A GUIDE TO STRATEGIC-BETA ETFs

INVESTORS HAVE AN APPETITE FOR STRATEGIC-BETA EXCHANGE-TRADED FUNDS (ETFs), AND THE MARKET IS RESPONDING; THESE ETF LISTINGS, ALSO CALLED SMART-BETA, CONTINUE TO GROW.

Lukas Smart
Vice President and Senior Portfolio Manager
Dimensional Fund Advisors LP

In fact, smart-beta equity ETFs and exchange-traded products (ETPs) listed globally reached a record high of US$696 billion at the end of January 2018, according to ETFGI, a London-based ETF research firm. That surpasses the previous record of US$658 billion at the end of 2017.

Further, ETFGI reports that during January 2018, assets invested globally in smart beta ETFs and ETPs increased by US$37.8 billion, or 5.74%.

As more investors become interested in these types of ETFs, they'll need expert advice to include them in their portfolios.

And Manulife Investments has advisors covered. The firm has been working with Dimensional Fund Advisors (Dimensional), which has over 35 years of experience in factor-based investing, and entered the Canadian strategic-beta ETF market in April 2017. Manulife's goal is to provide advisors with all the tools they need to educate investors on the benefits of strategic-beta ETFs.

"We wanted to make sure our ETF lineup was consistent with the high level of talent that we have within our actively managed mutual funds," says Darnel Miller, Director, ETF Institutional Sales and Capital Markets at Manulife Investments. "Our strategic beta lineup allows us to provide value for advisors and investors who are using ETFs as a component of their portfolios."

Lukas Smart, Vice President and Senior Portfolio manager at Dimensional Fund Advisors LP, notes, "Strategic beta is about trying to outperform [the broad index] in a systematic way, and good strategic beta will do it in a well-diversified, cost-effective way."

What makes smart beta different is that it "intentionally deviates from market cap weights in an effort to generate a different outcome," Miller says. "That different outcome can be lower volatility or a focus on dividends, for instance. In our case, it's an attempt to pursue higher expected returns over time, and we're very encouraged by the feedback we've received from clients so far."

Manulife
Investments

How does Manulife and Dimensional's strategic-beta approach work?

BY USING A FACTOR-BASED APPROACH THAT UTILIZES THREE KEY FACTORS TO CREATE ETF PORTFOLIOS.

1. SIZE

Smaller-cap companies usually outperform larger-cap companies over time.

2. RELATIVE PRICE

Companies that are lower in relative price tend to outperform higher relative-priced companies over time.

3. PROFITABILITY

Companies that have a higher level of profitability typically outperform those that are less profitable over time.

INDEX MEMORY* IS A DIFFERENTIATOR

Most investors are aware that the returns they get are after fees and taxes. When pursuing higher expected returns, it's important to manage the cost of implementation within an ETF portfolio, notes Smart.

"If a strategy has more turnover than is necessary to maintain its objective, then it is sacrificing return," he says. "Basically, pennies matter. Every penny that the strategy pays is a penny less that the investor gets."

One of the keys to Dimensional's strategic-beta ETF approach is utilizing Index Memory, which incorporates various concepts into rules in the index.

"We recognized we had to codify as much of the role of the portfolio manager as possible," adds Smart. "Index Memory is just an expression of that."

For instance, Dimensional's Index Memory uses a hold range because it recognizes that securities move all the time and "sometimes the moves aren't that meaningful," explains Smart. "If you change the strategy based on a small change in size, you're paying a cost for that. Hold range says that a security would have to fall outside of the size range and then some before we'd consider it for an exclusion from the ETF's index. And it would have to move the other direction, past that same range and beyond, before we'll consider it for inclusion."

Another concept is the idea of momentum. "If a security is at the bottom range of momentum, then we are less likely to increase its weight within the strategy because, empirically, downward-momentum securities tend to have lower expected returns," says Smart.

Each of these concepts, as well as various others, make up the Index Memory approach and seek to limit index changes to those that meaningfully improve expected returns.

Spotlight on specific funds

Manulife offers a range of ETF portfolios sub-advised by Dimensional Fund Advisors Canada ULC, including small, mid and large cap, as well as U.S., Canadian and international funds.

But there are two products in particular that advisors have been very interested in, says Miller. These are the Manulife Multifactor Developed International Index ETF (MINT) and the Manulife Multifactor U.S. Small Cap Index ETF (MUSC).

"The developed international fund gives investors access to over 20 developed equity markets," he explains. "There's broad diversification across developed markets and Dimensional is able to apply the factor-based methodology across all of those markets, allowing investors to invest in companies and markets they may not generally have within their portfolios."

Meanwhile, the U.S. small-cap fund stands out because it allows advisors to have small caps in client portfolios, but not have to manage each individual name, says Miller. "The small-cap space has typically been more challenging for advisors to implement because the spreads of those securities can be wide, research coverage on the companies is less and individual names within the small-cap space can be volatile."

Overall, Miller notes that each of the funds they offer can provide benefits for advisors and their clients. "It comes back to our relationship with Dimensional. We were very thoughtful in choosing them, and by utilizing their factor-based approach we were able to design smart-beta ETFs for investors."

