Smart Beta, Quant Funds and other Non-Traditional Index Funds

What are non-traditional index funds?

Some index mutual fund (/investing-basics/investment-products/mutual-funds) s and exchange-traded fund (/introduction-investing/basics/investment-products/exchange-traded-funds-etfs) s (ETFs) use more complex or targeted investing strategies than have been traditionally associated with index funds. Unlike traditional index funds, which track a market index, these funds use custom-built indexes to select the fund's investments. By tracking a custom-built index, a non-traditional index fund may seek to achieve performance greater than a particular market or sector. Or, such a fund may seek exposure to securities based on factors like financial strength, or environmental, social and governance concerns.

The custom-built indexes are constructed using criteria that a manager might consider when actively managing investments in a fund. But non-traditional index funds are still "passively managed." The investment adviser seeks to track an index, rather than using its own independent judgment to manage the fund's investments.

What are some examples of non-traditional index funds?

Non-traditional index funds do not always fall into distinct categories. Here are some examples:

- **Smart Beta** – The custom-built indexes for these funds often use "factors" to select the fund's investments. A factor is a characteristic or feature that is believed to cause certain types of securities to outperform or underperform the market as a whole. Examples of common factors are value, dividends or quality.

- **Quant Funds** – The custom-built indexes for these funds use numerical methods like quantitative analysis or algorithms to select the fund's investments.
- **Environmental, Social and Governance (ESG) Funds** –The custom-built indexes for these funds use environmental, social and governance factors to select the fund's investments. These factors are subjective and could include concerns like avoiding the use of toxic chemicals (environmental), using certain approaches to executive compensation (governance), or achieving diversity on the Board (social). ESG investing is sometimes referred to as socially responsible investing.

Take time to understand how the indexes are constructed. For example, a smart beta index may only use one factor or it may use multiple factors. Or, ESG funds may weight environmental, social and governance factors differently. For example, some ESG funds may have strong governance policies but may not have the environmental or social impact you want to encourage through your investment in the fund.

How are these funds different from traditional index funds?

Non-traditional index funds have unique characteristics and risks. In some cases, they may be complex and difficult to understand. Take time to make sure a fund is a good fit for you by considering such things as:

- **Correlation to market.** These funds may behave very differently than the market and traditional index funds. Because non-traditional index funds may be less correlated to the market, you may want to consider investing in them together with other types of funds. Depending on their characteristics, the other funds may help smooth out volatility and decrease risk.
- **Returns.** These funds may have some features of active management, including seeking to outperform the market. But, these funds will not necessarily outperform the market or even perform comparably to the market. In addition, these funds may have limited performance histories. It may not be clear how they will perform under different market conditions.
- **Diversification.** These funds can be used to help create a diversified (/research-before-you-invest/research/asset-allocation) portfolio. But, to ensure a fund adds diversity to your portfolio, you should understand how the index was constructed. In addition, look through the index to the actual holdings of the fund. Different indexes may include the same securities. Or, indexes could give more weight to certain securities than you might expect. Make sure your investments are as diversified as you think they are.
- **Complexity.** These products may be difficult to understand because their methods for attempting to achieve returns may not be straightforward. For example, an

index based on quantitative analysis or algorithms may involve complicated mathematical calculations and economic concepts.

- **Cost.** These funds may be less expensive than actively managed funds because managers are not actively picking securities, so they do not need the services of research analysts and others that help pick securities. But, these funds typically have higher expenses than traditional index funds. ***Always be sure you understand the actual cost of any fund before investing.***

Fees and expenses reduce the value of your investment return. If the holdings of two funds have identical performance, the fund with the lower cost generally will generate higher returns for you. For more information, see our Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio (/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-how-fees-expenses-affect) .

Before You Invest

Before investing in any fund, you should carefully read all of the fund's available information (https://www.sec.gov/answers/mfinfo.htm) . This information includes the fund's prospectus and most recent shareholder report. In addition, funds disclose their portfolio holdings quarterly in Form N-Q and shareholder reports. You can typically get this information from the fund's website or your financial professional, as well as on EDGAR (https://www.sec.gov/edgar/searchedgar/mutualsearch.html) .

In addition, consider asking the following questions before investing in a particular index fund:

1. What fees and expenses can I expect to pay for buying, owning, and selling this fund?
2. What specific risks are associated with this fund?
3. How is the makeup of the fund's index determined? What are the actual holdings of the fund?
4. How does the fund's investment strategy fit with my investment goals?

Additional Information

Investor Bulletin: Index Funds (/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-index-funds)

Questions You Should Ask About Your Investments (/system/files/publications/documents/english/AskQuestions_brochure_508_9-20.pdf)

Information Available to Investment Company Shareholders (/additional-resources/general-resources/glossary/information-available-investment-company)

Researching Public Companies through EDGAR: A Guide for Investors (https://www.sec.gov/oiea/Article/edgarguide.html)