The rise of smart beta ETFs:
The drive to design better benchmarks for optimal returns

Presenter: Russel Chesler, Director - Investments

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Important information

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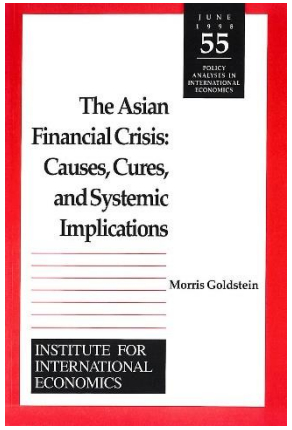
Cast your mind back to 1997



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A tale of two companies

Blockbuster sign revenue sharing with Warner Bros **1998**

Blockbuster makes $800 million in late fees **2000**

Blockbuster peaks with 9000 stores globally employing 84,000 **2004**

Blockbuster Scraps late fees **2005**

Blockbuster files for bankruptcy **2010**

1998 Reed Hastings creates Netflix Mail Order DVD

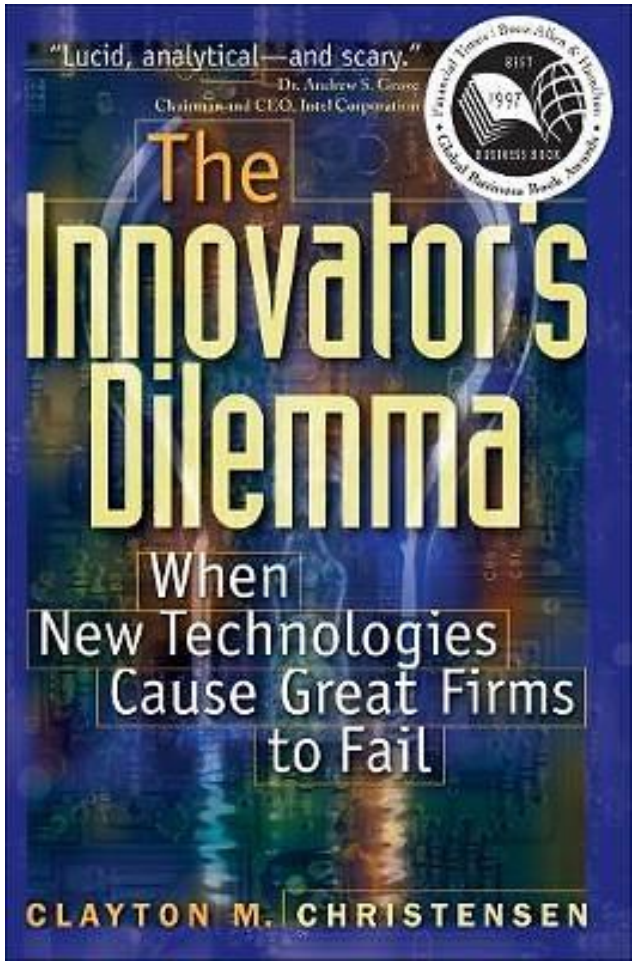
2000 Blockbuster declines to purchase Netflix for US$50 million

2004 Netflix passes four million subscribers

2007 Netflix delivers its billionth DVD

Now Netflix has 130 million subscribers and a market cap of US$137 billion

The Innovator's Dilemma

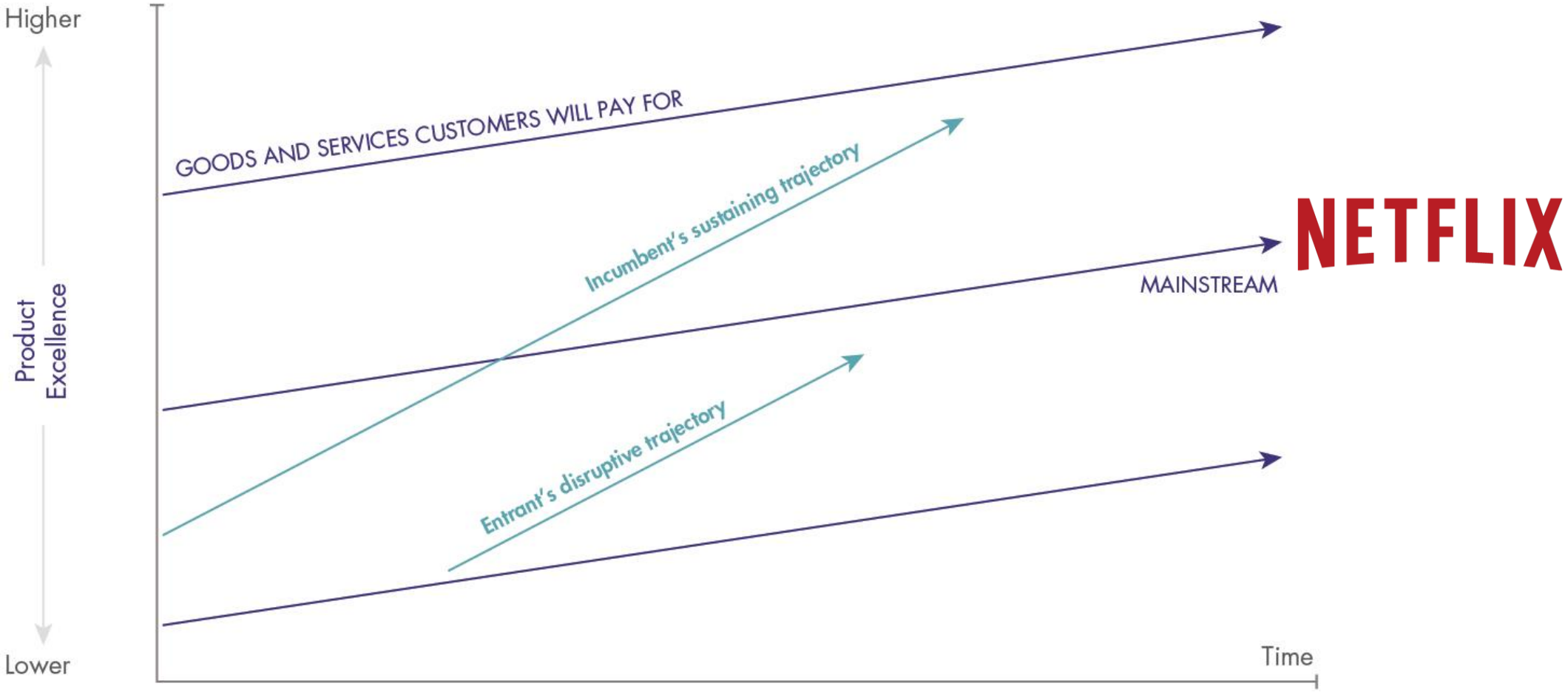


Revolutionary **Sustainable** **Disruptive**

"Disruptive technologies typically enable new markets to emerge."

- Clayton M. Christensen

The disruptive innovation model



Source: Clayton M. Christensen Michael E. Raynor and Rory McDonald "What is Disruptive Innovation?" Harvard Business Review, December, 2015

Which innovation is this?

