Volatility—lower risk stocks; Growth—earnings and revenue potential; Liquidity—relative trading volume.

<sup>2</sup> MSCI All Country World Index Investable Market Index is a market capitalization weighted index designed to provide broad exposure to global equities. MSCI ACWI IMI includes large-, mid-, and small-cap stocks from developed and emerging markets, excluding frontier markets.

<sup>3</sup> The Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF (GSLC) was the largest multi-factor ETF by assets, based on Morningstar's multi-factor strategic beta category as of 9/30/19. GSLC aims to track the Goldman Sachs ActiveBeta U.S. Large Cap Equity Index, a multi-factor index that targets four factors: value, quality, momentum and low volatility.

<sup>4</sup> The SPDR S&P 500 ETF Trust (SPY) was the largest U.S. large cap equity ETF by assets, based on Morningstar's large blend category, as of 9/30/2019. SPY aims to track the S&P 500 Index, a market-cap weighted index of 500 U.S. stocks selected by the S&P committee.

<sup>5</sup> FNDX is the largest ETF tracking the Research Affiliates Fundamental Index (RAFI), based on assets, as of 9/30/19.

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