Smart beta is all the hype these days with new strategies coming out frequently, making it one of the fastest-growing areas of new product launches. For the uninitiated, “smart beta” is simply a term used to describe any investment approach that deviates from traditional market cap–weighted benchmarks. A formulaic or rules-based approach to building a portfolio is used, rather than traditional market cap–weighted benchmarks such as the broad S&P 500 Index.

The strength of large cap stock performance in recent years has made the broad S&P 500 Index tough to beat—and only intensified investor desire to find another way to outperform traditional market cap–weighted benchmarks. An increasing number of new exchanged-traded funds (ETF) and mutual funds have popped up looking to capitalize on this latest trend.

CLOSER LOOK AT SMART BETA APPROACH

Regardless of the approach, the general thesis behind smart beta is that the traditional index-based philosophy is flawed, and by focusing on “smart” elements an investor can obtain 2.0% of annualized outperformance relative to a cap-weighted benchmark over a full market cycle. Or so the back-tested theories claim. To accomplish this, the products cite a unique way to uncover “smart beta.” Investment approaches focus on desirable investment factors such as high return on assets, high free cash flow, or accelerating sales growth (just to name a few), or a combination of several factors. The stocks that score strongest based on the methodology will have the greatest weighting; therefore, the portfolio will differ from a market cap–weighted index not only in concentration, but also in sector weighting and frequency of trading, or possibly a combination of the three.

Sound familiar? This approach is effectively the same story that active investment managers have recommended for a few decades—markets can be inefficient and there are better ways to find opportunity. Smart beta products have taken different approaches that try to capitalize on these market inefficiencies. In fact, listing and categorizing the different options can be daunting. A myriad of strategies are available that focus on equal weighting, dividends, valuations, size, style, volatility, beta, risk parity, momentum, fundamentals, defensives, dynamic, etc.

We are often asked, “Which smart beta strategy is the best?” It is difficult to answer this question for two reasons. First, there is very limited actual investment history for many of these strategies; and long-term track records of 10-years or more, covering an entire market or economic cycle, are extremely rare. Most strategies have investment histories of less than three years and provide a limited basis for evaluation.
Second, smart beta product creators point to hypothetical backtests as validation of the strategy. But hypothetical backtests almost never translate the same success once actually invested in the market with real dollars. “Past performance is no guarantee of future results” is particularly appropriate here.

Because each product uses a different methodology, a look under the hood reveals the underlying bias of each smart beta strategy. Differences can be significant. Equal-weighted products will provide more exposure to small cap stocks, while a dividend focus will emphasize value stocks. Some strategies focus on frequent rebalancing to trim winners and add to losers, while momentum-based strategies take the opposite approach and focus on sticking with winners.

NO FREE LUNCH

A look at the three smart beta strategies with the longest investment history reveals no distinct advantage relative to investing in the broad domestic stock market, as measured by the S&P 500 Index [Figure 1]. Both the equal-weight and fundamental approaches do produce greater annualized return over the horizon, but they do so with greater risk (standard deviation). Dividend-paying stocks produced the same amount of risk as the broad domestic benchmark, but fell short on return and perhaps proved the least efficient. Risk-adjusted performance, as measured by the Sharpe ratio, shows no particular advantage relative to the broad market and was weakest for the dividend strategy. In sum, while these smart beta strategies did not necessarily fare poorly, they also failed to exhibit notable added value relative to simply investing in the broad stock market.

While smart beta strategies did not necessarily fare poorly, they also failed to exhibit notable added value relative to simply investing in the broad stock market.

Considering a broad subset of smart beta strategies designed to outperform the S&P 500 Index shows similar results [Figure 2]. Using a shorter three-year history, to accommodate younger strategies, the subset of smart beta strategies reveals no particular advantage relative to the broad market. The PowerShares S&P 500 High Quality ETF (SPHQ) did produce greater risk-adjusted performance than the S&P 500 Index, which is noteworthy, but the 0.5% annualized return advantage is not overly compelling. The PowerShares S&P 500 Low Volatility ETF (SPLV) exhibited similar risk-adjusted performance as the broad market, but did so with less correlation to the market, and may make sense for investors seeking less correlated strategies that may boost portfolio diversification. Additionally, both SPHQ and SPLV suffered less drawdown during difficult markets, potentially suggesting some protection in down markets.
CAVEAT EMPTOR

Although any of these approaches can work over time, the key question is: How does the strategy fit with the rest of a client’s portfolio? Will adding an equal-weighted product tilt a client to owning too much small cap? Does a lower-volatility or dividend-focused product create an overweight to the utility sector, and therefore increase interest rate sensitivity? “Buyer beware” is an apt warning—investors need to understand the potential bias or underlying factor exposure they may be taking on.

POTENTIAL USE

Both SPHQ and SPLV illustrate a potential use as a complement to an existing portfolio. Some smart beta strategies may aid downside protection while an overly defensive portfolio could be adjusted with a high-beta solution. We believe that smart beta has expanded the investment tool box available to investors; however, being overweight a specific factor that underlies a particular smart beta strategy does not guarantee outperformance.