Disruptive

Revolutionary

Sustainable

Smart beta: Disruptive innovation

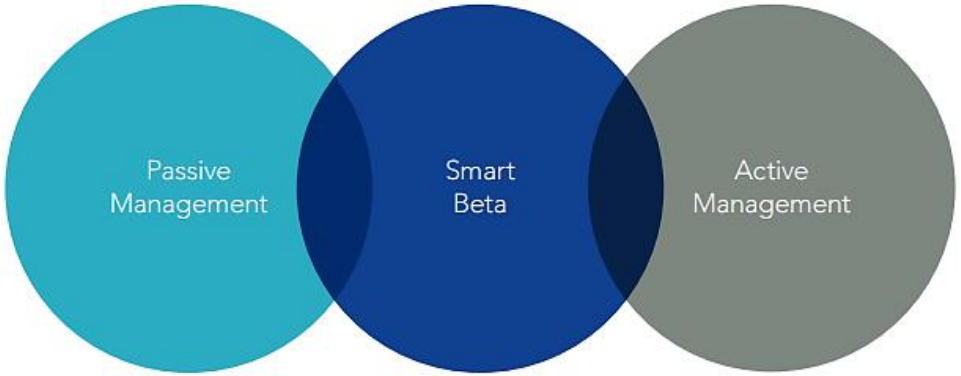
- Disrupting active management
- How to assess smart beta indices
- Using smart beta in portfolio construction

Let's start with a definition

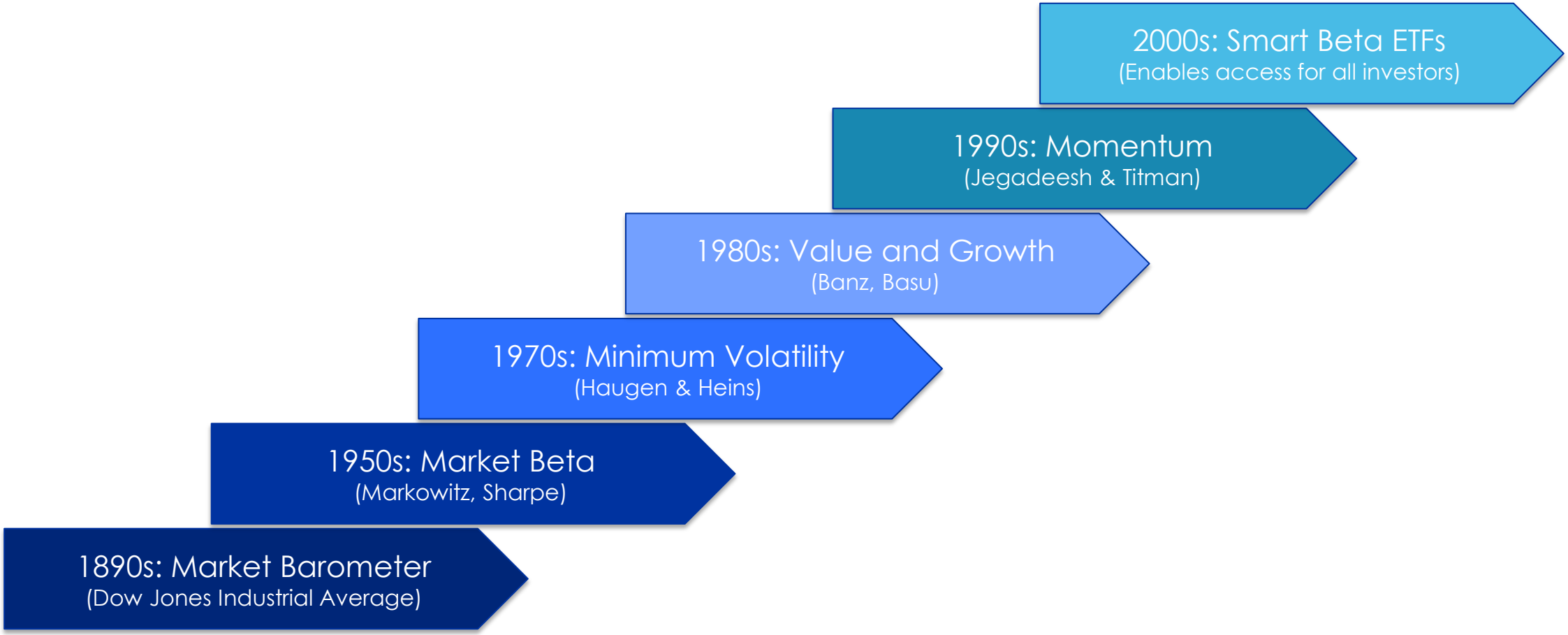
Smart beta is...

any index construction methodology different from market capitalisation

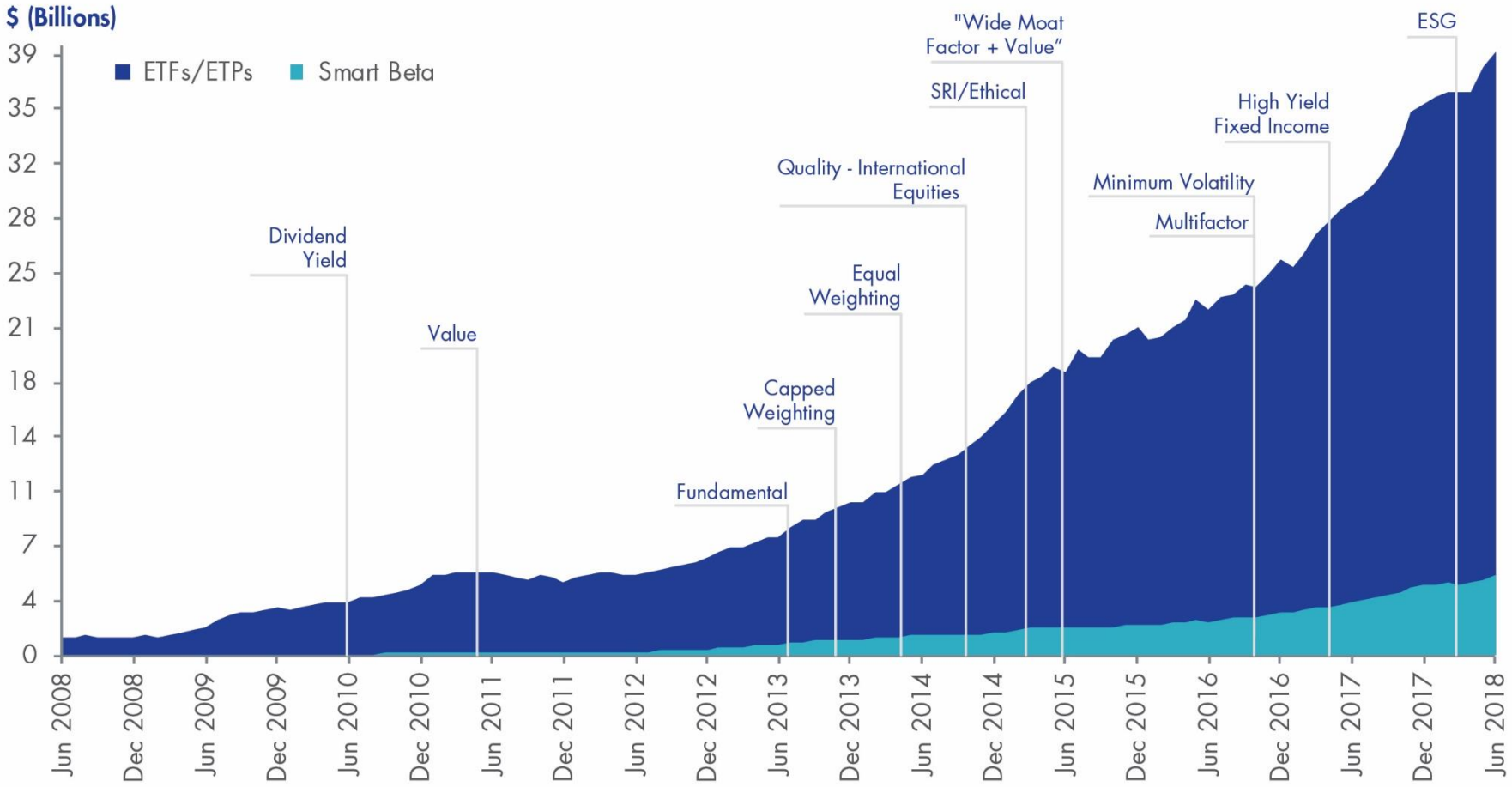
- Intersection between active and passive management
- Transparent and rules-based
- Designed to deliver targeted investment outcomes relative to market beta



