

TACTICAL INSIGHTS

IS SMART BETA SMARTER THAN INDEX?

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In the past 10 years, smart beta has become one of the fastest growing investment segments. Being called by different names such as strategic beta, fundamental indexing or factor investing, smart beta represents rules-based strategies that aim to deliver better returns than traditional market-cap-weighted indexes by selecting stocks or using different weighting schemes based on fundamental factor(s). The growth of the segment has been impressive. Blackrock reported the total ETF assets under management with smart beta strategies reached \$282 billion as of May 2016, and predicted that smart-beta ETF assets would quadruple to \$1 trillion by 2020. Despite its increasing usage, every investor should ask if smart beta can really deliver on its promise.

Most of the smart beta ETFs have short performance track records. We will try to answer the question by examining the major smart beta ETFs with at least \$1 billion AUM and the longest history in their respective factor category. Table 1 shows the performance of the ETFs on 1-year, 5-year and 10-year horizons. Normally, smart beta strategies use a single factor or multi factor models to select securities and/or create different weighting schemes from cap-weighted indexes. We will discuss each of the factor strategies and the performance of its related ETFs.

- **Dividend** – This strategy aims to capture excess returns by investing or over-weighting stocks with higher dividend yields. The most popular ETFs in this category are VYM, DVY and SDY. The average ten-year return of them is slightly lower than those of SPY and VTI.
- **Equal-Weighted Portfolio** - This strategy aims to capture the size effect, which states that stocks with smaller market capitalization tend to outperform the stocks with larger capitalization. Compared to a cap-weighted portfolio, an equal-weighted portfolio over-weights stocks with smaller caps. The most popular equal-weighted ETF – RSP – outperformed SPY and VTI slightly over a ten-year horizon.
- **Minimum Volatility** – This strategy aims to generate alpha through investing or over-weighting stocks with below-average volatility and beta. Empirical academic researches show there exists a low volatility premium historically. However, the average five-year return of the two most popular low-volatility ETFs – USMV and SPLV - is slightly lower than those of SPY and VTI.

- **Momentum** – This strategy aims to generate excess returns by investing or over-weighting stocks with the strongest price momentum, which is measured by price return in a certain period. The popular momentum ETF – FDP – underperformed SPY and VTI in past ten years.
- **Quality** – This strategy aims to capture excess returns by investing or over-weighting stocks with good “qualities” such as low leverage, stable earnings, high return on equity, etc. The longest-running ETF in this category – SPHQ – underperformed both SPY and VTI.
- **Value** – This strategy aims to capture the value premium by investing or over-weighting stocks that are “cheap” based on P/E, P/B or other valuation metrics. The value ETFs have the longest history. Two of the most popular value ETFs, IWD and VTV, underperformed SPY and VTI in past ten years.

Table 1. Performance of Major Smart Beta ETFs

Factor	ETF	Name	Performance (%)		
			1 Year	5 Year	10 Year
Dividend					
	VYM	Vanguard High Dividend Yield Index Fund	19.41	13.95	7.66
	DVY	iShares Select Dividend ETF	17.82	14.12	6.39
	SDY	SPDR S&P Dividend ETF	17.74	14.25	7.99
	Average		18.32	14.11	7.35
Equal Weight					
	RSP	Guggenheim S&P 500 Equal Weight ETF	20.81	13.87	8.16
Minimum Volatility					
	USMV	iShares Edge MSCI Min. Vol USA ETF	14.45	13.70	
	SPLV	Powershares S&P 500 Low Vol Portfolio	13.57	13.25	
	Average		14.01	13.48	
Momentum					
	FDP	Powershares DWA Momentum Portfolio	14.86	11.49	6.66
Quality					
	SPHQ	Powershares S&P 500 Quality Portfolio	17.19	14.25	5.91
Value					
	IWD	iShares Russell 1000 Value ETF	23.43	13.60	6.02
	VTV	Vanguard Value Index	23.16	14.22	6.52
	Average		23.30	13.91	6.27
Multi Factor					
	FEX	First Trust Large Cap Core AlphaDEX Fund	21.11	13.00	
Fundamental Indexing					
	PRF	Powershares FTSE RAFI US 1000 Portfolio	22.66	13.88	7.94
Benchmarks					
	SPY	SPDR S&P 500 Index	21.35	13.84	7.56
	VTI	Vanguard US Total Market ETF	22.25	13.68	8.07

Data Source: as of 3/09/2017. ETF.com

- **Multi-Factor** – This strategy aims to generate alpha by investing or over-weighting stocks selected by a quantitative model incorporating various factors like value, size, quality, momentum, etc. The longest running multi factor ETF – FEX – slightly underperformed SPY and VTI in past five years.
- **Fundamental Indexing** – This strategy is similar to the multi-factor strategy. Instead of weighting them based on their market capitalization, stocks in the portfolio are weighted based on a multi-factor fundamental score. The first ETF using Research Affiliate Fundamental Index – PRF – performed in line with SPY and VTI in last ten years.

Based on the performance records of different type of smart beta ETFs, the answer to whether smart beta can deliver better returns than cap-weighted indexes is not clear cut. It is unrealistic to expect outperformance by just picking any smart beta ETF. However, smart beta continues to be one of the most innovative investment segments. More managers and more smart beta ETFs are entering the market constantly. New factors are utilized and new models are created. To achieve a good investment outcome, investors who are interested in smart beta strategies should perform careful analysis and thorough due diligence.

Julex Capital Management is a SEC-registered quantitative investment management firm specializing in tactical investment strategies. The firm offers a variety of tactical unconstrained investment solutions aiming to provide downside risk management while maximizing the upside potentials using its unique [Adaptive Investment Approach](#).

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