

Strategic beta ETFs:

Aiming for more than a traditional index

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Traditionally, exchange-traded funds (ETFs) have been designed to track the performance of a market-capitalization-weighted (market-cap) index, such as the S&P 500. But in the early 2000s, a new type of ETF was developed, taking the concept of tracking an index a step further by attempting to improve the investment's return and/or risk. These new ETFs, known as strategic beta ETFs, emphasize single or multiple characteristics of an index (such as increasing dividends or value, or decreasing volatility) to achieve their performance goals. Let's consider an example.

What is an ETF?

- Most ETFs are passively managed investments designed to track the performance of a particular index by investing in the same securities as the index.
- ETFs are similar to traditional mutual funds in that they hold a variety of securities in one investment but are different in that they are generally passively, not actively, managed.
- ETFs trade on an exchange, like a stock, and therefore experience price changes throughout the day.

Key takeaways

- Strategic beta ETFs are designed to perform differently from a traditional index - emphasizing single or multiple characteristics such as value, low volatility, equal weight or dividends, to name a few.
- Strategic beta ETF investment considerations
 - Different from traditional ETFs in portfolio characteristics and performance results; therefore, they have the potential to outperform (or underperform) a traditional index
 - Generally lower internal expenses compared to actively managed funds, and higher internal expenses compared to traditional ETFs
 - Potential diversification, cost and tax-efficiency benefits
 - Possess active and passive management characteristics

Understanding strategic beta ETFs

As discussed above, an example of a market-cap index is the S&P 500 index. Within a market-cap index, companies with the greatest number of shares with the highest share price have the largest weight in the index. Then there is the S&P 500 Value Index, which emphasizes a single characteristic – in this case, companies in the S&P 500 index that have consistently raised their dividends.

At Edward Jones, we consider a strategic beta ETF to be any ETF designed to improve the return and/or risk compared to a market-cap index by emphasizing one or multiple characteristics other than market cap. Therefore, an ETF that tracks the S&P US Dividend Growers Index would be considered a strategic beta ETF, because it is designed to track an index that is based on a characteristic other than market cap (in this case, dividend characteristics).

Different names, same concept

Strategic beta ETFs have been given a variety of labels, including “Smart Beta ETFs,” “Fundamental ETFs,” “Factor ETFs” and “Alternatively Weighted ETFs,” to name just a few. In our opinion, these are all just different names to describe the same type of product – strategic beta ETFs.

It’s important to note, strategic beta ETFs should not be viewed as a superior option just because of their name; rather, strategic beta ETFs simply have a different goal and design compared to a traditional ETF that tracks a market-cap index.

How do strategic beta ETFs fit among passive and active investments?

We think it is useful to consider strategic beta ETFs as a blend of active and passive investments. They are similar to passive investments in that their performance goal is to track the performance of an index. But they are also like actively managed funds in that the index performance they track is designed to improve return and/or reduce risk. The chart on Page 3 shows additional points of comparison to consider.

Key benefits and trade-offs of strategic beta ETFs

Using strategic beta ETFs can potentially offer:

- Additional diversification
- Reduced internal expenses if used instead of actively managed investments
- Tax efficiency

Trade-offs to consider:

- Strategic beta ETFs generally cost more than traditional ETFs
- There is no guarantee strategic beta ETFs will meet their performance goal of improving return or reducing risk

	Traditional ETF	Strategic beta ETF	Actively managed mutual funds
Management approach	Passive	Blend of active and passive	Active
Performance	Seeks to track an asset class using market-cap weighting	Seeks to track an index that was designed to improve risk and/or return over a traditional index	Seeks to improve risk and/or return over a traditional index
Cost	Lower cost	Moderate cost	Higher cost
Tax efficiency	Low capital gains potential due to ETF structure	Low capital gains potential due to ETF structure	Higher potential for capital gains
Holdings transparency	Usually daily	Usually daily	Varied – usually quarterly

Important considerations before investing in strategic beta ETFs

- Strategic beta ETFs can be concentrated in certain sectors or market caps. This is important to know when comparing a given strategic beta ETF to a traditional market-cap index.
- Strategic beta ETFs focused on one characteristic may move in or out of favor for extended periods of time, which could make it tempting to “chase the winners” and lead to buying high and selling low.
- Strategic beta ETFs with similar names can behave differently. For example, two ETFs that are designed to focus on dividends may have very different holdings. It is important to familiarize yourself with how the benchmark index of the ETF works, as well as what characteristics are emphasized (such as dividends, value or volatility).
- Consider whether the benefits of an investment product (in this case, strategic beta ETFs) outweigh its associated fees and expenses.

To learn more about strategic beta ETFs and what role they can play in your portfolio, talk with your Edward Jones financial advisor.