ETFS 101, Part 6 - **SMART BETA**

Overview

Last month we looked at two different Exchange-Traded Funds (ETFs) that invest in the 500 stocks that make up the S&P 500 Index but go about their investment in very different ways.

The iShares Core S&P 500 (IVV) allocates its money in the same way the S&P 500 Index is constructed: market capitalization weighting. This means that the amount invested in each stock is weighted by the total value of all the stock of the company (its “market capitalization”), resulting in a very large company like Apple accounting for nearly 4% of the entire fund and the largest 10% of the 500 companies accounting for 46% of the entire fund.

We contrasted this with Guggenheim S&P 500 Equal Weight Fund (RSP) that allocates an equal amount to each of the 500 stocks, so Apple doesn’t count any more in the fund than the smallest of the 500 stocks.

Passive investment strategies, whether utilized in traditional open-end funds or ETFs attempt to closely track an index. The idea is to capture the return of the “market” as cheaply as possible.

There are many different “asset classes” such as: U.S. large companies, U.S. mid-size companies, U.S. small companies, foreign large companies, foreign small companies, emerging markets, etc.

Each of these classes of assets has one or more indexes designed to reflect the performance of that asset class’s “market.”

What is the “market” and how is it related to "Beta"?

Traditionally, when the “market” was measured, it was done through a “market capitalization” approach. The S&P 500 Index is an example, and IVV is an ETF that tracks that market capitalization index. Again, the idea is to capture the market return, which is also referred to as “Beta.”

Is the size of a company as measured by its market capitalization the *best* way to measure the performance of an individual company or

of the entire stock market?

After all, the price of a stock on any particular day is just an indication of how investors felt about that company and voted at that time. But does it really reflect what the value or significance of a company truly is?

Benjamin Graham, the father of “value investing,” once remarked that in the short-term the stock market behaves like a voting machine but in the long term it acts like a weighing machine (i.e., the *true* value will emerge in the long term, even if it doesn’t show up in the short term).

Back in 1999, Cisco’s market capitalization briefly resulted in it being the largest company in the U.S. However, if you looked at other measures (such as sales and profits), this huge company was a pigmy. The S&P 500 Index and the various funds that try to track that index had to buy more and more of Cisco simply because its price was going up and therefore its market capitalization was going up.

Is there a better way to measure the “market” than market capitalization?

Over the last 10 or 15 years, a number of different strategies and funds have redefined what it means to capture the market return, or Beta, by following various non-market capitalization weighting approaches. These strategies are referred to by various names, such as: alternative beta, fundamental indexing, enhanced beta, factor-focused investment, or simply as “smart beta.”

Stay tuned. Over the next several months we will be examining several of these “smart beta” approaches.

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