

Exchange traded funds

# Fundamental Index<sup>®</sup> and multi-factor strategies: Key differentiators



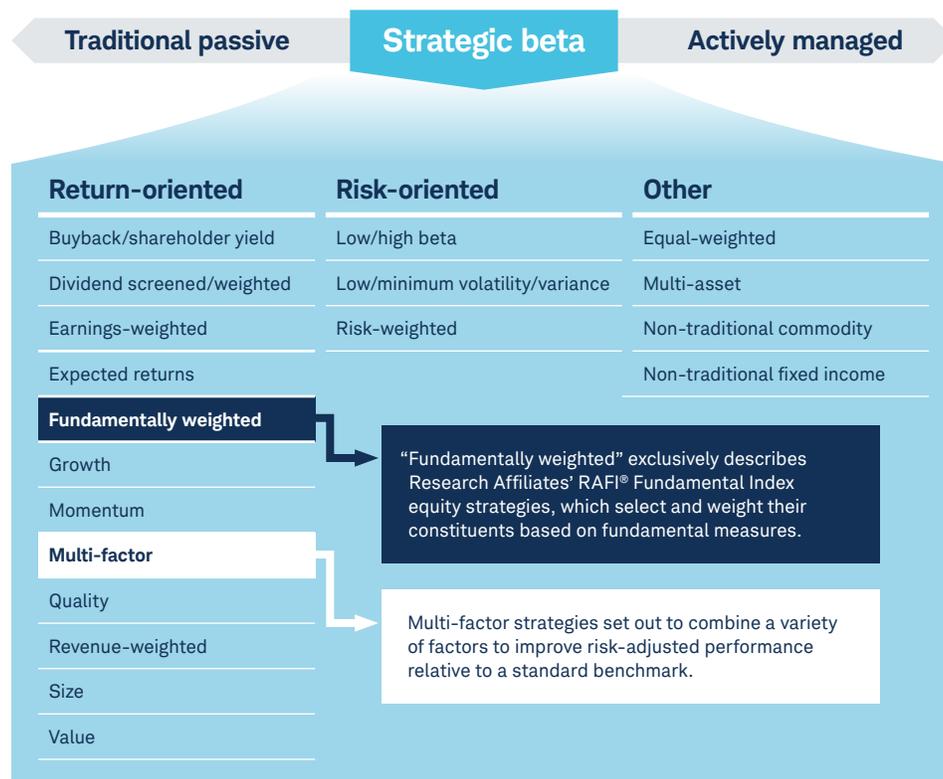
**The proliferation of strategic beta strategies, also known as “smart beta,” has made it more challenging for advisors to differentiate among all the options. As a result, these strategies are often grouped together.**

**Two strategic beta strategies—  
Fundamental Index<sup>®</sup> and multi-factor  
—may at first seem similar, but  
Fundamental Index is different from  
multi-factor in several important ways.**

# Fundamental Index® and multi-factor strategies have vastly different methodologies.

Morningstar’s strategic beta taxonomy shows that both Fundamental Index and multi-factor are strategic beta strategies, but their methodologies are distinctly different. Fundamental Index is not considered factor-based indexing, as it does not target specific factors; however, it tends to carry a dynamic value/size tilt as a by-product of its economic screening process.

Multi-factor strategies, by comparison, are considered factor-based indexing. They intentionally target a combination of specific factors, including size, momentum, value, low volatility, quality, and dividend yield.



Source: Morningstar.

# Fundamental Index<sup>®</sup> employs a straightforward, transparent methodology.

The Fundamental Index methodology was developed by Rob Arnott and his colleagues at Research Affiliates LLC over a decade ago. The methodology uses fundamental measures to select and weight each constituent based on its economic footprint. Because of its straightforward approach and transparent nature, this methodology may be easier to explain to clients.



Fundamental measures listed are specific to Russell RAFI<sup>™</sup> Index Series and may include additional measurements.

