INVESTING ETFS

Smart Beta ETF

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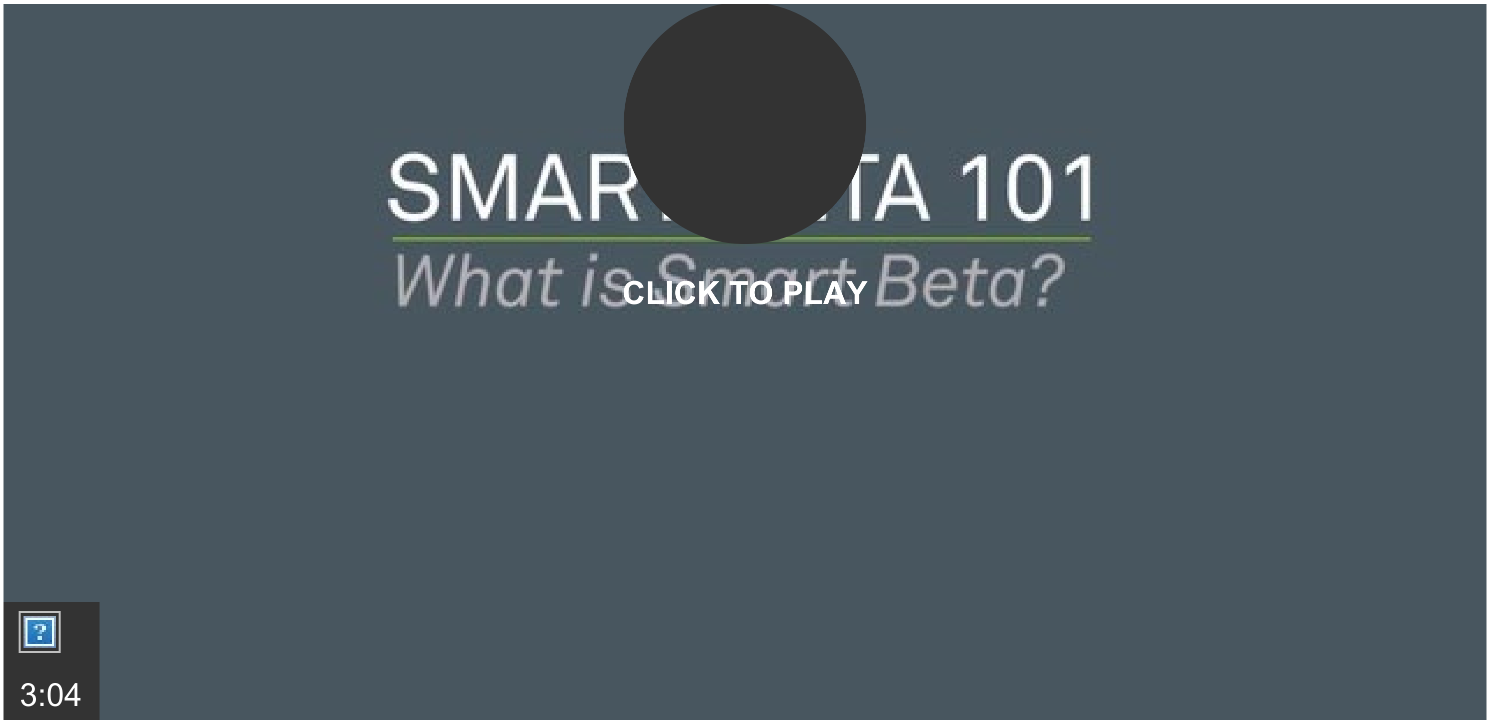
What Is a Smart Beta ETF?

A smart Beta ETF is a type of exchange-traded fund (ETF) that uses a rules-based system for selecting investments to be included in the fund portfolio. An exchange-traded fund or ETF is a type of fund that tracks an index such as the S&P 500. Smart beta ETFs build on traditional ETFs and tailor the components of the fund's holdings based on predetermined financial metrics.

KEY TAKEAWAYS

- Smart Beta ETFs use a rules-based, systematic approach to choosing stocks from a particular index.
- A smart Beta ETF might choose companies that only exhibit certain behaviors or metrics.
- Smart Beta is a blend of active and passive investing.
- Smart Beta investing follows an index, but it also considers alternative factors in choosing the stocks from the index.
- Common types of smart beta ETFs include strategies that are equally weighted, fundamentally weighted, factor-based, or low volatility.



Smart Beta 101: What is Smart Beta?

Understanding Smart Beta ETFs

The rules governing what stocks make up exchange-traded funds vary depending on the rules established at the fund's inception. Also, there are different weightings for each stock in a fund. Weighting means a fund might have more shares of one stock versus another based on an underlying aspect such as value. Some ETFs might track a stock index that contains only bank stocks, large companies, or technology stocks.

Market-cap weighting is one of the most common methods in selecting how many shares of a company's stock comprise an index or fund. A market-cap weighting means that a company is chosen based on its market capitalization or its share price multiplied by the number of outstanding shares. A company that has many shares outstanding, and whose stock has risen significantly, will have a significant weighting in a market-cap index.

