ETF Know:How

Your guide to evaluating strategic beta ETFs

Strategic beta exchange-traded funds (ETFs), especially multi-factor strategies, have become more common in recent years, making thorough due diligence an important step in evaluating them. Asking questions like those included here can help you determine the most suitable strategic beta ETF and better navigate the complexities associated with certain strategies.

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General strategic beta strategies

Questions to ask	Things to consider
Is the index strategy understandable and transparent?	**A transparent methodology should clearly explain index construction. Vague language implies greater complexity and uncertainty in what is supposed to be a "rules-based" index.** • Can the issuer explain the index methodology enough for you to fully understand it? If not, consider a more straightforward alternative.
How much history does the index strategy have?	**Having sufficient history allows you to analyze how the strategy performed during various market cycles, especially relative to cap-weighted indexes.** • Verify if the index strategy was newly created. If historical data is displayed, investigate whether it is real versus back-tested performance. • If the index was created by the ETF issuer to launch a product, confirm if the index was based on an existing active strategy. If so, make sure you understand any differences.
How does the strategic beta strategy fit in a portfolio?	**The ETF issuer should present a clear story and purpose behind the strategy's usage in a portfolio.** • Determine if the strategic beta ETF can serve as a complement or a replacement to cap-weighted ETFs. • Understand what, if any, differentiation the strategic beta ETF provides compared to cap-weighted ETFs in terms of size, sector and factor tilts. • If breaking the link with stock price and weighting is an objective, verify that the index does not carry an embedded link to price in its construction.
What is the ETF's closure risk?	**Checking the ETF's fund closure risk is imperative, especially for multi-factor ETFs, which have proliferated in recent years more than any other strategic beta category.** • To determine an ETF's closure risk level: – Check if the ETF's assets and liquidity are sufficient for long-term survival – Check the issuer's history with ETF closures – Check the competitive landscape to determine the ETF's viability in its category
Does the issuer provide a suite of ETFs across size and regions with the same index methodology?	**To create a diversified global portfolio, it may be helpful to use the same index methodology across a full suite of products.** • Check if the issuer has large- and small-cap size, as well as U.S., developed ex-U.S. and emerging markets regions ETFs.
How cost efficient is the strategy?	**Cost efficiency is an important element in achieving investment goals over time.** • Compare the ETF's expense ratio to ETFs with similar strategies from the same Morningstar Strategic Beta category, but avoid choosing a fund solely based on fees. Keep in mind that a fund that looks "inexpensive" may actually be "expensive" if it offers little to no differentiation from a low-cost cap-weighted ETF. • Look at the ETF constituents' size and liquidity. Smaller, less liquid stocks may carry large portfolio weightings in certain strategies, potentially leading to wider ETF bid/ask spreads and higher costs to transact in block sizes.

Complex factor-based strategies

Questions to ask	Things to consider
How does the index provider define each factor?	**Index providers often consider different metrics, or "ingredients" in creating factor-based indexes. For example, while the definition of value is widely accepted, value indexes may diverge in sector exposures (and performance) based on the metrics employed to create the value tilt.** • Check the index methodology to verify and understand the metrics used to create the factor tilts.
How are factors combined?	**Among multi-factor ETFs, there is great difference in how many and which combination of factors are employed. For example, two-, three-, four-, or five-factor models combine such factors as value, quality, momentum, size, low-volatility and yield.** • Check how many factors the index is targeting, and make sure the combination of factors employed aligns with your objectives.
How are factor exposures weighted?	**Some multi-factor strategies provide equal exposure to each factor. Others customize their factor exposures, giving certain factors greater exposure than others. And others may periodically shift the factor exposures "dynamically" based on a quantitative model.** • Understand how much exposure (or weight) is given to each factor in constructing the strategy.
How is the index constructed?	**Multi-factor indexes are constructed using an isolated (top-down) or integrated (bottom-up) approach, which can impact the factor characteristics produced by the index.** • Check if the index is employing an isolated or integrated approach. An isolated approach starts with the creation of several single factor indexes that are usually equal-weighted to create a "master" multi-factor index. An integrated approach often measures each constituent based on a number of factors, then selects and weights the constituents based on an aggregated "factor score." • Check if sector constraints are considered.

For more ETF insights and strategies, visit

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