By contrast, multi-factor strategies involve a complex, multi-step evaluation process. There are four essential “how” questions to ask in evaluating multi-factor strategies:

**1**

**How does the index provider define each factor?**

**2**

**How many and which factors are being combined?**

**3**

**How are the factor exposures weighted?**

Equal, customized, or dynamic?

**4**

**How is the index constructed?**

Isolated<sup>1</sup> (top-down) or integrated<sup>2</sup> (bottom-up) approach?

<sup>1</sup> Combining several single-factor indexes.

<sup>2</sup> Measuring each security based on multiple factors.

# The streamlined product set of Fundamental Index<sup>®</sup> ETFs simplifies the evaluation process.

Evaluation of Fundamental Index exchange traded funds (ETFs) may be easier given that there are only 12 of them in existence. In comparison, 239 ETFs exist for multi-factor. The proliferation of multi-factor ETFs, especially over the past three years, only adds complexity to the product selection and evaluation process.

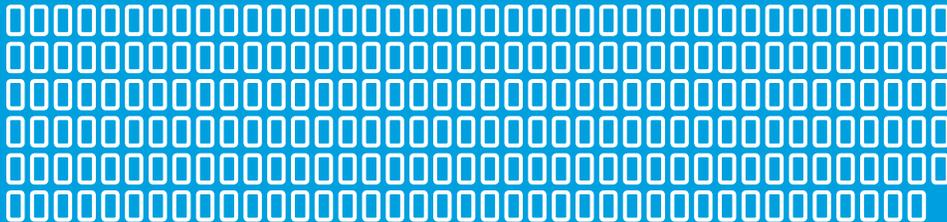
# 12

Fundamental Index ETFs



# 239

Multi-factor ETFs



Source: Morningstar, December 31, 2017.

# Fund closure risk is considerably lower for ETFs that utilize Fundamental Index<sup>®</sup>.

Fundamental Index ETFs have not proliferated to the degree multi-factor ETFs have. Eighty-six multi-factor ETFs are now at high risk of fund closure, whereas just one Fundamental Index ETF is at high risk of fund closure.<sup>3</sup>

