The Intentional Investor
Building your financial future

What's so smart about smart beta?

As an investor, you may increasingly hear the term "smart beta." That's for good reason. Smart beta is one of the fastest growing segments of the investment world. But what exactly does smart beta mean?

In its simplest form, smart beta is a rules-based investment process that seeks to reduce portfolio risk, outperform a benchmark or both. Using a consistent and predictable set of rules, regardless of market conditions, helps to remove emotion from the decision-making process. This is significant, as making investment decisions based on emotion can adversely affect performance over time. To understand what makes smart beta different, it's important to understand what we mean by "the market."

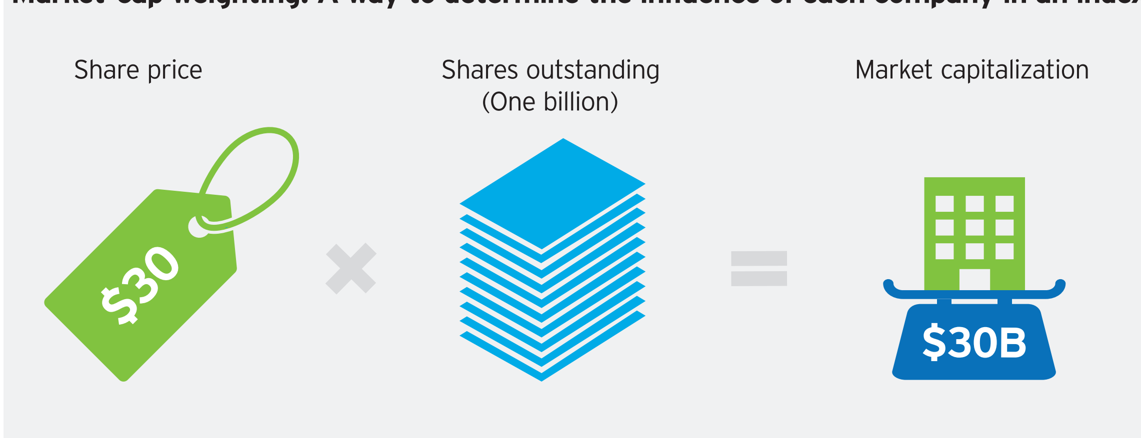
What is 'the market?'

There are thousands of securities listed on exchanges all over the world. When investors talk about whether "the market" is up or down, they're generally referring to a specific financial index, or a group of securities. For example, the S&P 500 Index is a well-known index of 500 US stocks. The widely recognized Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely traded stocks on the New York Stock Exchange. When people say that the US stock market is up or down, they are usually referring to either one of these indexes. Other indexes are used to define global stocks, small-cap stocks, and other market segments.

How do they decide how much each company contributes to the index?

Many traditional indexes weigh member companies (or "constituents") according to market capitalization, which is calculated by multiplying a company's share price by the number of shares outstanding. This is known as market-cap weighting, which is frequently an indicator of company size.

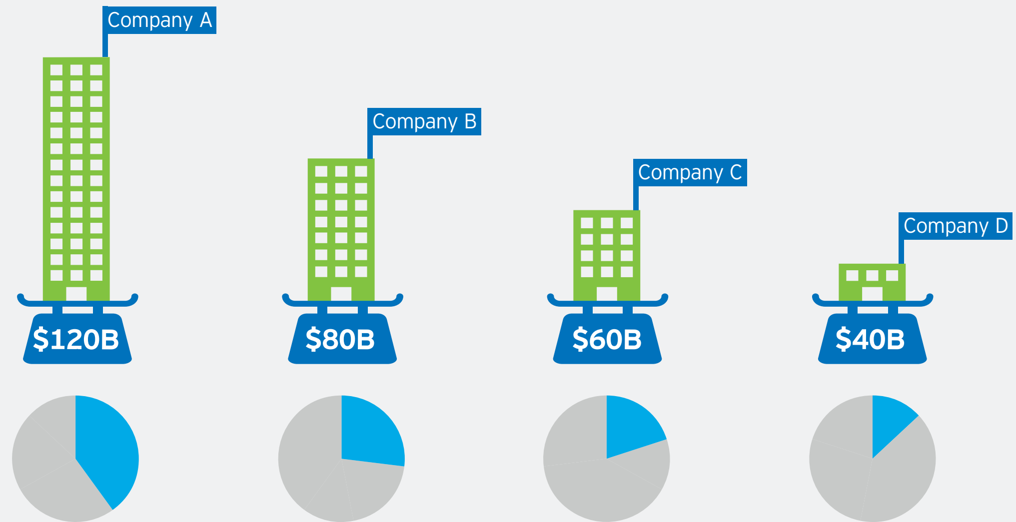
Market-cap weighting: A way to determine the influence of each company in an index



For illustrative purposes only.

