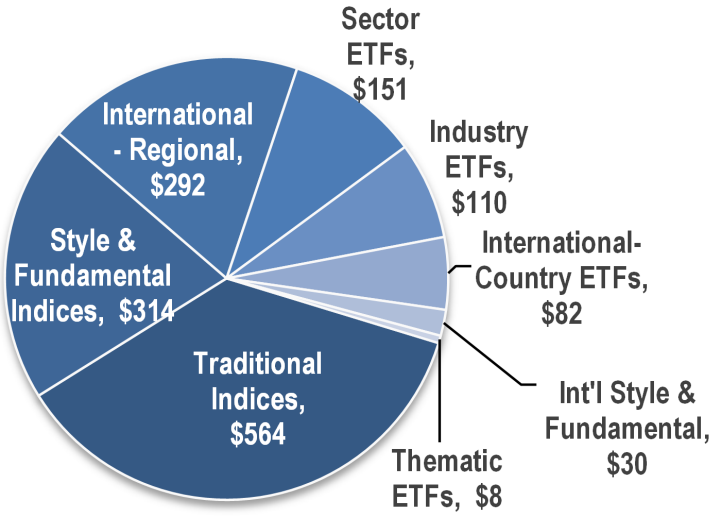
Evaluating Smart Beta ETFs

What is “Smart Beta”?

- Alternative to market cap-based indices that aims to outperform the market in a rules-based way
- Debate: marketing gimmick or value-creating innovation?
- Smart Beta funds about 1/3rd of equity ETFs; 22%+ by AUM

CATEGROY BREAKDOWN:
EQUITY ETFs, by AUM ($bns)



Source: AltaVista Research. Note: As of 1/31/2016

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Choices, choices

- Methodology madness: universe, selection criteria, weighting and rebalancing
- Competing back-tests and other claims
- Limited performance history

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Smart Beta Checklist

Checklist

1. Single or Multi-Factor?
2. Different from “Dumb Beta?”
3. Appealing Fundamentals?

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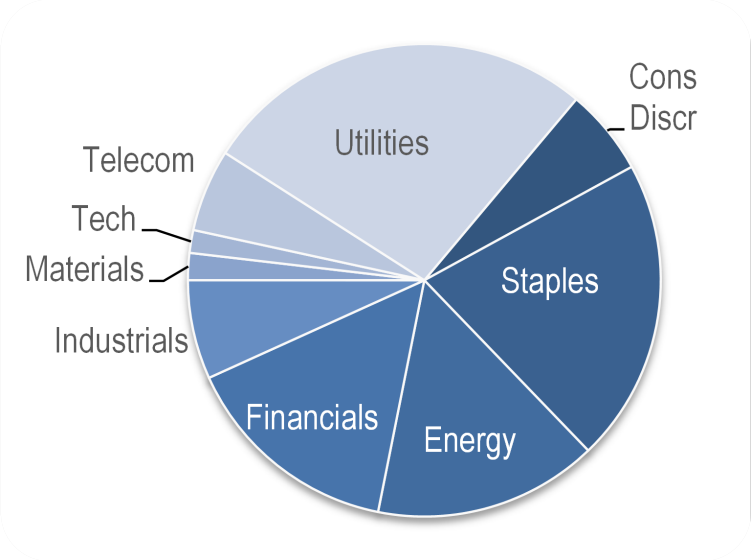
Check 1: Single or Multi-Factor?

- Single factors can introduce new risks or concentrations, reducing original benefit of indexing
- Factors come in & out of style; 10-year back test is only about one market cycle

SECTOR BREAKDOWN:
POWERSHARES HIGH YIELD EQUITY DIVIDEND ACHIEVERS (PEY)