Smart Beta doesn't employ the typical cap-weighted index strategy. Instead, it takes into account granular factors that are specific to a particular company or industry. A smart Beta ETF might choose companies that only exhibit certain behaviors or metrics. These metrics include factors like earnings growth, the momentum of a stock—the extent a stock moves up or down—or profitability. Each ETF has its own rules that are part of an overall systematic approach to picking stocks to be included in the fund.

Types of Smart Beta ETFs

A smart Beta ETF might screen and choose its holdings based on a company's dividend growth. Dividends are distributions paid to shareholders from the company's earnings as a reward for investing in the company. Companies that pay dividends tend to be large, well-established, and profitable companies.

Risk-weighted approaches take into account expected volatility in stocks. Funds might limit the holdings to stocks with low volatility to reduce risk in the fund. Volatility is a measure of how much a security's price fluctuates, or to the extent, it does or does not fluctuate in price. Conversely, some investors welcome risk and might want to invest in a fund that focuses on companies that have high-growth potential.

Although there are many types of Smart Beta ETF strategies, a few of the most common include:

- Equally weighted: Instead of weighting the fund based on stock price and market capitalization, this strategy equally weights the factors and each holding.
- Fundamentally weighted: Companies are selected and weighted by such factors as total earnings, profits, revenue, or financially driven fundamentals and metrics.
- Factor-based: Stocks are weighted based on specific factors such as balance sheet components, underpriced valuations, or smaller companies that are growing.
- Low volatility: This method focuses on stocks and indexes with low volatility or small price fluctuations over a historical period.

Passive and Active Management

Smart Beta ETFs use a combination of both passive and active methods of investing. Active investing is akin to having an investment manager choose stocks to include in a portfolio. An actively-managed fund buys and sells stocks as needed based on various fundamental metrics like earnings or financial ratios.

A fund is passive because it tracks an index without having an investment manager choosing the stocks. Passive funds tend to have lower fees as a result. For example, a fund might track all the stocks in the S&P 500 so that it mimics or tracks each move exactly as the S&P.

Smart Beta is a blend of active and passive investing. It follows an index making it passive, but it also considers alternative factors in choosing the stocks or investments from within the index. In other words, a smart beta fund that tracks the S&P 500 index would not select every stock on the index. Instead, it might select only the ones that exhibit a specific behavior such as a certain percentage amount of revenue growth.

Benefits Associated With Smart Beta ETFs

Many smart Beta ETFs are designed to increase portfolio returns, maximize dividends, and lower portfolio risks.

Some might argue that one of the benefits of Smart Beta strategies is the use of equally-weighted indexing. This parameter removes the emphasis on stocks in the index with the largest market-cap weightings. With market-cap weightings, if the largest stocks or holdings underperform, they will have a sizable impact on the performance of the index relative to the smallest components of the index.

Smart beta is not a passive strategy like the traditional market capitalization-weighted index funds. While many Smart Beta ETFs have higher expense ratios than passive index products, they are less expensive than most actively managed funds.

Smart Beta ETFs are ideal for investors hoping to maximize their income and returns while also allowing for the potential to minimize risk.

Risks Associated With Smart Beta ETFs

Smart Beta ETFs are still a relatively new method of investing and can exhibit low trading volumes. Low trading volume or liquidity can result in investors not being able to sell or exit their positions easily.

Trading costs can be high to re-establish the original index weighting. This increase in price comes from the fund purchasing stocks from the index that is to be included in the fund. As a result, the fees charged for smart Beta might be lower than actively managed funds, but the savings might not be significant.

Smart Beta ETFs can underperform traditional indexes, such as the S&P 500 since they need to be constantly readjusted to the indexes. In other words, holdings are added and sold based on the rules of the fund. Since smart Beta ETFs have so many variables to consider, trading them can be more difficult than trading with traditional indexes. As a result, the prices of smart Beta ETFs can vary from the fund's underlying value.

Pros

- Smart Beta is a blend of active and passive investing, following an index but also considering alternative factors.
- Smart Beta ETFs rely less on market-cap weightings to avoid one stock overly influencing an ETF's value.
- These funds have lower fees than actively-managed funds.
- Smart Beta ETFs allow for flexibility in choosing holdings and their behaviors including risk-based approaches.

Cons

- Some smart Beta ETFs can be expensive since stocks have to be bought and sold to meet the fund's rules.
- Smart Beta funds can underperform the passive indexes since they are traded continuously versus a buy and hold strategy.
- Trading volume can be low leading to difficulty buying and selling the funds.
- Smart Beta ETFs typically have higher fees than passively index-based funds.

Real-World Example of Smart Beta Funds

The Vanguard Dividend Appreciation Index Fund ETF Shares (VIG) is a smart-beta ETF that tracks an index of stocks that pay dividends. The fund chooses companies from the Nasdaq US Dividend Achievers Select Index. However, the VIG adds a layer of specific criteria that are needed for a company to be included in the fund's holdings. The VIG chooses companies that have made dividend increases for 10 consecutive years.

The expenses ratio is low at 0.06% and has companies from several industries including;

- Microsoft Corp.
- JPMorgan Chase & Co.
- Walmart Inc.
- PepsiCo. Inc.
- Johnson & Johnson

We can see from the list that the companies are well established, which is typical for companies that have consistently paid a dividend over the years. Since dividends are paid from earnings, only the most profitable companies can consistently pay them.

Related Terms

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An index fund is a pooled investment vehicle that passively seeks to replicate the returns of some market indexes. more

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