ETFS 101, Part 8 **- FACTOR-BASED INVESTING**

Last month, we began our discussion of "smart beta," a catch-all name given to newer indexing approaches that provide an alternative to traditional "market capitalization weighted" indexes. In addition, we focused last month on the "fundamental index," which was developed by Rob Arnott's firm, Research Affiliates.

This index uses a combination of the fundamental indicators of sales, cash flow, dividends and book value to determine not only which companies to include in the index, but also their weighting in the index. There are a number of open-end mutual funds as well as exchange-traded funds that track these fundamental indexes.

Of course, competition arises, so other firms have developed their own versions of fundamentally-weighted indexes. For example, Wisdom Tree is an ETF provider that created indexes (and funds that track these indexes) based on the fundamental factors of either earnings or dividends.

Another category of smart beta is "factor-based" indexes. But, before we jump into them, you need to have some background.

For over 50 years, academia taught that return on investment was due to a single factor - an investment's sensitivity to market risk. So an investment with high sensitivity to market risk (high "beta") should earn higher returns, but with the trade-off of also exhibiting higher volatility. However, over the years a number of anomalies were detected that were inconsistent with this single factor theory. These anomalies blossomed into a number of factors that are now recognized as the underlying exposures that explain and influence an investment's risk and return, beyond the simplistic single factor of sensitivity to market risk.

Factor-based investing attempts to harvest the long-term return advantage of certain types of investment risk. We will discuss six of these factors that apply to the equity markets.

Value - Less expensive, "value" stocks have earned a return above more expensive "growth" stocks.

Size - Stocks of smaller companies have earned a return above stocks of larger companies.

Momentum - Stocks with strong recent performance have earned a return above stocks with weak recent performance.

Low volatility - Stocks with low volatility have earned higher risk-adjusted returns than stocks with high volatility.

Dividend Yield - Stocks with higher-than-average dividend yields have earned higher returns than non-dividend stocks.

Quality - Stocks of companies with low debt, stable earnings growth, and other "quality" metrics have earned higher returns than low-quality stocks.

Factor indexes should not necessarily be viewed as replacements for traditional market capitalization indexes. Instead, think about market capitalization indexes being the starting point or the neutral position and factor indexes and factor-based investing representing an active view or decision to tilt away from that neutral, default stance.

Also, keep in mind that factor returns can vary substantially over periods of time. For example, stocks of smaller companies may indeed provide higher long-term return than stocks of larger companies, but there are also long periods of underperformance by small companies, as well as greater volatility.

For investors looking to pursue factor-based investing or just to gain more insights on this approach, you may want to view the information available on **www.ishares.com**and **www.powershares.com**, which are two - of many - providers of factor-based ETFs.

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