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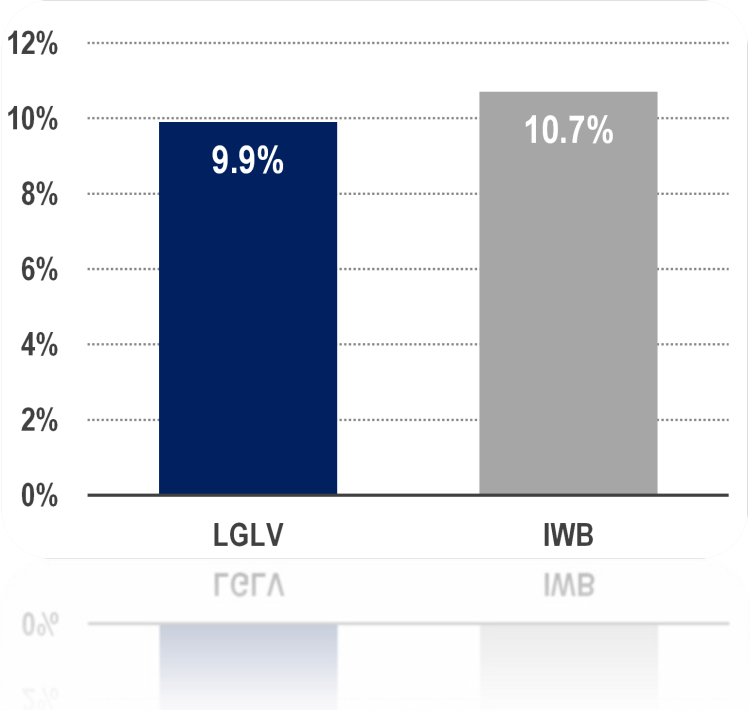
ANNUAL VOLATILITY:
SPDR RUSSELL 1000 LOW VOLATILITY (LGLV) VS. ISHARES RUSSELL 1000 (IWB)



Source: AltaVista Research. Note: Based on 36 monthly return observations ending 1/31/2016

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Check 2: Different Enough from “Dumb Beta”?

Alternative ETF Finder

For a list of similar ETFs based on overlap in holdings, enter an equity ETF ticker symbol: FNDB FIND ALTERNATIVE ETFs

Schwab Fundamental Broad Mkt (FNDB) Expense: 32 bp

Below is a list of 20 potential alternatives to FNDB based on the overlap in holdings. Consider funds with considerable overlap and lower expense ratios as possible replacements.

ticker	name	overlap[1] vs FNDB	expense ratio	research report
FNDX	Schwab Fundamental Large Cap	89%	32 bp	
PRF	PowerShares FTSE-RAFI U.S. 1000	82%	39 bp	
VLU	SPDR S&P 1500 Value Tilt	78%	12 bp	
THRK	SPDR Russell 3000 ETF	72%	10 bp	
VTI	Vanguard Total Market	71%	5 bp	
VTHR	Vanguard Russell 3000	71%	15 bp	
IYY	iShares DJ US Total Market	71%	20 bp	
IWV	iShares Russell 3000	71%	20 bp	
ONEK	SPDR Russell 1000 ETF	71%	11 bp	
VONE	Vanguard Russell 1000	71%	12 bp	

- Overlap with market cap ETFs often large
- Free tool on TWS finds similar ETFs based on overlapping holdings

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Check 2: Different Enough from "Dumb Beta"?

- Calculate the "Smart Cost"— i.e., the real cost of the smart portion of fund
- Is smart part large enough to overcome costs and deliver performance?

EXAMPLE:
SCHWAB FUNDAMENTAL BROAD MARKET (FNDB) vs. SCHWAB U.S. BROAD MARKET (SCHB)

