Generating alpha through smart beta ETFs

Smart beta ETFs give investors the opportunity to optimise performance in their portfolios, while retaining the attractive characteristics that ETFs are known for – low costs and convenience.

Smart beta ETFs take the traditional ETF model and enhance a selected aspect of the investment strategy, so that you can still access the benefits of being invested across a given market – but often a much more specific market.

The Exchange Traded Fund (ETF) concept

Exchange Traded Funds are a low-cost and convenient vehicle to achieving diversification and to trade within a portfolio.

ETFs are usually marketed to investors as an alternative to managed funds because rather than being an actively traded portfolio of stocks that may vary frequently, the ETF portfolio simply comprises all the holdings of a predetermined index (traditionally a major market index). Also, because ETFs have a fairly straightforward investment approach, investors avoid the relatively high on-costs of managed funds.

When you invest in an ETF you are effectively buying units in the ETF, similar to buying shares in a stock. ETFs trade on the stock exchange alongside stocks and, like stocks, their prices change throughout the trading day as they are bought and sold.

Different types of ETFs

While there is ongoing debate about the definitions of and the distinctions between different types of ETFs, some of the main types of ETFs that are available include:

- Equity ETFs (based on country stock exchanges)
- Foreign currency ETFs
- Sector or industry ETFs (eg. Healthcare or IT)
- Commodity ETFs
- Cash ETFs
- Fixed income ETFs

Are ETFs passive or active investments?

A traditional ETF portfolio that replicates a common market index is clearly a passive investment. The ETF market is becoming more sophisticated, however, and some ETF providers are now constructing specialised indexes for smart beta ETFs that represent sub-sections of major indexes. These could be regarded as active investments because this type of portfolio is seeking to outperform a major market index in a particular way.

What is a smart beta ETF?

'Smart beta' ETFs do more than passively replicate an existing market index like other ETFs. A smart beta ETF is one based on an index that has been custom-designed using stocks that have been selected for their potential to out-perform a specific market – rather than to simply replicate a market like a traditional ETF. A high-IQ version of an index fund, if you like.

How can you use a smart beta ETF in your portfolio?

Many investors use ETFs as the low-maintenance core in their portfolio because ETFs give them market returns at low cost, without the need to constantly trade stocks. Then they complement their ETF holdings with a smaller selection of more speculative investments that they trade actively. This is often referred to as a "core-satellite" approach.

Like traditional ETFs, smart beta ETFs can provide an excellent stable and low-cost core or base to a portfolio. The difference is that they give investors access to out-performance or different results from the market that traditional index funds won't provide. This could be enhanced returns, more consistent income or lower risk.

Example: How smart beta ETFs can boost performance in a portfolio

As an example, UBS has dubbed its two smart beta ETFs 'Intelligent ETFs'. One is designed to boost returns in a portfolio and the other is designed to boost income.

The UBS IQ Morningstar Australia Quality ETF has been designed with the objective of outperforming the broad Australian equity market. It is based on an index of companies identified by Morningstar's equity research team as undervalued and as having sustainable competitive advantages. In other words, companies that bear all the hallmarks of being excellent long-term investments.

The UBS IQ Morningstar Australia Dividend Yield ETF is based on an index of companies identified by Morningstar's equity research team as being those most likely to generate sustainable and consistent dividends.

A smart tilt to better focus your portfolio

Given the success of ETFs, it's not surprising that the smart beta ETF concept has evolved and that it is growing in popularity. It's a concept that enables investors to control costs and to better manage their portfolios, while tilting them toward their favoured strategy or their specific needs. The great thing about ETFs is that they give you instant access to a broad investment landscape in a single trade. Smart ETFs still do that, but the features in that landscape can be enhanced to suit your focus.

UBS IQ Morningstar Australia Quality ETF
ASX Code: ETF

Constructed with the objective of outperforming the broad Australian equity market, this ETF tracks the Morningstar Australia Moat Focus Index – a rules-based equally weighted index of companies identified by Morningstar's equity research team to be undervalued and to have sustainable competitive advantages.

Benefits

- Independent research – access to Morningstar's equity research in an ETF
- Quality – the portfolio tracks an index of companies identified by Morningstar to be undervalued and to have sustainable competitive advantage
- Instant diversification – exposure to a portfolio of 30* companies in one trade
- Cost-effective – competitively priced access to a high-conviction 'best-ideas' portfolio
- Easy to access – through one simple transaction on the ASX.

*The portfolio can hold 25 to 50 companies

UBS IQ Morningstar Australia Dividend Yield ETF
ASX Code: DIV

An ETF that provides instant access to a portfolio of 25 income-oriented Australian companies. It tracks the Morningstar Australia Dividend Yield Focus Index – an index of companies identified by Morningstar's equity research team as being those most likely to generate sustainable and consistent dividends.

Benefits

- Independent research – access to Morningstar's equity research in an ETF
- Income – the portfolio tracks an index of companies identified by Morningstar for their ability to generate stable dividends, paid to investors as quarterly distributions
- Instant diversification – exposure to a portfolio of 25 companies in one trade
- Cost-effective – competitively priced access to a portfolio of income oriented companies
- Easy to access – through one simple transaction on the ASX.

Find out more

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How to invest

ETFs are traded on the ASX in the same way as individual shares. For more information, contact your broker or financial adviser.

*The portfolio can hold 25 to 50 companies.

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