The infographic below shows a simple, hypothetical market-cap weighted index of four stocks. The largest company, with a $120 billion market cap, makes up 40% of the index ($120/$300 = 40%). The smallest company, with a $40 billion market cap, makes up just 13% of the index.

Figure 1: Market-cap-weighted indexes place more importance on the companies with the biggest market cap



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Using indexes in investing

Market-cap-weighted indexes have served an important purpose for more than 100 years as a simple way to define a market and gauge its direction. But many investors go beyond that and use these indexes as an investment strategy. Proponents of smart beta believe that using market-cap-weighted indexes isn't the best investment approach. Because it is based in part on a company's stock price, market-cap weighting can lead to an overweighting of overvalued securities, and an underweighting of undervalued securities.

What is the downside to market-cap weighting?

- Some companies may experience a rapid increase in stock price (and, therefore, their market cap) for reasons that are not related to the health of the company. For example, general excitement about the technology industry could cause all tech stocks to go up, regardless of their quality. These companies are said to be overvalued because they're valued higher than their balance sheets may suggest they're worth. Market-cap-weighted strategies include a relatively high level of these overvalued securities, potentially exposing investors to volatility if the stock price falls back in line with the company's fundamentals.
- Undervalued companies can be thought of as companies that are "on sale" — their stocks are valued lower than what the company's fundamentals suggest they should be. Market-cap-weighted strategies tend to include a smaller amount of these stocks, which may cause investors to miss out on good performance if these smaller, less-expensive stocks outperform larger companies.

How does smart beta work?

By contrast, a smart beta approach assesses and weights companies by other characteristics that have nothing to do with market capitalization. Two hallmarks of smart beta strategies are factors and alternative-weighting methodologies.

Factors

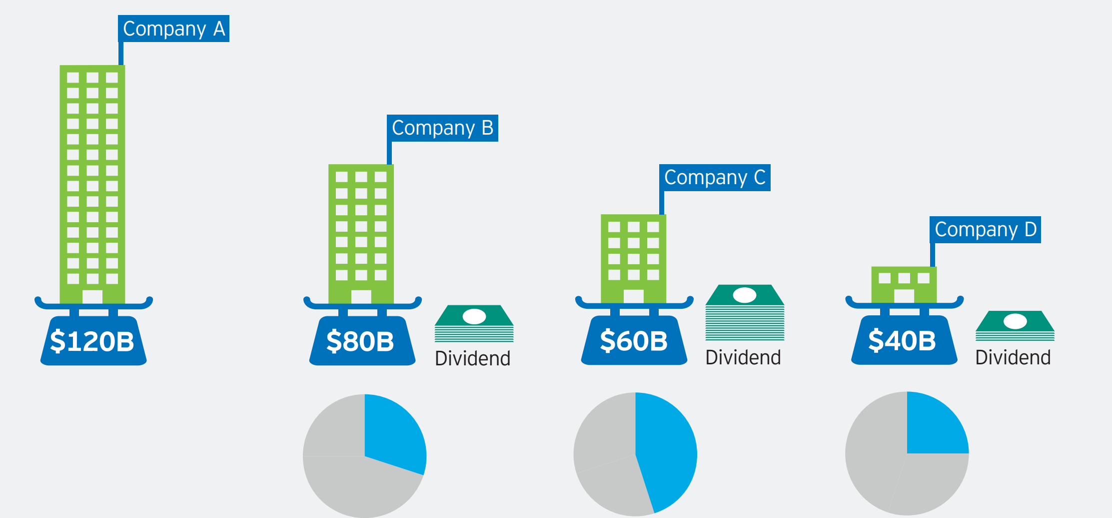
Many smart beta strategies choose their member companies based on factors, or investment characteristics that may help drive returns. Some examples of commonly used factors include:

- **Quality**. Stocks are selected and weighted based on their return on equity (which measures profitability).
- **Value**. Stocks are selected and weighted according to their price-to-book ratio, which is a means of valuing a company.
- **Low volatility**. Stocks are selected and weighted according to their historical volatility, with the less volatile stocks getting larger weights.

