FRANKLIN TEMPLETON INVESTMENTS

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Strategic Beta: Index Investing, Evolved

Global investing—literally and figuratively—is foreign to many Canadian investors. That's why some have taken a passive approach that's designed to track the performance of an index such as the MSCI All Country World Index (MSCI ACWI). Consisting of approximately 2,500 stocks, the MSCI ACWI weights each stock by market capitalization (share price multiplied by the number of shares outstanding).

For several decades, market capitalization-weighted indexes like the MSCI ACWI (for global investing) and the S&P/TSX Composite Index (for Canadian large-cap investing) have served as the foundation of a passive approach to investing, with many investors viewing them as an efficient way to gain broad exposure to a wide variety of equity markets. Yet today, more advanced approaches to index construction may help improve on this traditional approach.

One such methodology, called Strategic Beta, constructs indexes based on criteria other than market capitalization—with approaches that range from relatively simple to more complex. Exchange-traded funds (ETFs) are then designed to track these custom indexes.

This article will help provide an understanding of Strategic Beta, some of its benefits and how it may be used as part of an investment portfolio.

Broad Market Exposure, with Shortcomings

Did you know that the largest 5% of stocks in the MSCI ACWI comprise 41% of the index's weight? Traditional indexes weight stocks based on each company's overall market capitalization, meaning the largest, highest-priced companies make up the largest portion of an index. These indexes also increase their allocations to stocks that rise in price and reduce their allocations to those that fall in price—without consideration for whether the stocks are over- or under-valued, which could lead to heavier concentrations of overvalued securities. These are just two examples of concentrations that may occur in a capitalization-weighted index portfolio. (See "Traditional Indexing Has Some Shortcomings.")

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As index investing has evolved, new methods of index construction have emerged, offering additional ways for investors to gain exposure to specific areas of the market. One such approach is called Strategic Beta. It is based on quantitative methodologies originally designed for large institutional investors that have recently become available in ETFs designed for individual investors.

Traditional Indexing Has Some Shortcomings

Large- and mega-cap stocks

Largest 2% of companies in the MSCI ACWI account for 26% of the index

Over-valued stocks

Of the 10 largest stocks in the MSCI ACWI, 72% appear overvalued*

Sector weights

Increases in sector concentration such as technology or commodities have at times created additional risk, dragging down overall index performance

Geographic weights

The three largest countries in the MSCI Emerging Markets Index account for 53% of the index

Source: FactSet, MSCI, as of 12/31/16.
*1/1/07–12/31/16. Based on current price-to-earnings (P/E) versus 10-year average P/E.

A Case in Point: The Quality Premium

It's probably no surprise that, over time, the stock prices of high-quality companies have increased more than other stocks. While quality can be defined in different ways, it is designed to identify well-managed companies with a history of relatively stable earnings growth that's based on wise decisions about how to deploy capital. Some of the measures used to identify quality companies include return on equity (ROE), debt to equity, earnings variability, net income, operating cash flow, return on assets and leverage, among others.

The chart to the right illustrates how a hypothetical investment in high-quality stocks as measured by the MSCI ACWI Quality Index would have gained more than an investment in the broader MSCI ACWI over the time period shown.

Every Factor Has Its Day

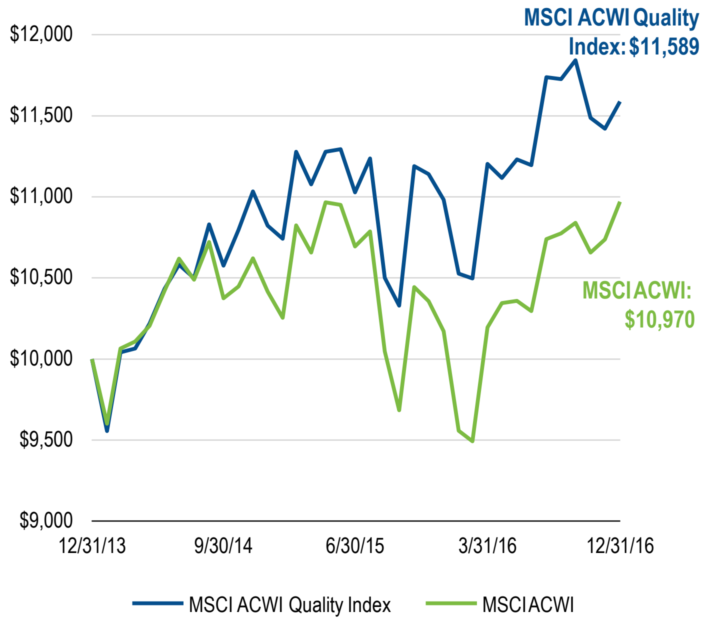
Some investors may be inclined to choose one or two factors for investments, but this approach can also come with its ups and downs. (See "Individual Factor Performance Has Fluctuated from Quarter to Quarter.")

Quality, Value, Momentum or Minimum-Volatility stocks by themselves have moved in and out of favour as markets have changed. Minimum Volatility, for example, was the top performer in Q3 and Q4 of 2014, but by Q2 of 2015, it was the worst performer. These swings in performance can be unsettling to many investors, causing them to sell and miss out on potential rebounding performance.

