How Smart Beta Can Help Investors Navigate Market Moves

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Global stock markets seem to be on a roll, with volatility unusually low despite tensions over North Korea and political infighting in the United States. But rallies ultimately end, so what can international equity investors do now to ensure they keep on track with their investment goals? In our previous article, we explained the concepts of smart beta and factors. In this second instalment of our series, we focus on how blending multiple factors can help investors navigate changing market conditions.

When markets are climbing, investor complacency tends to go high as well. But smart investors should also be thinking about what to do when the good times end. Ideally, investors would want to see their portfolios benefit from the rally for as long as possible, yet be protected from any reversal.

The conventional way of protecting against downside risk is to shift to a more conservative, fixed-income-based portfolio. However, given the prevailing low return expectations, a more conservative portfolio may not earn enough to meet investors' goals and timing the market can be tricky.

What if we say there's an equity portfolio that can provide consistent exposure to both growth and defensive factors aimed at providing smoother returns as market conditions change? Using smart beta, an investment strategy that harnesses the drivers of equity risk and return or "factors", investors can have a portfolio that's more responsive to market cycles.

Smoother Returns

The outperformance of factors over broad market-cap indices has been well-researched for decades. In our **previous article**, we introduced some of the commonly accepted factors; here is a recap of their general characteristics.

Value: Value stocks trade at a low price relative to their fundamentals, such as earnings or sales.

Low Volatility: Volatility measures the distribution of returns and is considered an effective way of gauging future expected risk.

Quality: This factor focuses on companies with low debt, stable earnings and high profitability.

With these attributes, it's no surprise that factors perform differently in different market conditions. Quality and low volatility strategies tend to outperform in market downturns, while value strategies usually deliver its strongest returns in risk-seeking environments.

A strategy that combines these factors in a single portfolio — or a multi-factor smart beta strategy — offers diversification throughout the business cycle, with at least one factor working in favour with the business cycle when others drag. The potential result is a more consistent and smoother return stream over the long run.

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Multi-Factor Smart Beta in Action

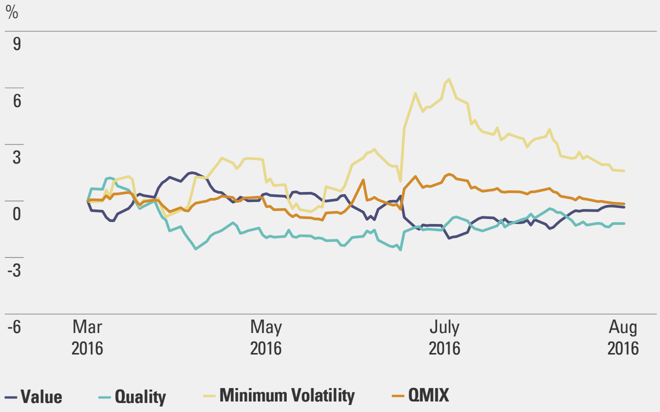
So how does the strategy work in practice? Let's consider the SPDR® MSCI World Quality Mix Fund (QMIX), an exchange traded fund (ETF) traded on the ASX that provides exposure to over 500 large to midcap stocks in more than 20 developed nations, including Australia. The Fund seeks to track the performance of the MSCI World Factor Mix A-Series Index which aims to represent the combined risk/return performance characteristics of quality, value and low volatility factors within global developed equities. Combining these three factor indexes in equal proportions has historically offered a smoother performance ride and greater diversification compared to individual factor indexes.

In Figure 1, we've compared the performance of the QMIX ETF and its underlying Factor's against the MSCI World Index (as representative of a broad market cap index).

In the volatile days following the surprise Brexit vote on 23 June 2016, investors may have found it difficult sell their stock holdings and shift to more defensive stocks without the risk of losing money. But an investor with a multi-factor smart beta portfolio could have already been defensively positioned without having to make a single transaction.

In this case, QMIX managed to cushion volatility during this period and ride the upside when markets recovered. QMIX's three factors performed differently — value stocks underperformed, but high quality and low volatility stocks outperformed, compensating for value.

Figure 1: QMIX and Single Factor Index Cumulative Excess Performance Returns Versus MSCI World Index



Source: State Street Global Advisors (SSGA), as at 22 August 2016.

Past performance is not a reliable guide to future performance.

Returns are measured in AUD and reflect the cumulative excess performance return for MSCI World Index vs MSCI World Value Weighted Index ("Value"), MSCI World Index vs MSCI World Quality Index ("Quality"), MSCI World Index vs SPDR MSCI World Quality Mix Fund ("QMIX "), and MSCI World ex Australia Index vs MSCI World ex Australia Minimum Volatility Index (AUD) ("Minimum Volatility"). The index returns are unmanaged and do not reflect the deduction of any fees or expenses. The index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. The QMIX performance figures contained herein are provided on a net of fees basis, before taxes but after management and transaction costs. Returns have been calculated assuming reinvestment of all distributions and is calculated in AUD. Returns do not reflect the brokerage fees or the bid/ask spread that investors pay to buy and sell ETF securities on the Australian Securities Exchange.

Why Smart Beta?

Active managers have long harnessed the power of factors to beat their benchmarks over time. The difference with smart beta is that it seeks to harness this power of factors by using a systematic, low-cost and transparent approach more synonymous with passive investing.

Investors can use an index that's specifically designed to screen for the desired factors. This rules-based approach can potentially result in consistent positive exposure to the desired factors over time as well as cost reduction. And in today's low-return environment, lower fees mean you get to keep more of your returns.

A growing number of multi-factor smart beta ETFs globally has made it easier for investors to access this opportunity. So instead of divining winners and market trends, why not consider a multi-factor smart beta strategy to diversify your exposure for different market conditions?

Learn more about QMIX and multi-factor smart beta investing at spdrs.com.au.

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Investing involves risk including the risk of loss of principal. Diversification does not ensure a profit or guarantee against loss. Sector ETF products are also subject to sector risk and non-diversification risk, which generally results in greater price fluctuations than the overall market.

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Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions. Low volatility funds/strategy can exhibit relative low volatility and excess returns compared to the Index over the long term; both portfolio investments and returns may differ from those of the Index. The fund may not experience lower volatility or provide returns in excess of the Index and may provide lower returns in periods of a rapidly rising market. Active stock selection may lead to added risk in exchange for the potential outperformance relative to the Index.

A "quality" style of investing emphasises companies with high returns, stable earnings, and low financial leverage. This style of investing is subject to the risk that the past performance of these companies does not continue or that the returns on "quality" equity securities are less than returns on other styles of investing or the overall stock market.

Companies with large market capitalisations go in and out of favour based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalisations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalisations.

Investments in mid-sized companies may involve greater risks than in those of larger, better known companies, but may be less volatile than investments in smaller companies.

Investing in foreign domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

The Strategy employs a value style of investing that emphasises undervalued companies with characteristics for improved valuations, which may never improve and may actually have lower returns than other styles of investing or the overall stock market.

Diversification does not ensure a profit or guarantee against loss.

Value stocks can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.