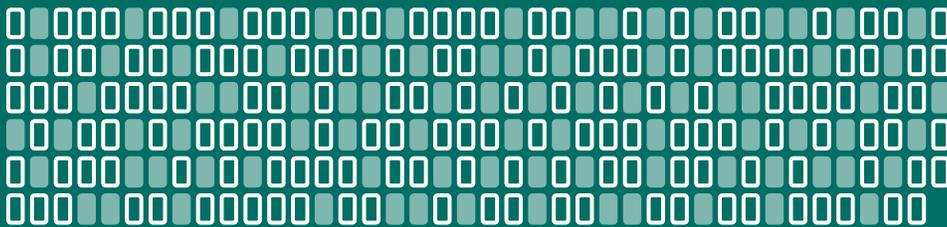
# 1

Fundamental Index ETF is at high risk of fund closure



# 86

Multi-factor ETFs are at high risk of fund closure



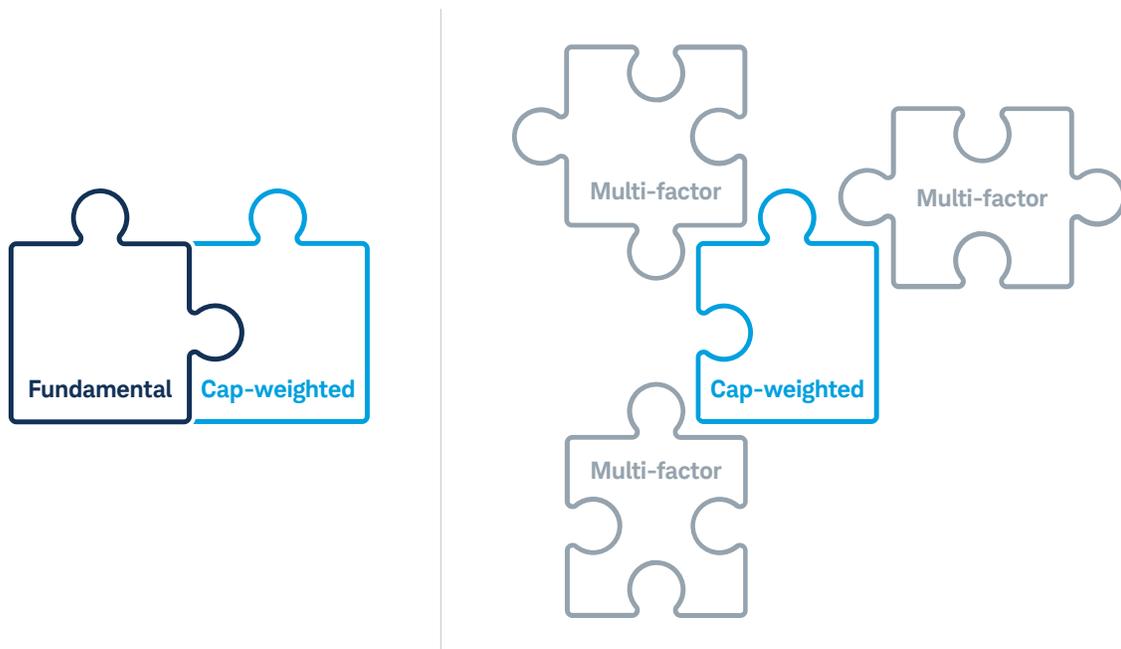
<sup>3</sup> ETF.com assigns a Fund Closure Risk metric measurement of “low,” “medium,” or “high” for each ETF, based on a quantitative methodology that considers fund assets under management, issuer strength, fund rank in segment, and ADV, among other metrics.

Source: ETF.com, December 31, 2017. Strategic beta classification sourced from Morningstar.

# Fundamental Index® strategies blend well with traditional cap-weighted strategies.

Fundamental Index's dynamic value/size tilt blends well with traditional cap-weighted strategies, which have benefited from a momentum bias in recent years.

Comparatively, multi-factor strategies are often highly differentiated from one another. Depending on the strategy and construction of the indexes, the use of multi-factor strategies as a complement for traditional cap-weighted strategies is less straightforward.



# Fundamental Index<sup>®</sup> often performs well during value-oriented and/or mean-reverting market environments.

The market environment in 2016 serves as a prime example. Mean reversion and value tilts were major contributors to Fundamental Index outperformance over their respective cap-weighted indexes.

## U.S. Large Cap

2016 total returns



## Emerging Markets

2016 total returns

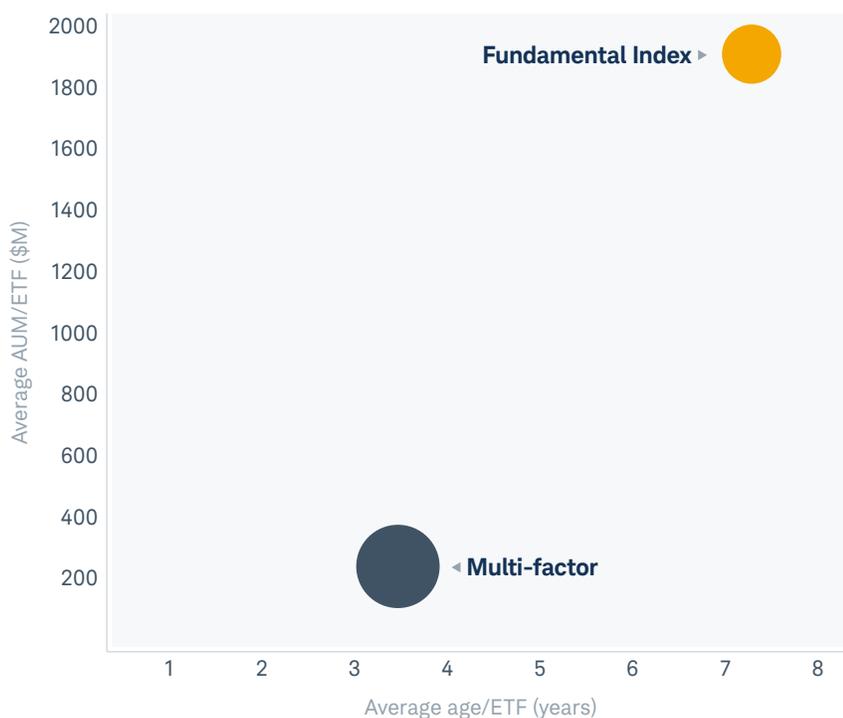


Source: Morningstar.