Academic origins of smart beta



Smart beta growth in Australia

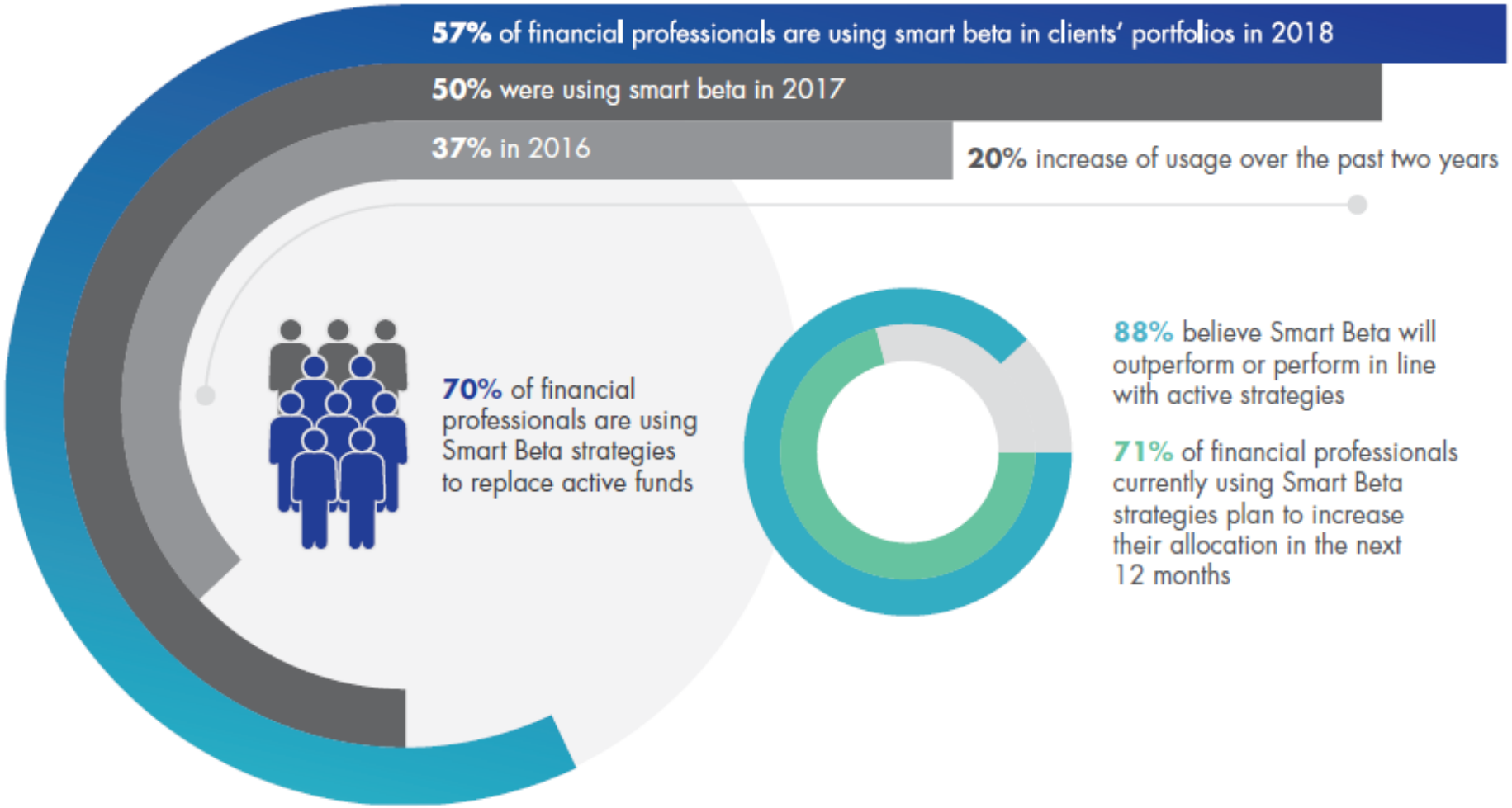


Smart beta:

