

---

# Morningstar Strategic Beta Guide

---

# Frequently Asked Questions: Strategic Beta

## **What is “strategic beta”?**

Strategic beta—often called “smart beta”—refers to a growing group of indexes and the investment products that track them. The majority of these indexes aim to enhance returns or minimize risk relative to a traditional market-capitalization-weighted benchmark. Others try to address well-known drawbacks of standard benchmarks, such as the overweighting of debt-laden issuers in market-cap-weighted fixed-income benchmarks.

These investable products and their underlying indexes capitalize on many of the same “factors” (size, value, quality, momentum, etc.) that active managers emphasize. Strategic beta products represent a middle ground on the active-to-passive spectrum—they deviate from a traditional, strictly passive market portfolio, but do so in a rules-based, transparent, and relatively low-cost manner.

Consider the S&P 500, a standard market index: The S&P 500 Growth Index draws constituents from the S&P 500, but adds a style tilt, screening specifically for stocks based on sales growth, ratio of earnings change to price, and momentum. Because of this style tilt, Morningstar has tagged investments that track the S&P 500 Growth Index—such as Vanguard S&P 500 Growth ETF (VOOG)—as strategic beta investments. Similarly, the S&P 500 Low Volatility Index screens for the 100 least-volatile stocks in the S&P 500. Products that track this index, such as PowerShares S&P 500 Low Volatility ETF (SPLV), are also considered strategic beta investments.

## **Is strategic beta the same as smart beta?**

The short answer is yes.

Some investors may be more familiar with the term smart beta, which has gained traction in the industry. At Morningstar, we don’t use this term because “smart” implies that these strategies are somehow superior to their traditional counterparts. We believe the term “strategic” is more appropriate; after all, the indexes underlying these investment products are designed with strategic objectives in mind (low volatility, for example).

## **How does Morningstar assign strategic beta attributes?**

The investment product must track an index to be included in our strategic beta grouping. After we screen out non-index-tracking investments, we analyze the products’ underlying benchmarks.

---

Some investors identify strategic beta products by what they don't do, limiting their definition to products tracking any benchmark that does not weight its constituents on the basis of their market capitalization. By Morningstar's definition, most of the indexes underlying strategic beta investment products are not market-capitalization weighted. But a few of these indexes are market-cap weighted. For example, we include those with style "tilts"—which screen their investable universe for certain characteristics and subsequently weight constituents by their market capitalization.

These are the types of indexes we include and exclude from our strategic beta grouping. We assign these attributes at the index level, but this list also applies to any investment products that track these types of indexes:

---

**Excluded**

Market-capitalization-weighted sector indexes  
Market-capitalization-weighted country indexes  
Thematic indexes (for example, clean energy or cloud computing)  
Indexes that screen constituents strictly on the basis of sector membership or geography  
Volatility indexes  
Indexes that employ options strategies  
Indexes that underlie products in our "trading" categories, such as leveraged and inverse funds  
Indexes that mimic quantitative tactical strategies

---

**Included**

Non-cap-weighted sector indexes  
Non-cap-weighted country indexes

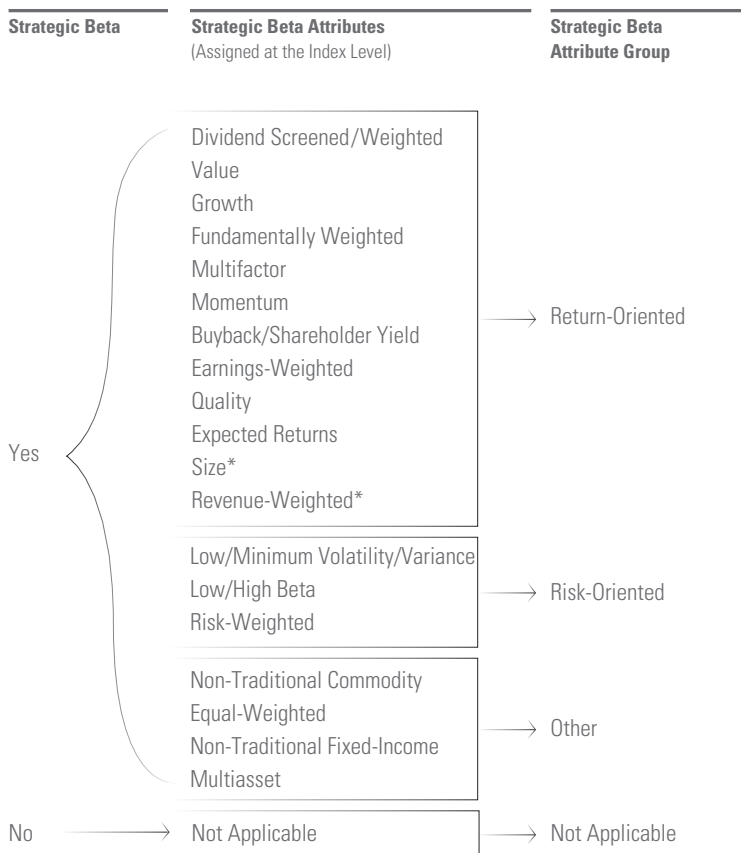
**How does Morningstar source strategic beta attribute information?**