BEST PRACTICES
WHEN TRADING ETFs

DARNEL MILLER, DIRECTOR, ETF INSTITUTIONAL SALES AND CAPITAL MARKETS AT MANULIFE INVESTMENTS, OFFERS ADVISORS SEVERAL BEST PRACTICES WHEN IT COMES TO TRADING ETFs.

Darnel Miller
Director, ETF Institutional Sales and Capital Markets
Manulife Investments

ETF LIQUIDITY

An ETF is essentially as liquid as its underlying securities, so when advisors are thinking about liquidity of an ETF, they should be considering the underlying holdings. For instance, an ETF that participates in the large-cap Canadian equity space essentially is as liquid as the average daily liquidity of the underlying Canadian large-cap securities broadly. So look at underlying liquidity, not just the volume that's traded on the specific ETF product.

ORDER TYPES

Consider the types of orders you're using. Miller recommends limit orders, which means that advisors can set a price and know they will not make a purchase of an ETF above a specified price.

TIMING TRADES

It can take 10 to 15 minutes at the beginning or close of the market for ETFs to have pricing as accurate as possible. So advisors should try not to trade near the open or close of the market.

TRADING

ETFs can track security markets all around the world, so, whenever possible, trade when the underlying international market is open.

LARGE VOLUME

As an ETF provider, Manulife has resources that can help advisors with execution. So if advisors have large trades that they need to transact, they can call Manulife and we will make sure they work with their respective organizations to get the best execution.

ACTIVE VS. PASSIVE
VS. STRATEGIC-BETA

PASSIVE ETFs, WHICH ARE INDEX-BASED PRODUCTS THAT FOLLOW TRADITIONAL BENCHMARKS, REMAIN THE LARGEST CATEGORY IN CANADA AND THE U.S.

But, increasingly, advisors are choosing alternatives to this traditional approach in the form of actively managed ETFs and strategic-beta ETFs, says Miller.

"We think it's because investors have become more comfortable with ETFs within their portfolios, and advisors are increasingly knowledgeable about how to implement them," he says.

"Strategic-beta ETFs are useful because they deliver some of the best components of each, with a rules-based, index approach that intentionally deviates from traditional benchmarks to offer the potential for returns greater than traditional market cap-weighted benchmarks over time."

TALK TO CLIENTS ABOUT STRATEGIC-BETA ETFs

PHILIP PETURSSON, CHIEF INVESTMENT STRATEGIST AT MANULIFE INVESTMENTS, SAYS, "STRATEGIC-BETA ETFs AREN'T COMPLETELY PASSIVE AND ARE TRYING TO DELIVER HIGHER EXPECTED RETURNS COMPARED TO THE BROAD INDEX."

Philip Petursson
Chief Investment Strategist
Manulife Investments

Before including strategic-beta ETFs in investors' portfolios, it's important to understand their goals, says Petursson. If they simply want the lowest price, then ETFs replicating performance of the TSX, S&P500, Dow Jones or other broad indexes can offer that.

"If we go back to June 2008 at the top of the market, the S&P/TSX peaked at 15,154," says Petursson. "Today it's about 15,558, so you're talking about a total return over almost 10 years of 2.7%. That doesn't include dividends, and that's not an annualized return. That's a cumulative return."

So ask clients if that was their goal, he notes. Say, "You could've bought the TSX composite, paid the lowest fee, maybe 10 basis points, but is that what you needed over the past 10 years? Did that serve your investment strategy and get you to your goals?"

Petursson adds that a strategic-beta ETF strategy, on the other hand, offers the potential to outperform the TSX and other broad indexes. "Yes, you're paying up for it a bit, but perhaps you're getting closer to your goal."

Risk tolerance is also a factor that advisors need to discuss with clients. Investors who want full exposure to ETFs that replicate the broad index will also be exposed to market risk, he says.

"That means that when the market is up, they'll capture almost 100% of the upside, less any minor adjustments for fees," explains Petursson. "When the market is down, they'll capture the downside plus the fee embedded in that ETF."

So ask clients if full exposure is what they're really after, he notes. "Overall, it's not just about fees. It's about the interaction of fees with your return expectations and risk tolerance."

DIMENSIONAL FUND ADVISORS HAS BEEN A LEADER IN THE DEVELOPMENT AND EVOLUTION OF SYSTEMATIC, RULES-BASED INVESTING

1973 — FIRST INDEX FUND DEVELOPED

Dimensional co-founders David Booth and Rex Sinquefield (both students of Eugene Fama) were involved in the launch of the first index funds for institutional investors, two years before the founding of Vanguard.

1981 — SMALL CAP

Booth and Sinquefield founded Dimensional to deliver solutions that capture the small-cap premium.

1992 — SIZE AND VALUE

Dimensional directors Eugene Fama and Ken French developed the Fama/French model, which identifies market, size and price factors as principal drivers of equity premiums.

2006 — STRATEGY ENHANCEMENTS

Dimensional enhanced strategies, incorporating momentum by delaying buying securities exhibiting negative momentum and delaying selling securities exhibiting positive momentum.

2012 — PROFITABILITY

Dimensional consultant Robert Novy-Marx documented the persistence of higher profitability in performance. As a result, the profitability factor was incorporated into Dimensional's investment approach.

2017 — ETF EXPANSION

Manulife Investments selected Dimensional Fund Advisors Canada ULC as subadvisor to the Manulife ETFs.

ETFs. DO IT DIFFERENT.

Manulife Investments