- Over 40 ETFs totalling over $5 billion
- Doubled AuM in the past two years

Source: Morningstar, VanEck, June 2018

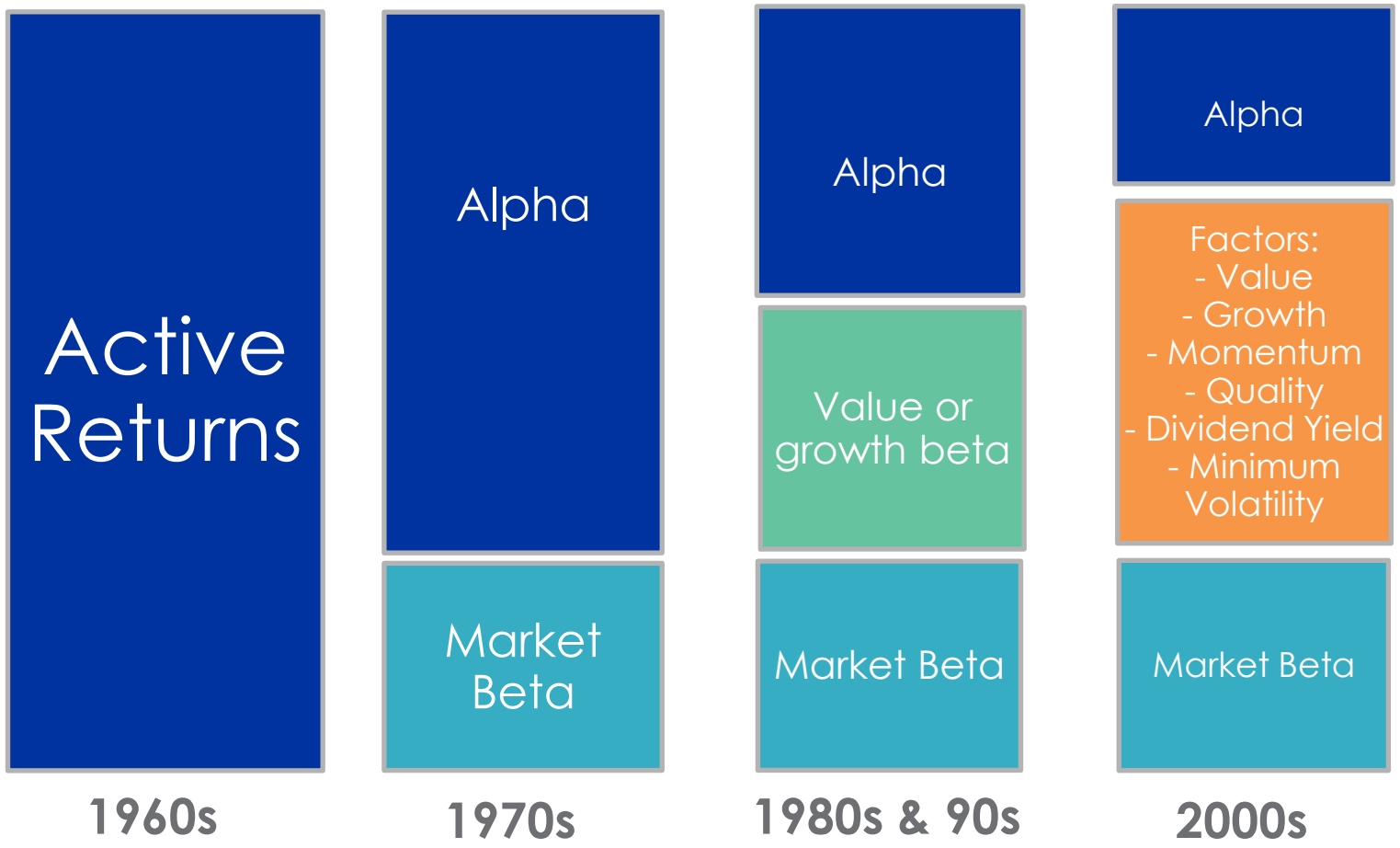
Adoption of smart beta is becoming mainstream



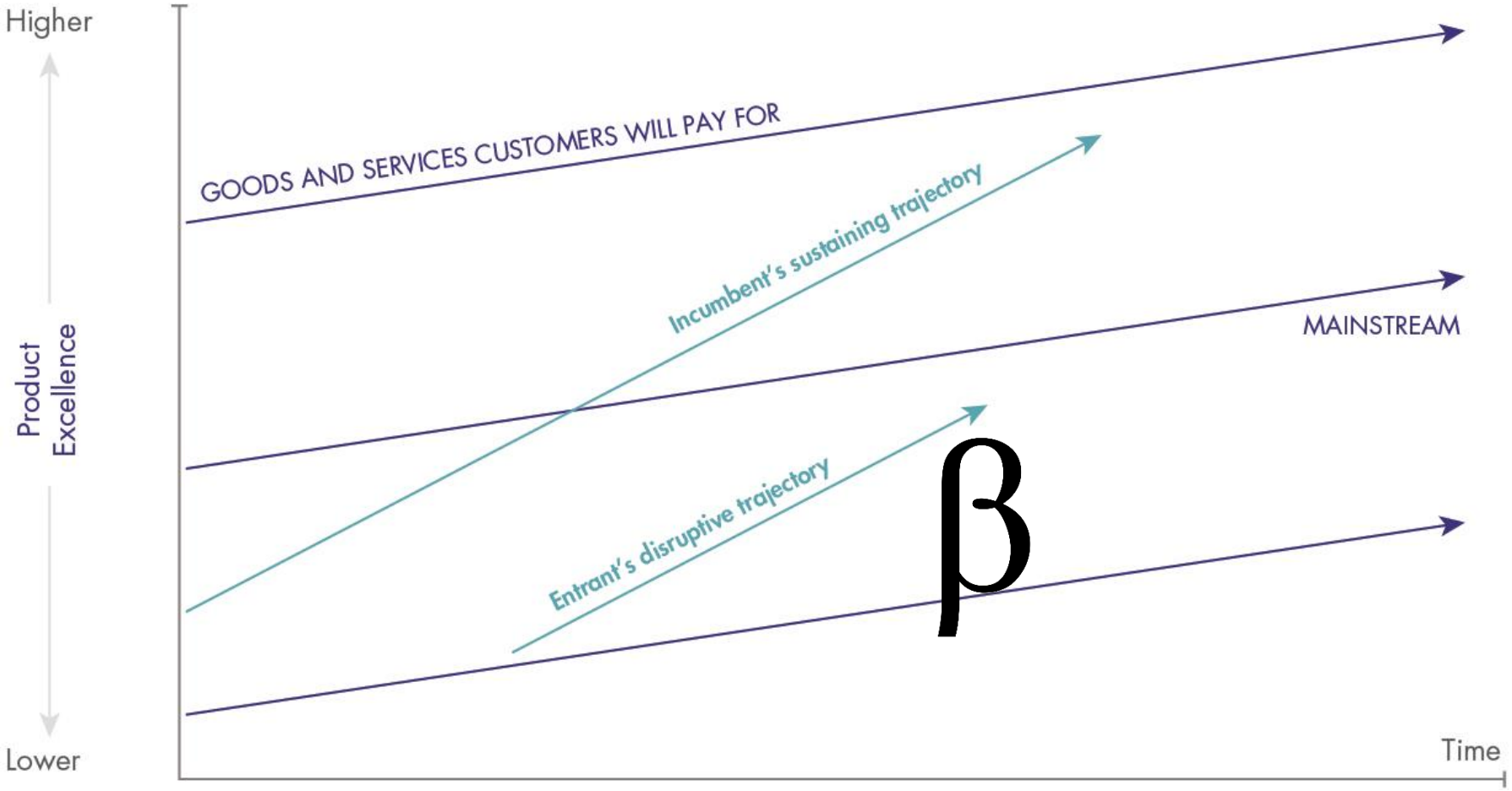
Source: Van Eck 3rd Smart Beta Adviser usage Australia July 2018

An active manager's alpha is attributable to smart beta

Investment style risk premiums explain active equity returns



The smart beta path to disrupting active



Source: VanEck, Clayton M. Christensen Michael E. Raynor and Rory McDonald "What is Disruptive Innovation?" Harvard Business Review, December, 2015

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PERSPECTIVES

The Asset Manager's Dilemma: How Smart Beta Is Disrupting the Investment Management Industry

Ronald N. Kahn and Michael Lemmon

Smart beta products are a disruptive financial innovation with the potential to significantly affect the business of traditional active management. They provide an important component of active management via simple, transparent, rules-based portfolios delivered at lower fees. They clarify that what investors need from their active managers is pure alpha—returns beyond those from static exposures to smart beta factors. To effectively position themselves for this evolution in active management, asset managers need to understand the mix of smart beta and pure alpha in their products, as well as their comparative advantages relative to competitors in delivering these important components.