We identify the index strategy by reviewing prospectuses, fact sheets, and index methodology documents. All indexes tracked by an exchange-traded product or open-end mutual fund are reviewed specifically for strategic beta attributes. If an index being tracked by an investible product does not have strategic beta characteristics, Morningstar will assign it a "not applicable" attribute. This indicates that we have reviewed the index and determined that it does not fit into this grouping.

## How does Morningstar identify strategic beta investments?

We have defined a list of attributes (included here), which are assigned to individual indexes within our database. These help investors and clients identify strategic beta investments, which they can screen for in a variety of ways using Morningstar products.

In Morningstar Direct<sup>SM</sup>, users can filter Morningstar's coverage universe at different levels. Users can search for all strategic beta vehicles (Strategic Beta = Yes/No), an attribute group (Return-Oriented, Risk-Oriented, and Other), or for a specific attribute (Dividend Screened/Weighted).



\* Pending release

---

### **Are these attributes new Morningstar categories?**

No, these are attribute tags. They are not intended to replace or override the Morningstar Category system, which continues to represent these products' peer groups. Strategic beta portfolios are assigned a Morningstar Category to calculate the Morningstar Rating™ and assess category-relative calculations related to performance, fees, etc.

### **Why do some strategic beta investments have multiple secondary attributes?**

Some portfolios emphasize multiple factors. For those products tracking multifactor benchmarks, Morningstar helps investors "look through" to the individual factors combined within the benchmark index. Indexes tagged with multiple secondary attributes (e.g., value, size, and momentum) will "roll up" into the "multifactor" classification. The "multifactor" classification, in turn, falls under our "return-oriented" grouping. This reflects the fact that the overarching objective of these strategies is to improve the risk-adjusted performance relative to a standard market-capitalization-weighted benchmark.

### **Why are fund companies such as Dimensional Fund Advisors, AQR, Parametric, and INTECH not included in your definition of strategic beta?**

These firms' funds do not set out to track the performance of an index. Morningstar's definition of strategic beta only includes index-tracking investment products. That said, these firms' strategies look to harness many of the same risk premia (value, size, momentum, etc.) as strategic beta indexes; they do so in a systematic (albeit active) manner, making them close cousins of strategic beta investments.

### **Why are some strategic beta exchange-traded products missing performance data?**

There are ETPs that list on multiple exchanges. The fund-to-exchange listing relationship can range from one to many. In these instances, each listing has a unique set of market data: open/high/low/close prices, trading volume, and so on. But these listings are secondary listings of the primary share class, so they do not have their own NAVs, distributions, and asset data.

For example, the db x-trackers EURO STOXX 50 UCITS ETF (DR) (1D) is listed on the Borsa Italiana (EUR), Deutsche Boerse Xetra (EUR), Mercado Continuo Espanol (in EUR), SIX Swiss Exchange (CHF), London Stock Exchange (GBP), and the Stuttgart Stock Exchange (EUR).

	Name	Base Currency	Ticker	Exchange	ISIN
1	db x-trackers Euro Stoxx 50® (DR) 1D	Euro	XESX	BORSA ITALIANA S.P.A.	LU0274211217
2	db x-trackers Euro Stoxx 50® (DR) 1D	Euro	DBXE	DEUTSCHE BOERSE AG	LU0274211217
3	db x-trackers Euro Stoxx 50® (DR) 1D	Euro	DXESX	MERCADO CONTINUO ESPANOL	LU0274211217
4	db x-trackers Euro Stoxx 50® (DR) 1D	Euro	DBXE	XETRA	LU0274211217
5	db x-trackers Euro Stoxx 50® (DR) 1D	Swiss Franc	XESX	SWISS EXCHANGE	LU0274211217
6	db x-trackers Euro Stoxx 50® (DR) 1D	Pound Sterling	XESX	LONDON STOCK EXCHANGE	LU0274211217

Morningstar has received requests to convert primary NAV data into the currencies of the countries where these products are cross-listed to “fill the gaps.” We have done extensive research in response to this request, but there are conflicting opinions about the validity of converted NAV data.

