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Can Strategic Beta Make You a Smarter Investor?

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Many investors still have misconceptions about exchange-traded funds (ETFs), including the type of market exposure they are getting with traditional capitalization-weighted ETFs. Dr. Chandra Seethamraju, director of systematic modeling, Franklin Templeton Solutions, gives us the lowdown on the concept of "beta" within ETFs—specifically strategic beta—and how it can offer a smarter investment approach.

Are you one of those people whose eyes glaze over when you hear the term "strategic beta?" Well, stick with me today as I explain how it could totally transform the way you think about investing in exchange-traded funds (ETFs).

You may be thinking: Why do I need the lowdown on strategic beta? Well, what if I told you it could completely change the way you think about index funds? Better yet, what if I told you it may make you a smarter investor?

But before we start diving into strategic beta, let's take a quick step back and talk about good old, regular beta.

What Exactly Is Beta?

In the world of investing, beta has traditionally been a measure of a security's or portfolio's volatility in comparison to the stock market as a whole. That leads us to a newer term that you might not know: cheap beta. If beta equals volatility, how can it be cheap—or expensive—for that matter?

Today, the word "beta" is also used as shorthand to describe getting broad stock-market exposure, typically through investments that often track the S&P 500 and other major indexes.

So, cheap beta refers to getting this exposure cheaply, for example, through exchange-traded funds (ETFs) that track indexes such as the S&P 500. But is that really a smart way to get broad exposure to the stock market?

These ETFs typically are market-capitalization weighted. Simply put, that means big companies automatically represent a bigger part of the portfolio, while smaller companies are a small—often even a tiny—part of the portfolio. Determining which companies represent the best value doesn't even enter into the equation.

Not exactly rocket science!

But, of course, you get what you pay for. If only there was a more thoughtful way to get broad exposure to the market in a systematic fashion.

The "Factor" Factor

Thankfully, there is! This is where strategic beta comes in. Strategic beta ETFs are based on time-tested "factors" that have historically driven stock performance. What's a factor, you say? Well, take quality for example. It considers a company's profitability and balance sheet.

A strategic beta ETF might start building its portfolio with the same stocks that are included in a capitalization-weighted index, but applying a quality factor would mean that the ETF would invest only in the index constituents that appear to have healthy profits and strong balance sheets. It doesn't stop here, but can help in developing a portfolio that is overweight high-quality stocks relative to a traditional capitalization-weighted ETF.

Other popular factors are value, momentum and low volatility. And, similar to the quality factor, extensive academic research spawned their emergence.

To sum it up, investing in a capitalization-weighted ETF will give you broad exposure to the stock market, including inadvertent exposure to many stocks that may not be considered high quality. By contrast, a strategic beta ETF takes what we consider a smarter approach, shifting the parameters to invest in stocks from the broader index to reflect the desired factors.

This is why they are called "strategic"—because they deliberately strive for more than just market exposure, and they seek to deliver risk-adjusted performance that is better than the benchmark index.

While strategic beta is a methodology that seeks to achieve better risk-adjusted returns compared to traditional market-capitalization weighted benchmark indexes, there is no guarantee that any strategy will achieve its objective. I encourage you to learn more—talk to your advisor or find out more about strategic beta ETFs on www.LibertyShares.com.

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Investors should carefully consider a fund's investment goals, risks, sales 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 www.franklintempleton.com for mutual funds and www.libertyshares.com for ETFs. Please carefully read a prospectus before you invest or send money.

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