# Fundamental Index<sup>®</sup> ETFs have, on average, longer trading histories and higher AUM.

Fundamental Index ETFs have longer trading histories and relatively larger asset bases compared to most multi-factor ETFs, many of which have little to no trading history.

## Average age and assets under management (AUM)



**Source:** Strategic Insight Simfund<sup>®</sup> Mutual Fund Database, using Morningstar's strategic beta classifications as of December 31, 2017. Fundamental Index and multi-factor strategic beta categories based on Morningstar's strategic beta taxonomy. Some strategic beta ETFs initially launched as market cap products that were later converted to strategic beta products. The chart reflects initial fund inception dates, per Morningstar, and not the date of conversion to strategic beta. Circle size in chart reflects the strategy's total AUM (Fundamental Index \$23,433M and multi-factor \$55,894M).

# Fundamental Index<sup>®</sup> ETFs have lower holding costs.

Fundamental Index ETFs have, on average, lower expense ratios than multi-factor ETFs. Fund expenses alone should not determine the most appropriate strategic beta strategy; however, selecting a strategy with low expense ratios remains an important consideration, especially over long time horizons.



<sup>4</sup> Includes all ETFs classified as “Fundamentally weighted” by Morningstar, including Schwab Fundamental Index ETFs.

Source: Strategic Insight Simfund<sup>®</sup>, using Morningstar’s strategic beta classifications, December 31, 2017.

\* Schwab is a registered trademark of Charles Schwab & Co., Inc. (Schwab).

## Key takeaways:

- ✓ Fundamental Index® is different from multi-factor strategies. It does not target specific factors.
- ✓ The Fundamental Index methodology is transparent, straightforward, and easy to understand.
- ✓ The proliferation of multi-factor ETFs adds complexity to the product evaluation process.
- ✓ Fundamental Index can be a complement to traditional cap-weighted indexes.
- ✓ Fundamental Index ETFs have a longer trading history than most multi-factor ETFs.
- ✓ Schwab Fundamental Index ETFs have, on average, lower expense ratios than multi-factor ETFs.

### Schwab Fundamental Index ETF lineup

<b>FNDB</b> Schwab Fundamental U.S. Broad Market Index ETF Expense ratio: 0.25%	<b>FNDX</b> Schwab Fundamental U.S. Large Company Index ETF Expense ratio: 0.25%	<b>FNDA</b> Schwab Fundamental U.S. Small Company Index ETF Expense ratio: 0.25%
<b>FNDF</b> Schwab Fundamental International Large Company Index ETF Expense ratio: 0.25%	<b>FNDC</b> Schwab Fundamental International Small Company Index ETF Expense ratio: 0.39%	<b>FNDE</b> Schwab Fundamental Emerging Markets Large Company Index ETF Expense ratio: 0.39%

To learn more, call  
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Past performance does not guarantee future returns.

Diversification does not eliminate the risk of market loss.

Indexes are unmanaged, do not incur management fees, costs, and expenses, and cannot be invested in directly.

There can be no assurance that the Fundamental Index® methodologies will achieve their desired outcomes. Each investing strategy involves its own set of unique risks and benefits.

Investment returns will fluctuate and are subject to market volatility, so an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

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The MSCI Emerging Markets Index (Net) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance in the global emerging markets. This series approximates the minimum possible dividend reinvestment. The returns are calculated applying dividend withholding rates applicable to non-resident persons who do not benefit from double taxation treaties.

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