FEES: FNDB = 32bp SCHB = 3bp

OVERLAP: 71% by weight

"SMART" PART: 29%

$$\text{"SMART COST"} = \frac{(32bp - 3bp)}{29\%} = 100bp$$

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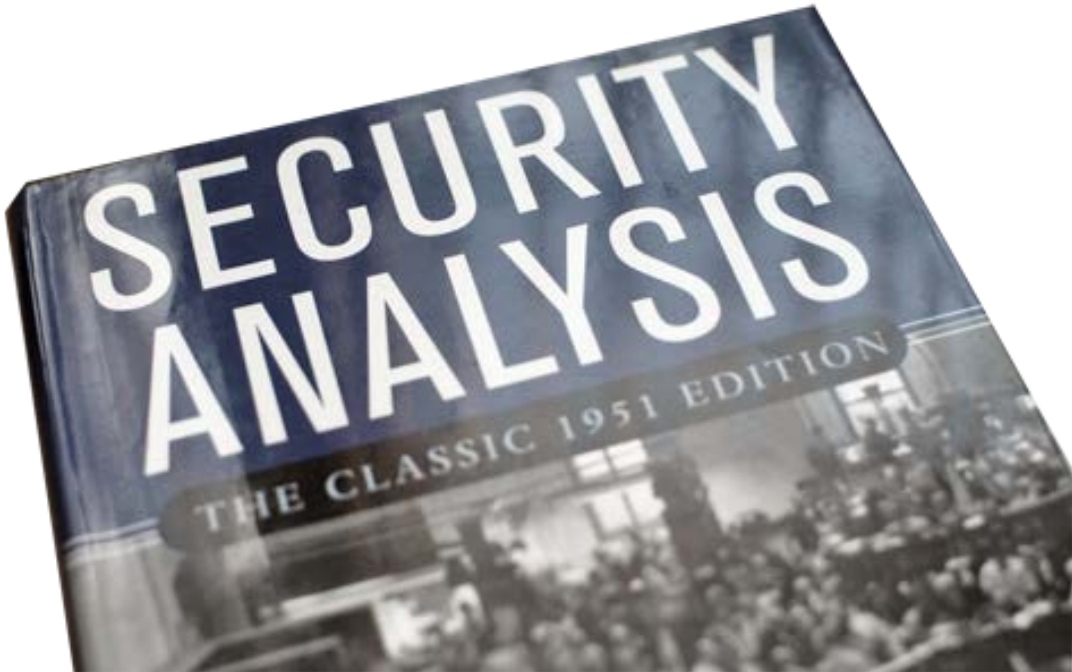
Check 3: Appealing Fundamentals?

- Apply the traditional tools of stock analysis to ETFs
  - What are expectations for sales and EPS growth?
  - Are estimates changing as economic conditions do?
  - What's happening on the balance sheet?
  - How is it valued in relation to these fundamentals?

- Resources available
  - ETF Analyzer Tear Sheets on TWS (subscription)
  - ETF Research Center website (free & paid)



-Graham & Dodd, 1934

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Check 3: Appealing Fundamentals?

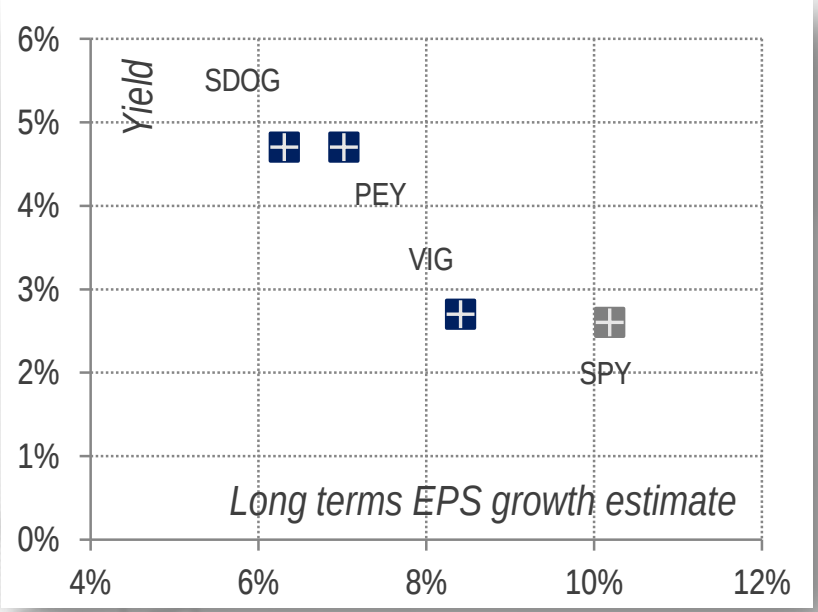
EXAMPLE:
YIELD & EARNINGS GROWTH

HIGHER YIELD

- **ALPS SECTOR DIVIDEND DOGS (SDOG)**
- **POWERSHARES HY EQUITY DIVIDEND ACHIEVERS (PEY)**

GROWTH WITH DIVIDENDS

- **VANGUARD DIVIDEND APPRECIATION (VIG)**



Source: AltaVista Research. Note: As of 2/12/2016

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Using Smart Beta ETFs

- Choice is good. Nothing sacred about traditional market cap indices.
- Watch costs where similar funds might be cheaper and beware single-factor strategies, especially for core holdings.
- Check fundamentals and monitor periodically

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