Smart beta is currently a hot topic among investors. Numerous articles on the topic have appeared in popular magazines as well as academic forums. Many investment seminars now include sessions on smart beta. About $330 billion is invested in smart beta products; Towers Watson clients have doubled their allocation to smart beta over the past year.[1]

Are smart beta strategies new? Are they just the latest fad in investment management? Or are they an innovation poised to significantly affect traditional investment management? According to one commentator, "Smart beta, done right, is a fund manager's worst enemy."[2] And only somewhat less ominously, an *Economist* article describes how the investment industry is being squeezed by both index funds and smart beta, predicting that only hedge funds and private equity will remain beyond the reach of those two categories.[3]

Innovation[4]

In Clayton Christensen's (1997) influential book *The Innovator's Dilemma*, he describes three types of innovation: revolutionary, sustaining, and disruptive. Revolutionary innovations are rare and result in products so improved that they simply replace the prior products, as the automobile replaced the horse and buggy. Sustaining innovations are common and improve existing products incrementally, often in response to client demands. A new version of Microsoft Word is a sustaining innovation. Disruptive innovations are somewhat rare and create new markets. They are responses not to client demands but, rather, to client needs, whether expressed or not. We believe that smart beta is a disruptive innovation with the potential to significantly affect the market for investment products, particularly traditional active products.

The ultimate goal of disruptive innovation in investment management is to deliver superior investment outcomes and meet investors' *needs* (as opposed to requests). In the case of smart beta, the investment outcome is higher returns and/or lower risk after fees and costs. The innovation is motivated by a vision of how clients ought to invest—even when they do not realize a change is needed. So, investors sometimes adopt these disruptive innovations only slowly. Disruptive innovations often do not come from focus groups or client interviews, because clients are not asking for these types of innovations (e.g., no one was demanding personal computers when they first came out). Rather, they result from understanding current practice and having a vision of how to advance that practice. For example, when indexing strategies were first developed, no client demand existed.[5] In fact, most of the disruptive innovations in asset management have arisen despite seemingly little, if any, appetite for them in the marketplace—in certain cases, in spite of explicit opposition to them.

Ronald N. Kahn is global head of Scientific Equity Research and Michael Lemmon is managing director of Scientific Equity Research at BlackRock, San Francisco.

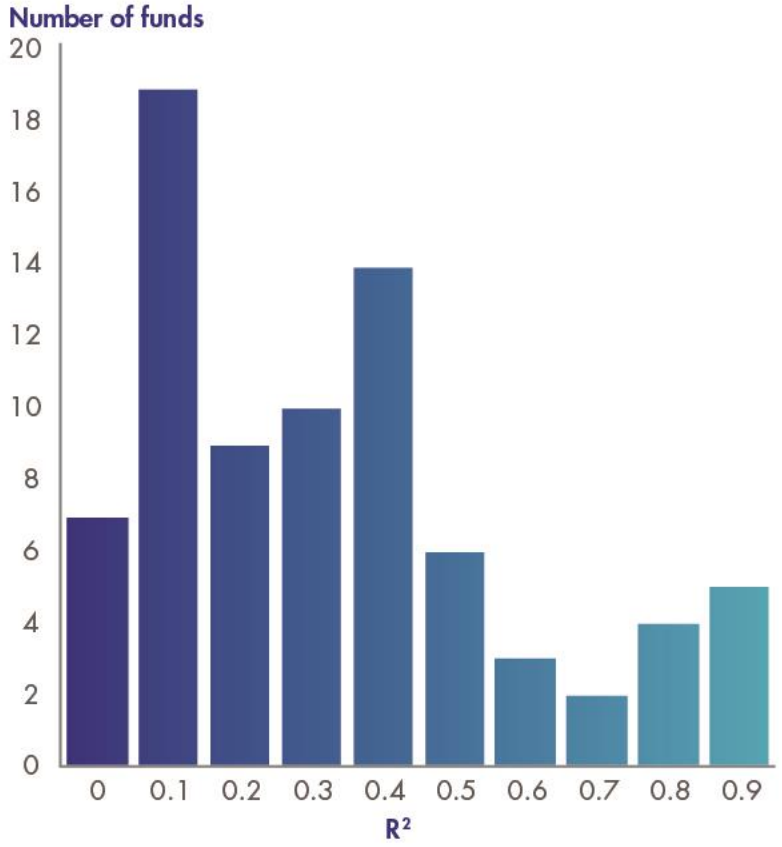
Editor's note: This article was reviewed and accepted by Executive Editor Robert Litterman.

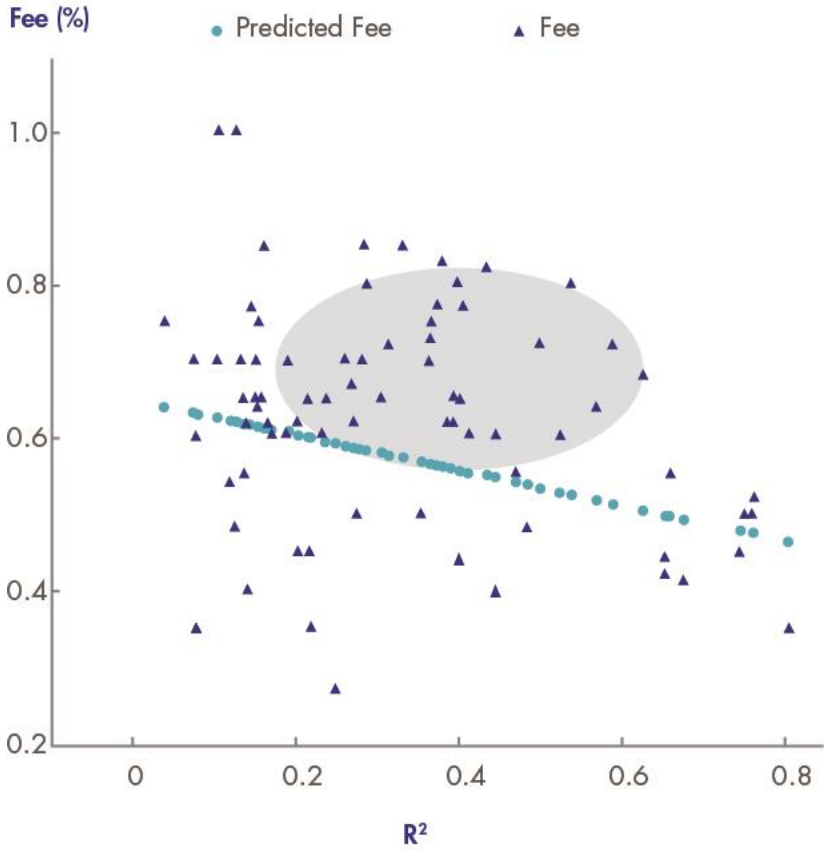
Authors' note: This article reflects the opinions of the authors and not necessarily those of their employer.

