

# Smart beta: Not all strategies are created equally

**Anthony B. Davidow, CIMA®**

Vice President, Alternative Beta and  
Asset Allocation Strategist  
Schwab Center for Financial Research™

With the tremendous growth of smart beta strategies—both assets under management and the number of strategies available to investors—one of the biggest challenges is often how to distinguish amongst the various options.

While smart beta strategies are often grouped together, as we have shown with our research, there is a great deal of diversity across the various types of strategies. Fundamental index strategies are quite different from Momentum, Quality, Low Volatility and Equal-Weight. To help advisors, we've dissected these strategies, comparing their sector allocations, market-capitalization and value vs. growth tilts against the broad-based benchmarks (see "Strategic Beta Strategies: An Evaluation of Different Approaches").

Another way of distinguishing amongst the options is comparing returns over time. While most smart beta strategies claim they outperform their market-cap equivalents, the return patterns—and type of market environment they thrive in—vary by strategy. To illustrate this point, we compare the year-over-year results of a few of the indexes. We rank the yearly returns of Equal-

Weight, Fundamental, Momentum, Low Volatility, Quality and Market-Cap from 2007 through 2016. We then compare the annualized returns and risk of each index over the entire time period.

The modified "quilt" chart (Figure 1) shows the rotation of the best and worst performing strategies. There are a couple of interesting observations to point out. During this time period, Quality was the best performing index in aggregate, but wasn't the top performer in any given year. Momentum was the best performing strategy in 2015 and the worst in 2016. Conversely, Fundamental lagged in 2015 but was the best performer in 2016.

As other research has suggested, these strategies outperformed the market-cap index over the 10 year period. Note, they don't all outperform every year.

The point of this illustration is to highlight the differences in return from one period to the next. Momentum did quite well in 2015—fueled by the FANG stocks. Conversely, as we’ve seen increased volatility in 2016, and more attention to valuations, fundamental index strategies have performed better. **The point is—not all smart beta strategies are created equally.**

# Smart beta year-over-year results

Figure 1

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Annualized returns 2007–2016	Standard deviation 2007–2016
17.4% Momentum	-21.4% Low Volatility	46.3% Equal Weight	21.9% Equal Weight	14.8% Low Volatility	17.7% Equal Weight	36.2% Equal Weight	17.5% Low Volatility	8.7% Momentum	16.7% Fundamental	9.0% Quality	17.9% Equal Weight
11.6% Quality	-31.1% Quality	33.1% Fundamental	17.9% Fundamental	8.5% Quality	16.7% Fundamental	34.9% Fundamental	14.5% Equal Weight	4.3% Low Volatility	14.8% Equal Weight	8.5% Low Volatility	16.1% Fundamental
5.5% Market Cap	-34.7% Fundamental	26.7% Quality	17.8% Momentum	5.5% Momentum	16.1% Quality	34.0% Momentum	14.2% Momentum	2.1% Quality	12.0% Market Cap	8.4% Equal Weight	16.0% Momentum
3.6% Fundamental	-36.7% Market Cap	26.5% Market Cap	15.1% Market Cap	2.9% Fundamental	16.0% Market Cap	32.4% Market Cap	13.7% Market Cap	1.4% Market Cap	10.7% Quality	8.2% Fundamental	15.3% Market Cap
1.5% Equal Weight	-39.7% Equal Weight	19.2% Low Volatility	14.5% Quality	2.1% Market Cap	14.3% Momentum	31.7% Quality	13.3% Quality	-2.2% Equal Weight	10.4% Low Volatility	7.2% Momentum	14.0% Quality
0.6% Low Volatility	-41.1% Momentum	17.1% Momentum	13.4% Low Volatility	-0.1% Equal Weight	10.3% Low Volatility	23.6% Low Volatility	12.7% Fundamental	-2.6% Fundamental	4.6% Momentum	6.9% Market Cap	11.2% Low Volatility

Source: Schwab Center for Financial Research with data provided by Morningstar Direct. Data used from January 1, 2007 through December 31, 2016. Annualized Return and Standard Deviation are calculated from January 1, 2007 through December 31, 2016. Strategy performance represented by annual total returns for the following indexes: Market Capitalization—S&P 500; Fundamental—Russell RAFI US Large Company; Equal Weight—S&P 500 Equal Weight; Momentum—MSCI Momentum Factor; Low Volatility—S&P 500 Low Volatility; Quality—Russell 1000 Quality Factor. The inception date for the Russell RAFI Index® Series is 2/24/2011. All data before that date is back-tested. The Russell RAFI Index data published herein is simulated, unmanaged, and cannot be invested in directly. Past simulated performance is no guarantee of future performance and is not indicative of any specific investment. Actual investment results may differ. Back-tested performance is hypothetical, done with the benefit of hindsight, and provided for informational purposes only to indicate historical performance had the stocks actually been invested in over the relevant time period. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. **Past performance is not indicative or a guarantee of future results.**

For institutional use only—Not for further distribution

The information here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice.

The type of investment strategies mentioned may not be suitable for everyone. Each investor needs to review a security transaction for his or her own particular situation. All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data here is obtained from what are considered reliable sources; however, its accuracy, completeness, or reliability cannot be guaranteed. **Past performance is no guarantee of future results. The opinions presented should not be viewed as an indicator of future performance.**

Past performance of a back-tested model is not a guarantee that the model will produce similar results in the future.

Russell Investments and Research Affiliates LLC have entered into a strategic alliance with respect to the Russell RAFI Index Series. Subject to Research Affiliates’ intellectual property rights in certain content, Russell Investments is the owner of all copyrights related to the Russell RAFI Index Series. Russell Investments and Research Affiliates jointly own all trademark and service rights in and to the Russell RAFI Indexes.

Charles Schwab & Co., Inc. is not affiliated with Russell Investments or Research Affiliates. The Schwab Center for Financial Research is a division of Charles Schwab & Co., Inc.

The Schwab Center for Financial Research is a division of Charles Schwab & Co., Inc.

©2017 Charles Schwab & Co., Inc. All rights reserved. Member SIPC. TWI (0217-U1DM) SLS93490-01 (02/17)



*Own your tomorrow.*