For example, converting NAV information will only add a layer of complexity to these already complex structures. Different fund companies use different foreign exchange rates and calculate their own data at different intervals, so it is challenging to be sure investments are represented accurately across the world.

At this time, Morningstar is continuing to research the client/investor need for converted NAV data and the best way to deliver it without causing confusion or negative effects on our products and clients.

### **Where can I find additional materials on strategic beta?**

Morningstar thought leaders have written extensively about strategic beta. Please contact your Morningstar representative for access to these materials.

---

# Morningstar's Approach to Strategic Beta

---

## Our Definition of Strategic Beta

---

Strategic beta—commonly called smart beta—refers to a growing group of indexes, as well as the exchange-traded products, open-end funds, and other investment products that track them.

The majority of these indexes aim to enhance returns or minimize risk relative to a traditional market-capitalization-weighted benchmark.

Others try to address well-known drawbacks of standard benchmarks, such as the negative effect of contango in long-only commodity futures indexes or the overweighting of debt-laden issuers in market-capitalization-weighted fixed-income benchmarks.

These investable products and their underlying indexes capitalize on many of the same “factors” (size, value, quality, momentum, etc.) or mitigate risk the way active managers might.

Strategic beta products represent a middle ground on the active-to-passive spectrum—they deviate from a traditional, strictly passive market portfolio, but do so in a rules-based, transparent, and relatively low-cost manner.

Many define strategic beta products by what they don't do, limiting their definition to products tracking any benchmark that does not weight its constituents on the basis of their market capitalization.

By Morningstar's definition, most of the indexes underlying strategic beta investment products are not market-capitalization weighted, but some are. For example, we include those with style “tilts”—which screen their investable universe for certain characteristics and subsequently weight constituents by their market capitalization.

Morningstar does not include these in our strategic beta grouping: market-capitalization-weighted sector indexes (though non-cap-weighted sector benchmarks are included); thematic indexes (e.g., socially responsible indexes, clean energy indexes, etc.); market-capitalization-weighted country indexes (non-cap-weighted indexes are included); and other indexes that screen constituents strictly on the basis of sector membership, investment theme, or geography.

---

Morningstar does not include in our strategic beta grouping:

- ▶ Products tracking benchmarks that employ options strategies (e.g., covered calls and protective puts)
- ▶ Products using quantitative tactical strategies
- ▶ Products offering some form of exposure to volatility indexes
- ▶ Products included in our “trading” categories, such as leveraged and inverse funds

The common elements amongst this diverse set of products are:

- ▶ They are index-tracking investment products.
- ▶ They track non-traditional benchmarks that have an “active” element contained within their methodology, which typically aims to either improve returns or alter the index’s risk profile relative to a standard benchmark.
- ▶ Many of their benchmarks have short track records and were designed solely as the basis of an investment product.
- ▶ Their expense ratios tend to be lower relative to actively managed funds.
- ▶ Their expense ratios are often substantially higher relative to products tracking “bulk beta” benchmarks, like the S&P 500.



---

# Strategic Beta Attribute Groups

We group strategic beta investments by return-oriented and risk-oriented strategies, as well as a wide-ranging “other” classification.

---

## Return-Oriented Strategies

Return-oriented strategies aim to improve returns relative to a standard benchmark. Value and growth-based benchmarks are prime examples of return-oriented strategies. Other return-oriented strategies seek to isolate a specific source of return. Dividend screened/weighted indexes, such as those followed by the iShares Select Dividend ETF (DVIY) and SPDR S&P Dividend ETF (SDY), are the chief examples of this type of return-oriented strategy.

### **Dividend Screened/Weighted**

Dividend screened and/or weighted strategies aim to deliver equity income by employing a number of dividend-oriented screening and/or weighting criteria. These include screening a universe of stocks for dividend-paying firms, weighting stocks on the basis of dividend payments, screening on the basis of dividend growth, isolating firms based on metrics that would indicate dividend stability, and other dividend-related criteria. Some of these strategies will weight the results of their screening criteria by market capitalization.