"We believe that smart beta is a disruptive innovation with the potential to significantly affect the market for investment products, particularly traditional active products."

- Ronald N. Kahn and Michael Lemmon

Disrupting active: variance (R^2) explained by six smart beta factors and relationship with fees





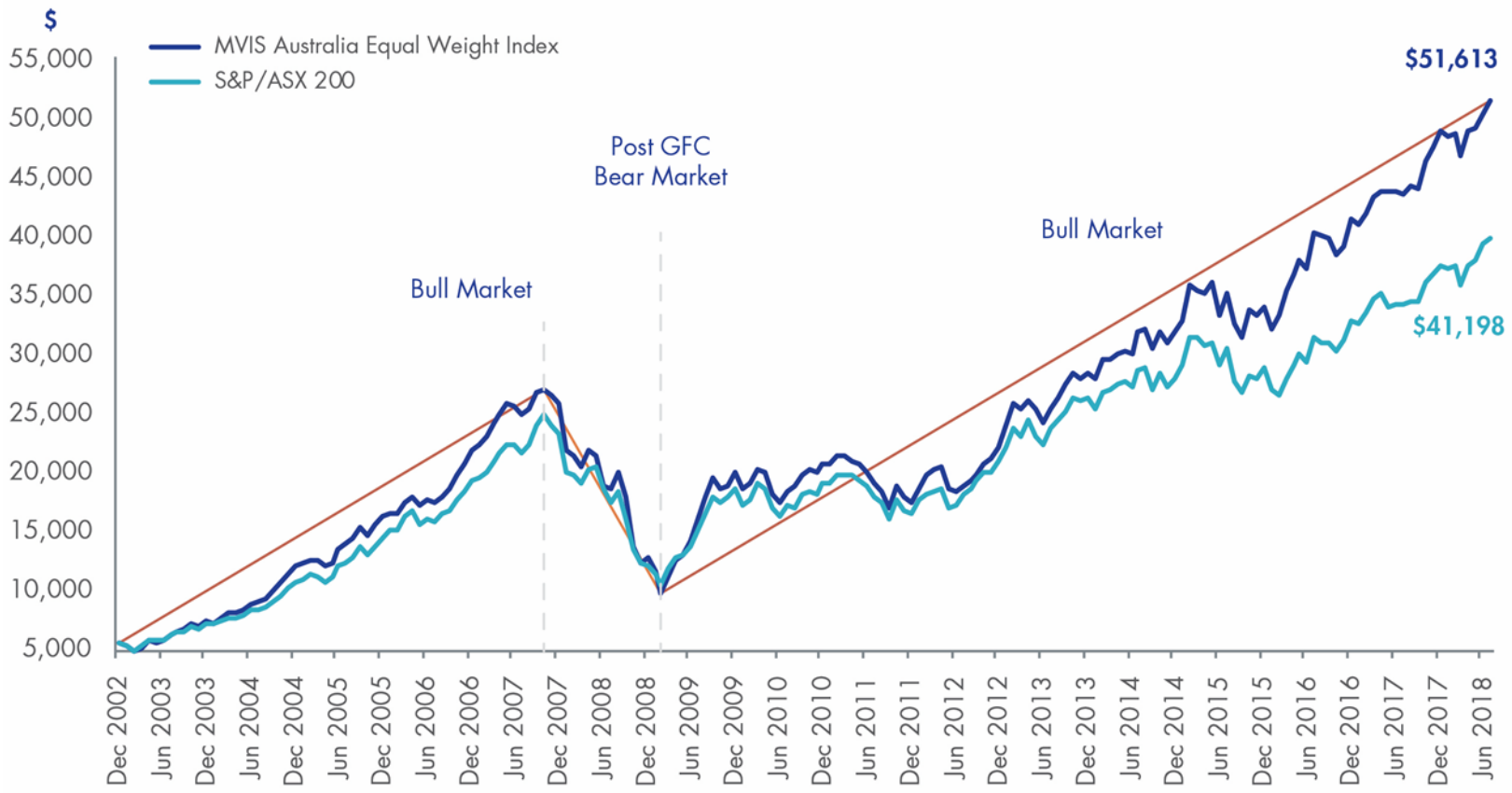
Understanding the engine that drives the smart beta strategy

What are you trying to achieve for your client's portfolios?

Fundamental questions:

1. Assess the index like an active strategy
2. What is the targeted/desired outcome?
3. Is the index supported by academic research and experience or is it a fad?
4. Is it easy to understand?
5. Does it perform as expected in the respective market conditions?

Equal Weight: Performing how you would expect



Targeted outcome

- Reduce stock and sector concentration
- Potential to improve returns
- Underweight mega-caps and overweight large- and mid-caps

