# Smart Beta: Unlocking Higher Potential Returns

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A rules-based approach can be disciplined and effective in harnessing specific attributes of risk and return, known as "factors" to try to generate better risk-adjusted returns, a style typically used by active managers.

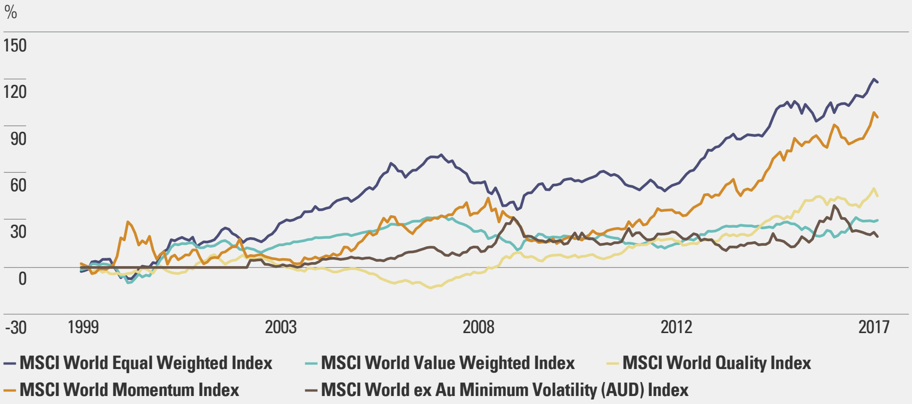
Smart beta is attracting increased interest as investors find they may no longer be able to meet their desired outcomes using traditional investment approaches. In an environment of potentially extended low and slow growth, and increased uncertainty, many investors are considering rethinking how they build portfolios. Smart beta gives them the opportunity to potentially achieve higher returns than the traditional market-cap benchmark over time and/or lower risk using cost-efficient implementation strategies.

A rules-based approach can be disciplined and effective in harnessing specific attributes of risk and return, known as "factors" to try to generate better risk-adjusted returns, a style typically used by active managers. Investors who are also looking for cost efficiency, greater transparency and consistency — attractive features of passive investing — may find smart beta more suitable for their needs because it offers active-like investing within a relatively low cost, passive-like structure.

## What Investors Should Consider

Figure 1 below shows how indices tracking six main, broadly accepted equity factors performed against the market cap-weighted benchmark (MSCI World Index) over the long-term. It's worth noting, however, that there have been periods when certain factors underperformed the broad market while others outperformed.

**Figure 1: Excess Cumulative Returns to MSCI World Index**
AUD, net accum, Jan 1999–July 2017*




Source: FactSet, as of 07/31/2017.

* MSCI World ex Au Minimum Volatility (AUD) Index from Nov 2002.

Data are quoted in AUD, net of withholdings tax. All indices are based off MSCI World Index, except MSCI World ex Au Minimum Volatility (AUD) Index which excludes Australia due to data availability.

Past performance is not a reliable indicator of future performance. Index returns reflect all items of income, gain and loss and the reinvestment of dividends. It is not possible to invest directly in an index.

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That's why when it comes to smart beta investing, we believe the first thing an investor needs to decide is which factor to capture in a portfolio. Factor selection should be influenced by the investor's risk preferences and should be aligned with his or her investment goals. Below we briefly outline the most common smart beta factors that drive portfolio returns:

- **Value:** Value stocks are those that trade at a low price relative to their fundamentals, such as earnings or sales. Value stocks have been shown to outperform the broader market indices over the long-term. These results have been replicated by numerous researchers over many different sample periods and for most stock markets around the world.[2] Possible explanations of excess returns include investors' behavioural biases and the reward for taking additional risk or providing liquidity in a stressed environment.
- **Quality:** This factor focuses on companies with low debt, stable earnings and high profitability. Higher quality companies seem to be rewarded with higher returns over the longer term because they have been shown to be better at deploying capital and generating wealth than the broader market.[3]
- **Size:** Small-cap stocks have tended to outperform their large-cap peers over time.[4] Some of the outperformance of small-caps can be attributed to the fact that fewer analysts typically cover these companies, giving them the potential to surprise the market to the upside because there is less visibility into their operations. Another argument for their long-term outperformance may be that they are higher risk than their large-cap brethren.
- **Low Volatility:** Volatility — or the standard deviation of past returns — is one measure of risk. The long-term historic outperformance of low volatility strategies may appear to be at odds with more traditional financial theory, but empirical evidence suggests otherwise.[5] One explanation for this outperformance is that investors overlook "boring" low volatility stocks in favour of "glamorous" ones — such as popular tech stocks — and, in the process, miss out on the consistent returns low volatility stocks can offer.
- **Momentum:** Empirical evidence shows that stocks that have done well recently may have greater potential of doing well in the near term than the broader market.[6] Obtaining more exposure to these stocks could potentially result in a portfolio benefitting from the momentum premium.
- **Yield:** Over the long-term, stocks with higher dividends tend to perform better than stocks with lower yields.[7] This outperformance could be attributable to the Value or Quality characteristics of yield.

At the end of May 2017, there were 1,237 smart beta equity exchange traded funds (ETFs) and exchange traded products (ETPs) globally, with US$585 billion in assets.[7] With a growing number of smart beta strategies now offered in Australia, investors should conduct ample due diligence before choosing a smart beta fund. Not all smart beta funds are created equal, so knowing what lies beneath the label can assist investors to make better decisions on when, how, and why they may want to implement smart beta within a portfolio. Investors should work with their financial adviser to find the right strategy for their individual risk tolerance level and objective.

1 "The cross-section of expected stock returns," Fama, E. & French, K., Journal of Finance, as of 6/1992, 47, 427–465. Fama, E., & French, K., "Common risk factors in the returns on stocks and bonds," Journal of Financial Economics, Volume 33, issue 1, as of 6/1992, 3–56.

2 "Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?" Sloan, R.G., The Accounting Review, as of 1996, 71, 289–315.

3 "The cross-section of expected stock returns," Fama, E. & French, K., Journal of Finance, June 1992, 47, 427–465; Fama, E., & French, K., "Common risk factors in the returns on stocks and bonds," Journal of Financial Economics, Volume 33, issue 1, as of 6/1992, 3–56.

4 "Low Risk Stocks Outperform within All Observable Markets of the World," Baker, Nardin and Haugen, Robert A., as of 4/27/2012.

5 "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency," Jegadeesh, Narasimhan and Titman, Sheridan, The Journal of Finance, Vol. 48, No. 1, as of 3/1993, pp. 65–91.

6 "Stock Returns and Dividend Yields: Some More Evidence," Blume, M.E., The Review of Economics and Statistics, 1980, 62 (4) 567–577.

7 ETFGI, as at 27/06/2017.

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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 emphasizes 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 emphasizes 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.






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