Quality Matters

MSCI ACWI Quality Index vs. MSCI ACWI

December 31, 2013–December 31, 2016



Source: Morningstar. Returns assume reinvestment of dividends and are adjusted for withholding taxes. The information above is for illustrative purposes only and does not represent any ETF's actual performance. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.**

It's understandable, then, that most investors don't have the fortitude to ride out these ups and downs. By contrast, attempting to move in and out of individual factor investments in anticipation of market changes may be challenging, so a multi-factor approach could be an attractive option for long-term investment goals.

Individual Factor Performance Has Fluctuated from Quarter to Quarter

Quarterly Returns %: MSCI Factor Indexes (USD)

Q1 2014–Q4 2016

Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016
Value 1.91	Value 5.36	Min Vol 0.17	Min Vol 4.38	Momentum 4.66	Momentum 0.59	Min Vol -4.20	Momentum 6.83	Min Vol 6.05	Momentum 5.18	Quality 5.90	Value 4.91
Min Vol 1.70	Quality 5.28	Quality 0.07	Quality 2.44	Min Vol 4.12	Value 0.49	Quality -6.22	Quality 6.44	Quality 2.16	Min Vol 4.98	Value 5.50	Momentum -1.18
Quality 0.78	Min Vol 4.96	Momentum -1.07	Momentum 2.31	Quality 2.50	Quality -0.32	Momentum -8.95	Min Vol 5.25	Value 0.98	Value 1.50	Momentum 0.93	Quality -2.03
Momentum 0.45	Momentum 4.64	Value -2.76	Value -0.82	Value 0.35	Min Vol -1.53	Value -10.16	Value 4.22	Momentum -0.14	Quality 0.09	Min Vol -0.11	Min Vol -2.77

Source: FactSet, MSCI. **Past performance is not an indicator or a guarantee of future performance.** Quality is the MSCI ACWI Quality Index; Value is based on the performance of the MSCI ACWI Value Index; Momentum is based on the MSCI ACWI Momentum Index; Volatility is based on the MSCI ACWI Minimum Volatility Index. The information above is for illustrative purposes only and does not represent any ETF's actual performance. Returns data represents quarterly total returns and assumes reinvestment of interest or dividends and are adjusted for withholding taxes. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance.

Applying Multiple Factors: Innovation in Index Design

Because individual factor performance may vary considerably from quarter to quarter, combining several factors in a single index—particularly those with historical records of low correlations—may result in lower volatility and more consistent, diversified sources of return.

Like single-factor Strategic Beta, multi-factor portfolios draw on decades of academic research. Beyond that, they draw on analysis of how various factors interact. This analysis allows a manager to diversify among factors in a way that seeks to reduce risk and increase return potential over time.

Additional research also helps guide the relative weights of factors in a Strategic Beta ETF portfolio—which may help pursue specific portfolio attributes and investment outcomes.

An investor who holds a more advanced, multi-factor portfolio may be better diversified, may not need to time factor cycles, and may not incur the costs that come with switching from one product to another.

Just as an investor might benefit from holding multiple stocks to diversify away stock-specific risk, that same investor could benefit from this more advanced approach to factor investing.

Combining Active and Passive Investing

A Strategic Beta portfolio starts with a list of stock included in a cap-weighted index. Factor analysis then identifies the subset of stocks that exhibit a desired factor—or combination of factors—that reflect the index provider's research and analysis (referred to as a "Custom Index"). The ETF's portfolio then tracks the Custom Index. (See "Creating a Strategic Beta Portfolio.")

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For example, the MSCI ACWI is the basis for some popular cap-weighted index funds. It's also the foundation for some multi-factor Strategic Beta indexes.

The difference is that with a Strategic Beta index, an index provider's research and multi-factor analysis has been applied to the stocks in the MSCI ACWI to produce a more focused custom index that features exposure to the desired factors.

Think of a Strategic Beta ETF as an advancement in the binary world of passive and active management. It combines the appeal and intuition of a passive approach—transparency, diversification, a rules-based methodology and lower costs—with active management insights.

Creating a Strategic Beta Portfolio

1. Start with Cap-Weighted Index

2. Apply Factor Methodology

3. Create Custom Index

4. Strategic Beta ETF Tracks Custom Index

Put Strategic Beta to Work

Strategic Beta ETFs can be used in a number of ways and may be useful for a wide variety of investor portfolios. Two examples:

- **Replace cap-weighted index-based funds:** Multi-factor Strategic Beta ETFs offer exposure to the same investment universe as cap-weighted index funds while targeting specific exposures. For investors who use passive investments at the core of their portfolios, Strategic Beta ETFs offer an efficient way to seek better long-term risk-adjustedreturns.
- **Complement actively managed funds:** Strategic Beta ETFs can complement actively managed mutual funds. Thisapproach may help improve overall risk-adjusted returns over time while the investor continues to benefit from the expertise of theactive mutual fund manager along with a rules-based methodology that's built on active management insights.

Conclusion

Challenging times have led many investors to focus ona manager's performance versus both his peers and his benchmark—as both market and economic conditions have continuallychanged.

For many years quantitative, factor-based strategies were available only to large institutional investors. Today, factor research, as well as advances in investment product design,have made these more advanced, index-based strategies available to individual investors.

We believe this advancement in index construction and portfolio design represents an opportunity for investors to seek better investment performance over time, with less volatility—something any investor may find attractive.

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The trading prices of an ETF units in the secondary market generally differ from the ETF's daily NAV and are affected by market forces such as supply and demand, economic conditions and other factors.

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

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