Academic research

- Monash CSIRO and numerous others

Easy to understand

✓

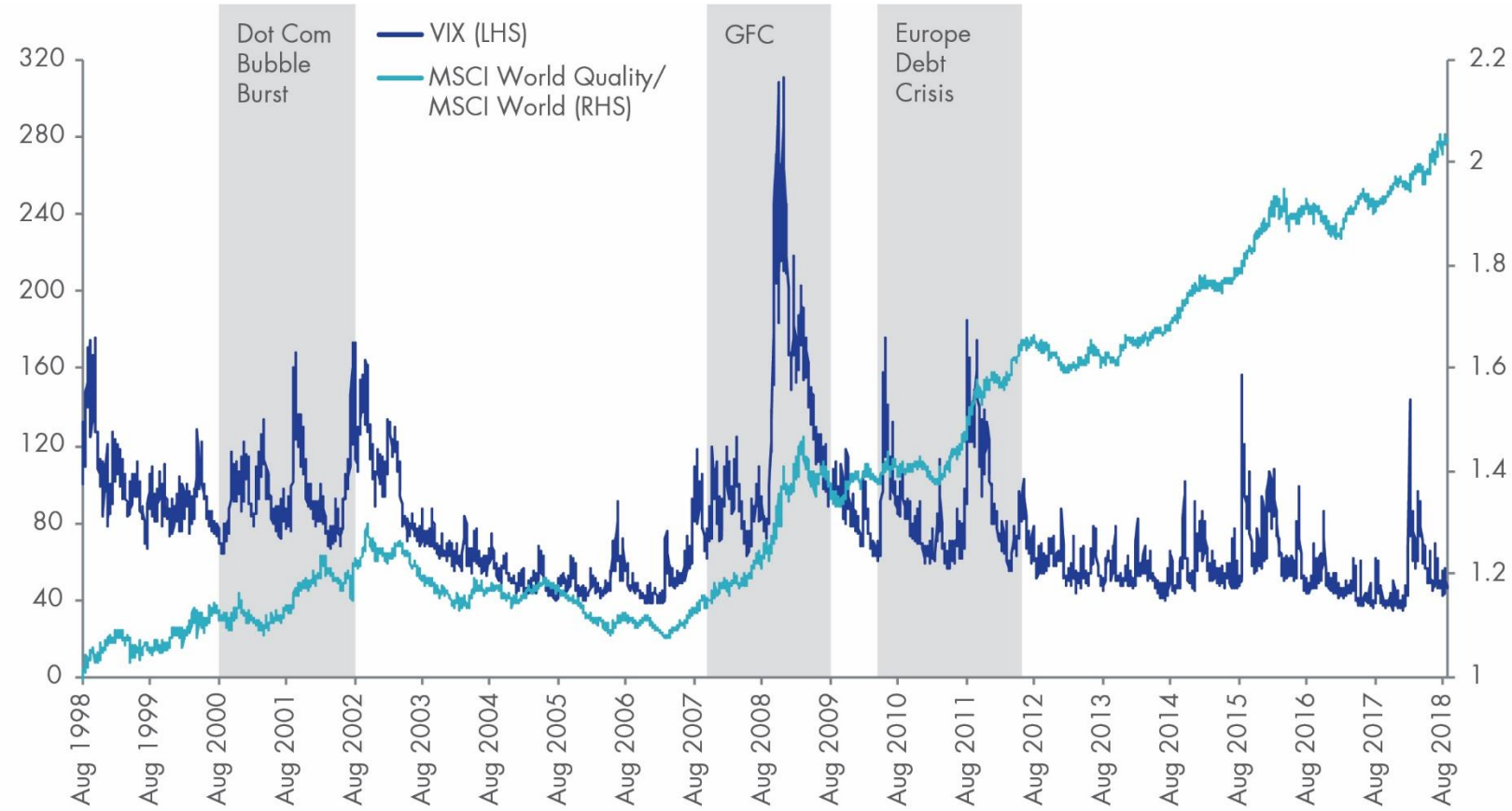
True to label

✓

Source: VanEck, FactSet; as at 31 July 2017
The above graph is a hypothetical comparison of performance of a $10,000 investment in MVW's Index and other recognised indices. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude costs associated with investing in MVW. You can not invest directly in an index. Past performance of MVW's Index is not a reliable indicator of future performance of MVW.

In volatile times, quality factor significantly outperforms

Relative performance of quality vs VIX



Targeted outcome

- Potential to improve long term returns
- Manage downside risks

Academic research

- Benjamin Graham plus numerous others

Easy to understand

✓

True to label

✓

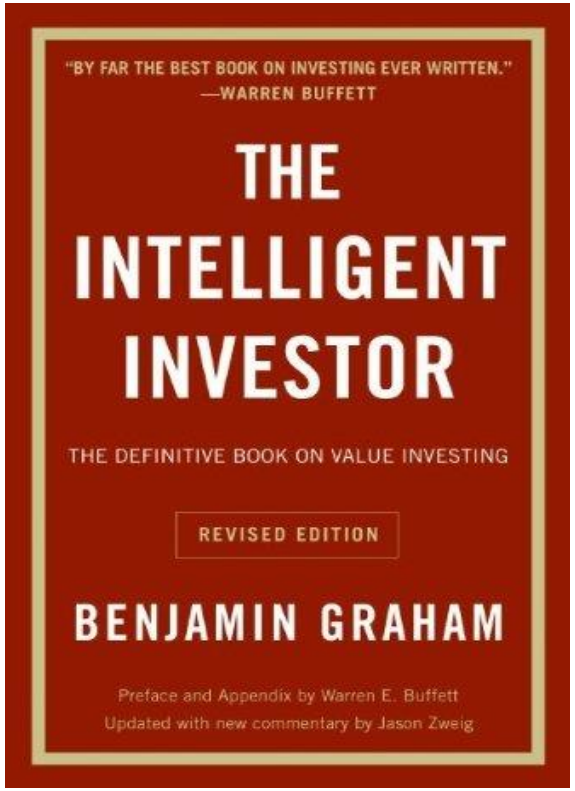
Source: MSCI Data/Calculations, Bloomberg. Past performance is not a reliable indicator of future performance.

Building an optimal portfolio with smart beta

A successful active manager mantra

The concept of quality

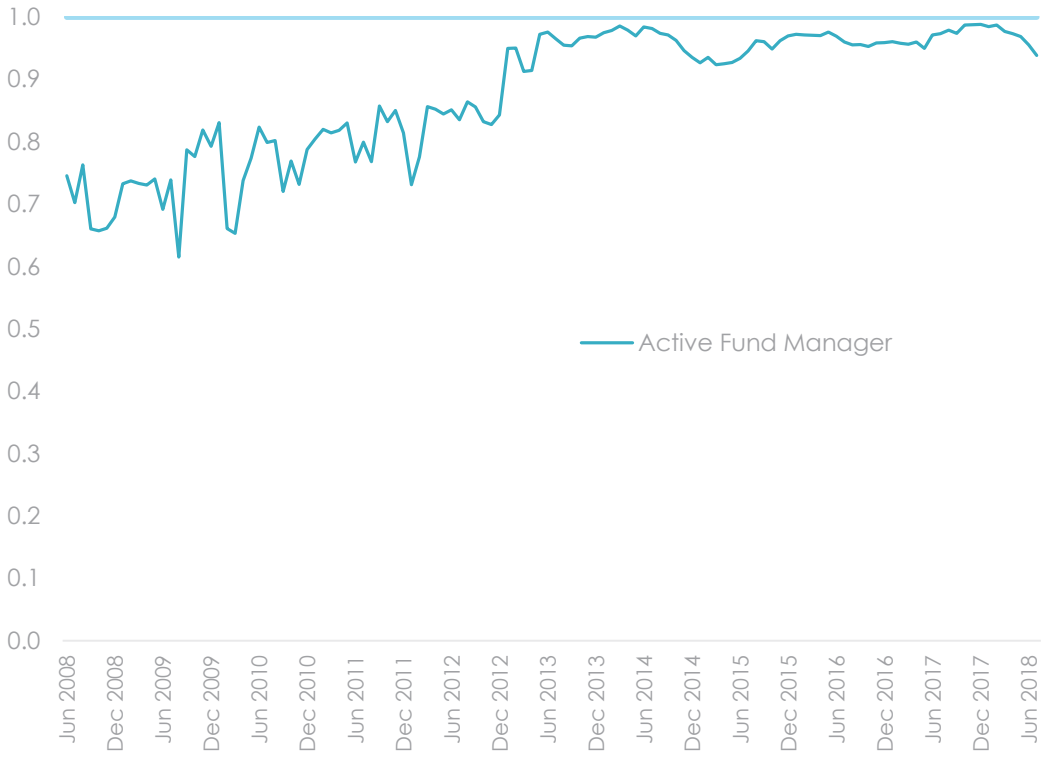
- The concept of "margin of safety" from quality investing is deeply embedded in Benjamin Graham's value investing philosophy
  - Durable business models of companies
  - Companies that are better placed to withstand negative business cycles
- Graham's seven fundamental measures
  - Adequate size of the enterprise
  - Sufficiently strong financial condition
  - Earnings stability
  - Dividend record
  - Earnings growth
  - Moderate Price to Earnings ratio
  - Moderate ratio of Price to Assets



Active manager attribution to quality factor

Twelve Month rolling correlation between MSCI World ex Australia Quality Index

Ten Years ending 31 July 2018



Source: Morningstar Direct, as at 31 July 2018. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude costs associated with investing in the ETF. You can not invest directly in the Index. The above performance information is not a reliable indicator of current or future performance of the indices or QUAL, which may be lower or higher.