### **Value**

Value strategies look to identify stocks that display “value” characteristics, which will differ across index providers. Common value characteristics can include: low price/prospective earnings; price/book, price/sales, and price/cash flow ratios; and

above-average dividend yields. Some of these strategies will weight the results of their screening criteria by market capitalization.

### **Growth**

Growth strategies identify stocks that display “growth” characteristics, which will differ across index providers. Common growth characteristics can include: above-average long-term projected earnings growth, historical earnings growth, sales growth, cash flow growth, and book value growth. Some of these strategies will weight the results of their screening criteria by market capitalization.

### **Fundamentally Weighted**

Fundamental-weighted strategies exclusively describe Research Affiliates’ RAFI fundamental index equity strategies, which select and weight their constituents based on fundamental measures such as sales, adjusted sales, cash flow, dividends, dividends plus share buybacks, book value, and retained cash flow.

### **Multifactor**

Multifactor strategies set out to combine a variety of factors (e.g., value, growth, size, momentum, quality, low volatility, etc.) to improve risk-adjusted performance relative to a standard benchmark.

---

### **Momentum**

Momentum strategies will select and/or weight their constituent securities on a number of factors that could include price momentum, adjustments to earnings estimates, and earnings surprises.

### **Buyback/Shareholder Yield**

Buyback/shareholder yield strategies will select and/or weight their constituents based on some measure of cash returned to shareholders over a specified period. Typically this is some combination of the following: dividends, share repurchases, and debt retirement.

### **Earnings-Weighted**

Earnings-screened and/or weighted strategies aim to deliver excess returns by employing a number of earnings-oriented screening and/or weighting criteria.

### **Quality**

Quality strategies look to build a portfolio of stocks from quality companies, characterized by their durable business models and sustainable competitive advantages. Quality companies tend to have high and stable levels of profitability and clean balance sheets.

### **Expected Returns**

Expected return equity strategies will select their constituents based on one or more measures of expected returns or relative performance, such as quantitative rankings or broker recommendations, and weight them in a variety of ways.

### **Size**

Morningstar only considers size within the context of a multifactor strategy that introduces size “tilts.” Products tracking small-cap benchmarks, such as the Russell 2000, are not classified as strategic beta. Morningstar does not classify small- or mid-cap benchmarks that screen constituents for growth or value characteristics as “multifactor.” Only those products that track multifactor benchmarks that implement a size “tilt” will be tagged with this attribute—for example, the J.P. Morgan Diversified Return Global Equity ETF (JPGE).

### **Revenue-Weighted Strategies**

Revenue-weighted strategies weight their holdings according to each company’s revenue relative to the total revenue of all the companies in the portfolio.

---

## Risk-Oriented Strategies

Risk-oriented strategies look to either reduce or increase the level of risk relative to a standard benchmark. Low-volatility and high-beta strategies are the most common examples.

### **Low/Minimum Volatility/Variance**

Low/minimum volatility/variance strategies select and weight their constituents on the basis of historical volatility.

### **Low/High Beta**

Low/high-beta strategies select and weight their constituents based on their beta relative to a standard market-capitalization-weighted benchmark.

### **Risk-Weighted**

Risk-weighted strategies weight constituents according to their individual expected contributions to overall portfolio risk.

---

## Other

This classification encompasses a wide variety of strategies ranging from non-traditional commodity benchmarks to multi-asset indexes.

### **Non-Traditional Commodity**

Non-traditional commodity benchmarks aim to improve the performance of standard indexes (e.g., DJ UBSCI, S&P GSCI) by avoiding their chief drawbacks (e.g., roll losses resulting from contango). These include benchmarks that employ alternative weighting and/or rolling methodologies.

### **Equal-Weighted**

Equal-weighted strategies assign an equal weight to their constituent securities.

### **Non-Traditional Fixed-Income**

Non-traditional fixed-income benchmarks are not market-capitalization weighted. The well-known drawback of market capitalization weighting in bond benchmarks is that it results in a portfolio that overweights the most heavily indebted issuers. At present, most non-traditional bond benchmarks weight constituents on the basis of fundamental metrics indicative of debt service capacity, which results in portfolios that skew toward more credit-worthy issuers.

### **Multiasset**

Multiasset strategies tend to be income-oriented and will screen eligible securities (which may include stocks, bonds, preferred securities, master limited partnerships, and other securities) on the basis of yield or other characteristics.



22 West Washington  
Chicago  
Illinois 60602

+1 312 696-6000  
[global.morningstar.com](http://global.morningstar.com)