FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

Bringing the Human Factor to Index Investing

June 9, 2016

For decades, Franklin Templeton has been a vocal advocate for active management, believing that the skills and insight that human oversight brings should play a crucial role in the investment process. But the emergence of risk factor investing and the evolution of traditional indexes have opened up fresh opportunities to bring a human touch to evolve what has traditionally been considered the passive space. As Franklin Templeton unveils its new Franklin LibertyShares lineup of strategic beta ETFs, Chandra Seethamraju, director of systematic modeling, Franklin Templeton Solutions, details why he believes strategic beta combines the appeal of both the research that drives active strategy and the passive approach to investment, and why the Human Factor is at the heart of his new approach.

It was Austrian neurologist and psychiatrist Viktor E. Frankl who said, “A human being is a deciding being.” But in many aspects of our modern lives, it seems human beings are handing over responsibility for decision-making to computers. The recommendations we encounter when shopping online, suggestions for music on streaming sites and potential matches in dating services are all built on algorithms.

While it might seem that we are simply outsourcing decision-making to a computer, in each case we are relying on technology to serve us within certain parameters that human beings have set. At the heart of each example is a human decision-maker who has constructed the framework in which the algorithm operates. The more skilled and intuitive the human designer, potentially the better the outcome for the human user.

As a company with its global headquarters in California’s Silicon Valley, we think we are more aware than most of the power and potential of algorithms and technology to simplify and improve modern life.

We recognize and embrace the valuable interplay of humans and technology. It's one of the reasons why we have historically been vocal advocates of active investment management—and we still are—even as passive, index-based approaches have grown in popularity.

[frk_blue_box title="Understanding Strategic Beta" width="60%" align="right"]

Strategic beta portfolios range from fairly straightforward to quite complex. One of the simplest approaches holds securities in equal weights, rather than weighting them by market capitalization.

Others take a quantitative approach that systematically analyzes, selects, weights and rebalances portfolio holdings based on certain investment style characteristics—called factors—with some focusing on a single factor and others combining factors in a single portfolio.[/frk_blue_box]

Traditional market-capitalization weighted indexes are known to suffer certain biases. They are, by their nature, backward-looking, reflecting stocks that have performed well in the past (mega-cap stocks), stocks that trade at high multiples or stocks that belong to popular industries, rather than stocks with potential opportunity. Active management, on the other hand, strives to identify potential in assets and apply it.

Index investing has been going through an evolution in recent years, particularly with the emergence of advanced approaches to index construction, known as strategic beta.

Put simply, while traditional market-capitalization indexes reflect the hands-off approach of following a simple—generally market-capitalization-based—index, strategic beta employs indexes based on criteria (or factors) other than market cap. Approaches range from relatively simple to more complex. Exchange-traded funds (ETFs) are then designed to track these custom indexes.

[frk_blue_box title="What Is a Factor?" width="90%" align="centre"]

A factor is a primary characteristic of an investment that explains a stock's behavior over long periods of time. Think of a factor as a DNA marker of an investment that causes it to respond to certain events, driving it to behave the way it does over time.

Stocks can be grouped based on primary factors they share. Some factors have provided investors with positive returns above and beyond market indexes over the long term—called a “return premium.”

Factors that have provided a return premium over time include:

- Quality—companies with stable earnings growth;
- Value—stocks that are attractively priced relative to historical and forecasted valuations, and historically have paid attractive dividends;
- Momentum—companies that have demonstrated strong performance over the past six to 12 months;
- Volatility—stocks that have demonstrated lower-than-average variability of returns.

[/frk_blue_box]

We’ve seen plenty of investment fads come and go over the years, and there are certainly some commentators who believe strategic beta is just another one of those fads.

Our view is different. We see the strategic beta ETF as an advancement in the binary world of passive and active management. Advances in index construction and portfolio design represent to us an opportunity for investors with the right tools and expertise to potentially improve risk-adjusted investment performance over time—something any investor would find attractive.

In particular, we perceive an opportunity to apply further enhancements to strategic beta by bringing the research skills, experience and insight honed in an active management sphere to the strategic construction of sophisticated indexes.

Market-capitalization based indexes have served a useful purpose as indicators of broad market performance and as benchmarks against which to measure active manager performance. We believe rules-based index design that analyzes individual stock exposure to specific factors provides a more advanced, forward-looking—and more effective—approach than traditional market capitalization-weighted indexing.[1]

For us, such an approach combines the appeal and intuition of more sophisticated passive approaches—transparency, diversification, a rules-based methodology and lower costs—with the prudence and perspective of an active manager who uses research to determine specific exposures that pursue a desired outcome. That's why we believe an index designed and constructed on risk factors should not neglect the most important factor of all: the Human Factor.

Chandra Seethamraju's comments, opinions and analyses expressed herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

What Are the Risks?

All investments involve risks, including possible loss of principal. Performance of the funds may vary significantly from the performance of an index, as a result of transactions costs, expenses and other factors. The information contained in this document is for illustrative purposes only. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect deduction of any fees or expenses. ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETF's net asset value. Brokerage commissions and ETF expenses will reduce returns.

To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor or visit libertyshares.com. Please carefully read a prospectus before you invest or send money.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @LibertyShares and on LinkedIn.

1. Even an index determined by market weights is exposed to factors such as quality, value, volatility and momentum. For index funds, these exposures are determined by the stock market's ups and downs, on which market-cap indexes are based. We believe it is preferable to plan for factor exposure, rather than be subjected to it by market fluctuations. A systematic factor approach offers the advantage of always knowing exactly which factors are driving your index's returns.

Posted in Fixed Income, Liberty Shares Tagged Dr Chandra, ETFs, Human Factor, LibertyShares, Strategic Beta, Technology

Important Legal Information

FINRA's BrokerCheck

You can check the background of your investment professional on FINRA's **BrokerCheck**.

Links can take you to third party sites/media, directly or through new browser windows. We urge you to review the privacy, security, terms of use, and other policies of each site you visit. You use any third-party site, software, and materials at your own risk. Franklin Templeton does not control, adopt, endorse or accept responsibility for content, tools, products, or services (including any software, links, advertising, opinions or comments) available on or through third party sites or software.

Franklin Templeton welcomes your feedback on this blog. To keep the conversation respectful and focused, please follow our current Commenting Guidelines. We review comments and reserve the right to block any comment or commenter, including those that we may deem inappropriate or offensive. We may block any comment or commenter whose posts include investment testimonials, advice, or recommendations, or advertisements for products or services, or other promotional content.

Questions or comments about your Franklin Templeton account or customer-service issues? Please contact us directly but never include account or personal financial information in your comments.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.

All investments involve risk, including possible loss of principal.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.

© 2017. Franklin Templeton Investments. All rights reserved.

Using this site means you agree to our **Terms of Use**

Click to view our Privacy Policy