Top 10 Holdings

International Equity Quality Factor	Active Manager Fund
Alphabet	**Alphabet**
Apple	**Apple**
Facebook	**Facebook**
Intel	HCA Healthcare
Johnson & Johnson	Kraft Heinz
Mastercard	Lowe's
Microsoft	**Microsoft**
Nestle	Starbucks
Roche	**Visa**
Visa	Wells Fargo

Management Costs

Smart Beta	Active Manager Fund
0.40% pa	**1.35% pa + performance fees**

Source: VanEck, Active Manager website, as at 31 July 2018

Australian equity: An outperforming core

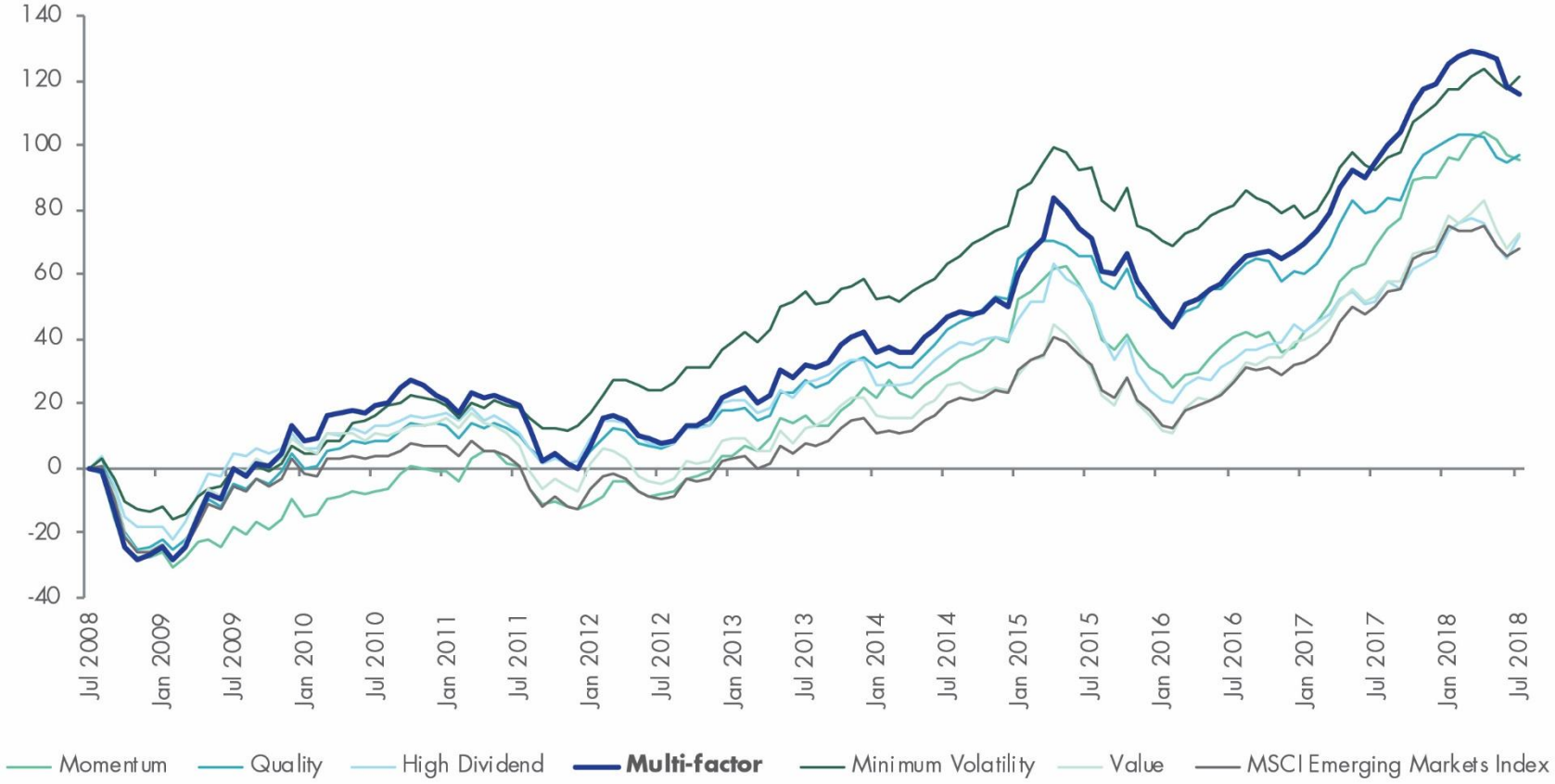
Growth assets - 50% allocation to Australian Equity

Money Smart Risk Profiles	S&P/ASX 200 Index		MVIS Australia Equal Weight Index		Difference		
5 year period	Return (% pa)	Sharpe ratio	Return (% pa)	Sharpe ratio	Return (% pa)	Sharpe ratio	Estimated additional costs
Conservative: 30% growth	5.82	1.24	6.39	1.39	+0.57	+0.15	0.03% p.a.
Balanced: 70% growth	8.34	1.00	9.68	1.20	+1.34	+0.20	0.07% p.a.
Growth: 85% growth	9.27	0.96	10.89	1.16	+1.62	+0.20	0.09% p.a.

Source: Morningstar Direct, Performance period ending 31 July 2018. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Rebalanced at the end of each calendar year.
Indices used to approximate investments: Cash – RBA target cash rate, International Bonds – Barclays Global Aggregate Bond Index A$ Hedged, Australian Bonds – Bloomberg AusBond Composite 0+ years, International Equities – MSCI World ex Australia Index , Australian Equities – S&P/ASX 200, MVW Index.

‘Factoring’ in the emerging markets premium

MSCI Emerging Markets Single Factor Performance
10 years to 31 July 2018



Source: MSCI, Morningstar Direct VanEck. Results are calculated monthly and assume immediate reinvestment of all dividends. Data is in Australian dollars converted from US dollars returns. You cannot invest in an index. Past performance is not a reliable indicator of future performance.
Indices used: Momentum – MSCI Emerging Markets Momentum Index, Quality – MSCI Emerging Markets Quality Index, High Dividend – MSCI Emerging Markets High Dividend Index, Multi-factor - MSCI Emerging Markets Diversified Multiple-Factor Index, Minimum Volatility – MSCI Emerging Markets Minimum Volatility Index, Value – MSCI Emerging Markets Value Weighted Index.

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Emerging markets: Diversified multiple-factor

EMKT Index vs MSCI Emerging Markets Index vs Active Managers

Performance
10 year to 31 July 2018

Source: Morningstar. Inception date is 29 December 2000. Returns in Australian dollars. Past performance of the index is not a reliable indicator of future performance of EMKT. You cannot invest directly in an index. The MSCI Emerging Markets Diversified Multiple-Factor Index was launched on Feb 17, 2015. Data prior to the launch date is back-tested data.

Question time