

# SMART BETA ETFs: WHY NOT ALL STRATEGIES ARE CREATED EQUALLY

Wisdomtree EU  
23 Aug 2017

Exchange-traded funds, or ETFs, are gaining momentum in Europe and showing few signs of slowing any time soon. Not the least of which is smart beta, which represents around 27% of the \$4.1 trillion global ETF market<sup>1</sup>. Despite smart beta's growing popularity, however, the nuances present within the different smart beta strategies warrant a closer look.

Firstly, smart beta is not a single strategy, but an all-encompassing term to describe a multitude of strategies ranging from simple to complex. Secondly, smart beta strategies are rules-based, that is, they aim to achieve better risk-adjusted returns in a systematic way. The difference between smart beta funds are the ways in which each fund selects and weights specific securities or investment objectives.

Some of the smart beta strategies that are attracting attention are listed in Table 1. A range of products are offered within each of these categories, ranging from those weighted by a single factor, such as dividends, to those skewed towards multiple factors within a single ETF.

Table 1: The range of smart beta strategies	
Smart beta strategy	Description
Fundamentally-weighted indices	Components are selected to provide broad exposure to an equity market, but companies are weighted by a fundamental factor, such as aggregate dividends or earnings, rather than market capitalisation.
Equal-weighted indices	Components are based on established indices like the S&P 500, but are equally weighted so that all components have identical weights when rebalanced.
Factor-based indices	Components are selected and weighted, based on one or more fundamental factors.
Low-volatility indices	Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility.

Some investors believe that smart beta strategies have only performed well because money has flowed into them. In other words, investor enthusiasm would have driven returns by

bidding up valuations. We find this unlikely given the short history of smart beta and the relatively small scale of investment. In fact, this may be applicable to more traditional market capitalisation-weighted indices that assign more weight to a stock as its price rises. This contrasts with how we here at WisdomTree weight companies in our fundamental ETFs—which is by their annual cash dividends in a proprietary methodology called Dividend Stream<sup>®2</sup>.

This is because we believe dividends offer the most objective measure of a company's health, value and balance-sheet strength and, therefore, this weighting serves as the foundation for most of our European ETFs. And, because stocks owned by smart beta strategies could become overvalued or no longer representative of the factor(s) under consideration, we also rebalance to a measure of fundamental value annually.

### Different strokes for different folks

Ultimately, transparency and education is the key to the future success of smart beta ETFs. Investors therefore need to take a closer look at providers' smart beta strategies: the approach, what it invests in, whether it complements what they already own and what type of exposure it gives. It can certainly be challenging to distinguish all that is out there. When it comes to identifying truly smart beta strategies, we believe investors should seek the following:

- A rules-based, repeatable methodology that offers broad, representative exposure to an asset class.
- Alternative weighting methods that allow for ample investment capacity.
- High correlations to established benchmarks.
- An established track record on a total return and risk-adjusted basis.
- Regular rebalancing.

#### Sources:

<sup>1</sup> *ETF Strategy, as of 01/08/2017*

<sup>2</sup> *The Dividend Stream is the sum of the cash dividends of all the constituents in the index. A company's weight in the index is defined by its cash dividend as a proportion of the Dividend Stream.*

View the online version of this article [here](#).

### Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

**For professional clients only.** The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.