COST CONSIDERATIONS

ETFs were originally created as a low-cost, tax-efficient vehicle that offered daily liquidity and full transparency. The argument for daily liquidity still holds with smart beta ETFs, the most common vehicle for smart beta strategies, but their cost and tax efficiency are questionable. Generally, single-factor strategies have lower costs, but costs increase with more complex, multi-factor strategies. As an example, the average expense ratio for a large cap U.S. market cap-weighted ETF is 0.13%, according to Morningstar data. The average for a single-factor strategy (e.g., equal weighted, dividend weighted, earnings weighted) is 0.44%. More complex, multi-factor products have average expenses of 0.61%. Tax efficiency is also challenging as turnover can be higher in many strategies.
Do the costs outweigh the benefits? Unfortunately, only a few strategies possess a longer-term track record; and they show mixed results, at best, relative to the S&P 500 Index.

CONCLUSION

Despite a flawed name, some smart beta strategies can help to complete the portfolio construction process by providing more niche ways to access markets. But remember, there is never a “best” product available for every investment environment. Strategies and investment styles fall in and out of favor over time and no two investment environments are exactly alike. Each strategy will behave differently depending on the current market environments. Most smart beta strategies have too short a history for full evaluation, but those with the longest track record have not necessarily exhibited a better way to invest. Most importantly, investors should know the underlying factor bias that may influence investment results. Be sure to take a look under the hood before taking one for a spin.

3 STANDARDIZED PERFORMANCE OF SMART BETA STRATEGIES DISCUSSED HEREIN

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Description</th>
<th>1-Year Annualized Return, %</th>
<th>3-Year Annualized Return, %</th>
<th>5-Year Annualized Return, %</th>
<th>Since Inception Annualized Return, %</th>
<th>Inception Date</th>
<th>Gross Expense Ratio, %</th>
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<tbody>
<tr>
<td>PRF</td>
<td>PowerShares FTSE RAFI US 1000 ETF</td>
<td>12.21</td>
<td>20.98</td>
<td>16.10</td>
<td>9.00</td>
<td>01/06</td>
<td>0.41</td>
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<td>DVP</td>
<td>iShares Select Dividend</td>
<td>14.89</td>
<td>17.79</td>
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<td>7.89</td>
<td>12/03</td>
<td>0.39</td>
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<td>SPHB</td>
<td>PowerShares S&amp;P 500 High Beta ETF</td>
<td>12.72</td>
<td>23.22</td>
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<td>10.91</td>
<td>06/11</td>
<td>0.25</td>
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<tr>
<td>RSP</td>
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<td>05/03</td>
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<td>RPG</td>
<td>Guggenheim S&amp;P 500 Pure Growth ETF</td>
<td>13.88</td>
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<td>04/06</td>
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<td>RPV</td>
<td>Guggenheim S&amp;P 500 Pure Value ETF</td>
<td>12.26</td>
<td>27.44</td>
<td>20.16</td>
<td>9.37</td>
<td>04/06</td>
<td>0.35</td>
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<tr>
<td>SPHQ</td>
<td>PowerShares S&amp;P 500 High Quality ETF</td>
<td>16.09</td>
<td>20.67</td>
<td>17.62</td>
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<tr>
<td>VQT</td>
<td>Barclays ETN+ S&amp;P VECTOR</td>
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<td>6.75</td>
<td>6.86</td>
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<td>09/10</td>
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<td>VSPY</td>
<td>Direxion S&amp;P 500 Volatility Response ETF</td>
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<td>N/A</td>
<td>15.79</td>
<td>02/12</td>
<td>0.88</td>
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<tr>
<td>SPLV</td>
<td>PowerShares S&amp;P 500 Low Volatility ETF</td>
<td>17.19</td>
<td>16.70</td>
<td>N/A</td>
<td>15.14</td>
<td>06/11</td>
<td>0.25</td>
</tr>
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</table>

S&P 500 | 13.69 | 20.41 | 15.45 | N/A |

Source: LPL Research, Zephyr 02/27/15

Performance data quoted represent past performance, and are not indicative of future results.

Investment return and principal value will fluctuate; an investor’s equity, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain current month-end performance, contact your financial advisor.

Individual client experience may have differed dependent upon the timing of cash flows. Gross performance is gross of overlay and advisory fees but net of investment management fees and expenses. The impact of overlay fees and advisory fees would decrease performance quoted above. Net performance is net of expenses and the maximum advisory fee of 2.5%. The returns shown include reinvestment of income distributed from the underlying mutual funds.
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Alternative strategies, including smart beta, may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor’s portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

Investing in ETFs involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus. As ETFs trade on a stock exchange they may be at greater risk for volatile price fluctuations. Please read the fund’s prospectus for more information on risks, fees, and other important information.

Investing in SPQH entails numerous risks, including the possible loss of principal. Fund specific risks include, but are not limited to: sector concentration risk, passive management risk, and market risk.

Investing in SPLV entails numerous risks, including the possible loss of principal. Fund specific risks include, but are not limited to: sector concentration risk, margin and short selling risk, and market risk.

**Investors should consider the investment objectives, risks, charges, and expenses of the investment company carefully before investing. The prospectus, and if available, the summary prospectus, contains this and other information about the investment company. Your client can obtain a prospectus from you. They must read carefully before investing.**