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Smart beta strategies have come of age. I remember them being discussed several years ago with either cynicism or amusement among the institutional circles . Not many took 'smart beta' seriously.

The tone has changed. By 2025, expect smart beta ETF assets to hit US$2.4 trillion globally as more investors embrace them as an effective means to gain the benefits of both active and passive investing.

That said, the smart beta approach is not immune to the effects of market cycles and volatility so financial advisers still need to tread carefully. In this edition, we find out why smart beta multifactor strategies can potentially offer investors 'more outperformance for less' based on the thinking of iShares by BlackRock.

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A new way to seek outperformance for less

Using factors in investment strategies has been popular for decades. Since the 1930s, investors have investigated what drives returns and aimed to harness these "factors" for better investment performance. Today, this factor driven approach to investing is more widely available in the form of smart beta strategies.

Smart Beta combines the performance benefits of factors with the simplicity of an Exchange Traded Fund (ETF). While, Smart Beta ETFs aim to enhance investment returns through exposure to factors, as indexed, rules-based products, they're a low-cost alternative to an active factor investing approach. Smart Beta ETFs might offer exposure to a single factor - such as minimum volatility to reduce risk - or to a number of factors to improve diversification and drive better performance.

Rewriting the return/cost equation

Traditionally, active investing strategies are seen as high performing, high cost elements of a portfolio. Passive strategies incur lower fees but performance expectations are lower too.[1]

Smart Beta multifactor ETFs brings a hybrid of active and passive investment characteristics to this equation:

- They have the potential to produce better performance by seeking out identified drivers of return.
- As a rules-based, indexed fund, Smart Beta ETFs aim to deliver this enhanced performance for lower fees.

Seek enhanced, consistent returns

By combining exposure to a number of factors in one product, Smart Beta multifactor ETF offerings have the potential for consistent performance under different market conditions. Some factors produce better returns relative to the overall equities index when markets are rising, while others are more resilient when markets are declining. Table 1 shows how some popular factors tend to perform during different market cycles.

As a diversified product, Smart Beta multifactor ETFs may also offer this enhanced performance with the added benefit of a lower risk profile. Because they're seeking out drivers of risk and return that underlie all securities, Multifactor products don't tend to favour a particular sector or industry in their weighting. With this diversification, and the presence of different factors driving returns throughout the market cycle, the potential for outperformance compared with market cap indices is strong.

A compelling alternative for investment portfolios

With their potential for above benchmark performance without the associated cost, Smart Beta multifactor products and strategies are gaining in popularity throughout the investment community. They can be used to replace or complement existing passive strategies to boost returns without adding significant costs to a portfolio or as an effective substitute for active portfolio elements, delivering comparable returns with less risk and cost involved.

Figure 1 shows the comparative performance of portfolios, one with a 60% market cap index composition and one using 60% multifactor indices instead. Over the 10- year period, the multifactor period is the clear winner for analysed, risk-adjusted returns.

The quote

Smart Beta multifactor ETF offerings have the potential for consistent performance under different market conditions.

Discover Outperformance

iShares currently offer two products that harness the benefits of a Smart Beta multifactor approach to provide a cost-effective way to potentially enhance returns: iShares Edge MSCI Australia Multifactor ETF (AUMF) and iShares Edge MSCI World Multifactor ETF (WDMF). These funds offer a choice between investing in Australian or global equities and provide exposure to companies with the potential for market-like returns in the long term.

The indices of these two multifactor ETFs have been designed to capture stocks that display attributes of four 'factors' - quality, value, size and momentum. They seek to align the risk profile and sector/country weights of each index with the broad market, enabling these funds to function as long-term core allocations. FS

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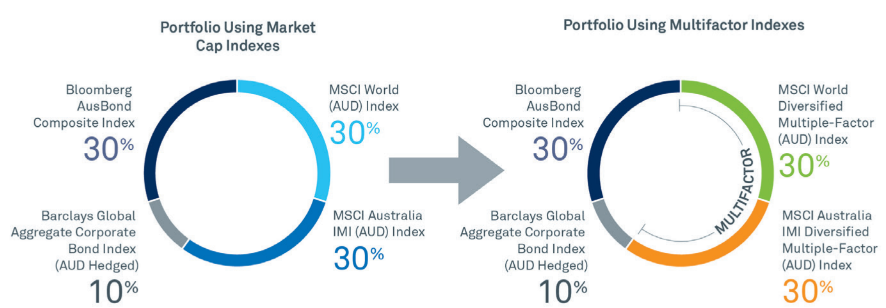
Watch the video on www.fsitv.com

Figure 1. Seek to outperform with Multifactor strategies



Reflects Period: 1/9/2006 – 31/8/2016 (10-Year)	Market Cap Portfolio	Portfolio With Multifactor Indexes
Annualised Return (%)	5.67	6.41
Annualised Standard Deviation (%)	7.12	7.23
Sharpe Ratio*	0.15	0.25

This is strictly an illustrative example only. There is no guarantee that the stated outcomes will be achieved. Source: BlackRock, MSCI, 31 August 2016. Analysis based on back-tested index data from 1 September 2006 to 31 August 2016. Data for time periods prior to the index inception date is hypothetical and is provided for informational purposes only to indicate historical performance had the index been available over the relevant time period. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future performance. This is not a recommendation to invest in any particular financial product. No analysis of their suitability was conducted and no statement of opinion in relation to their suitability is provided.
* The Sharpe Ratio is a measure of risk-adjusted return. It is defined as the excess return of a portfolio above the risk-free rate, per unit of risk. The risk-free rate assumed in this calculation was 3 Month LIBOR (AUD).

Table 1. Factors in Different Market Environments

FACTORS	TYPES OF COMPANIES/STOCKS	FAVORABLE ENVIRONMENTS
SMALLER SIZE	Smaller, more nimble companies	Early economic cycles
VALUE	Stocks with low prices relative to fundamentals	Early economic cycles
MOMENTUM	Stocks with a positive price trend	Trending markets and expansions
QUALITY	Companies with strong balance sheets	Late economic cycles or recessions
MINIMUM VOLATILITY	Stocks with lower than average volatility	Volatile, risk-averse and/or declining markets

[1] ASX Newsletter August 2016, Difference between active and passive investing, http://www.asx.com.au/education/investor-update-newsletter/201608-difference-between-active-and-passive-investing.htm "How active and passive investing differs Active investing involves choosing investments you believe will outperform the broader market surroundings. Passive investors try to replicate the price and yield performance of an index. Passive management is often seen as a low-cost, low-governance way to invest."

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