Some smart beta investors take a multi-factor approach, selecting stocks and assigning weights based on a combination of traits.

To show how a smart beta strategy could differ from a market-cap-weighted index, we've taken the hypothetical four-company index from Figure 1, and re-calculated it based on a factor – in this case, **dividend yield**. Dividend yield measures how much a company pays out in dividends every year relative to its share price. Using this smart beta approach, the company with the highest dividend yield gets the biggest weight, despite the fact that it has a small market cap, and the company without any dividend yield is not included in the strategy, despite its large market cap.

Figure 2: Factor strategies ignore market cap and choose stocks based on specific investment characteristics



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This is, of course, a simplification meant to illustrate the difference between a smart beta strategy and a market-cap-weighted index. In real life, many smart beta strategies use more complicated methodologies.

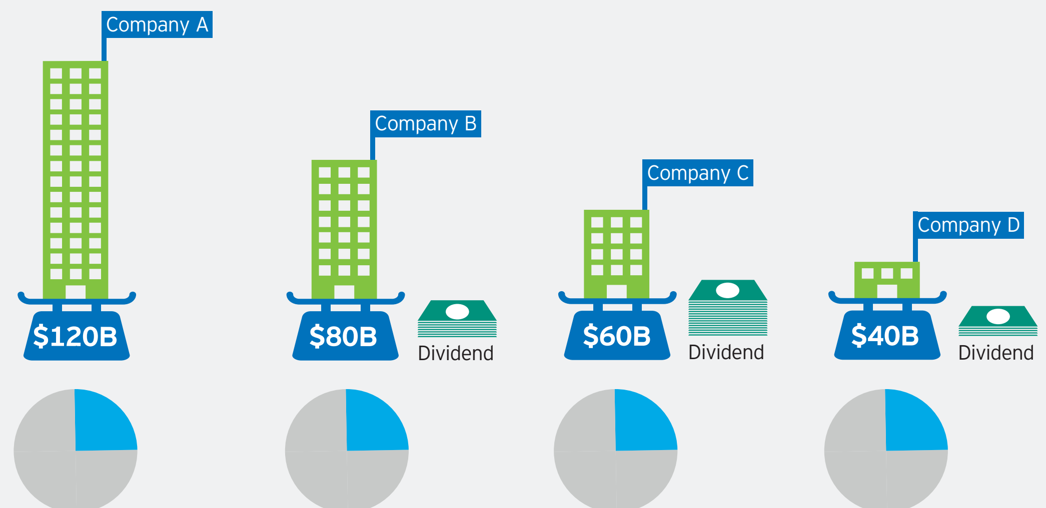
Alternative weighting

While factors are used to filter for stocks with certain characteristics, alternative-weighting methodologies include a much broader set of stocks. However, they weight those stocks in an "alternative" manner from market-cap weighting.

For example, a low volatility factor strategy would only include stocks with a certain level of volatility. A low volatility *alternative-weighted* approach might include all of the same stocks of a traditional benchmark, but would give higher weights to the stocks with the lowest volatility.

The simplest form of alternative weighting is **equal weighting.** Using our hypothetical four-company index from Figures 1 and 2, the illustration below assigns every stock the exact same weight, regardless of market cap or any other factors, such as dividend yield.

Figure 3: Equally weighted is one type of alternative-weighted methodology



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You can see how a smart beta approach may alter the makeup of a portfolio simply by weighting stocks differently or providing exposure to different factors. The same large-capitalization stocks that carry disproportionate weight in a market-cap-weighted index can have far less impact on a smart beta index. Smart beta strategies may offer the additional advantage of being rules-based. That means they follow the same rules regardless of market conditions – removing emotion and often-fickle market sentiment from the investment process. Over time, this could reduce risk or potentially result in outperformance.

Smart beta? Smart indeed.

Talk to your financial advisor

Talk to your financial advisor about your portfolio's exposure to smart beta strategies that could potentially reduce risk, outperform a benchmark or both.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

Price-to-book (P/B) ratio is the market price of a stock divided by the book value per share.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time.

Beta is a measure of risk representing how a security is expected to respond to general market movements. **Smart Beta** represents an alternative and selection index based methodology that seeks to outperform a benchmark or reduce portfolio risk, or both in active or passive vehicles. Smart beta funds may underperform cap-weighted benchmarks and increase portfolio risk.

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