

UBS ETF Factor Matters

Undervalued Healthy Stocks = Prime Value Investing

- The first generation of growth and value style indices splits the complete market capitalization of each respective parent index equally into growth and value sets. This symmetric approach results in overlaps, thus diluting the tilt.
- The newest generation of indices (also known as alternative beta or smart beta) aims to purify exposure via more stringent selection and ranking criteria, thus weighting the most suitable stocks according to their strength in capturing the specific tilt.
- We review some recently developed value indices (incl. MSCI Enhanced Value vs MSCI Prime Value), highlighting the key differentiating aspects. The wide range of available value-orientated indices requires investors to understand key differences, when deciding which strategy is more suitable, as passive value investing has many forms.

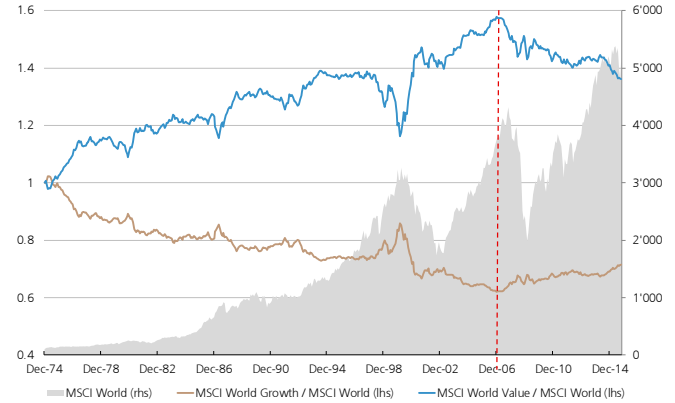
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Value investing is a well-known investment strategy of selecting stocks that trade at discount relative to their intrinsic value. It has been developing since the early 30s, when Graham and Dodd published the book illustrating the "market's tendency to irrationally undervalue certain out-of-favor securities"¹. Value investing has developed in many forms, driven by the key challenge to identify stocks which are *mispriced* relative to their (long-term) intrinsic value, estimated in many different ways. Value-based strategies have proven to be successful investment frameworks. For example, **Figure 1** shows the MSCI World Value and MSCI World Growth indices relative to the standard MSCI World benchmark back to the 1970s. The value stocks have outperformed growth stocks, and the broad market, over this period of time. Understandably, value stocks also have lengthy periods of relative underperformance, including the most recent beginning in early 2007 (Figure 1).

Style indices: splitting the market into halves

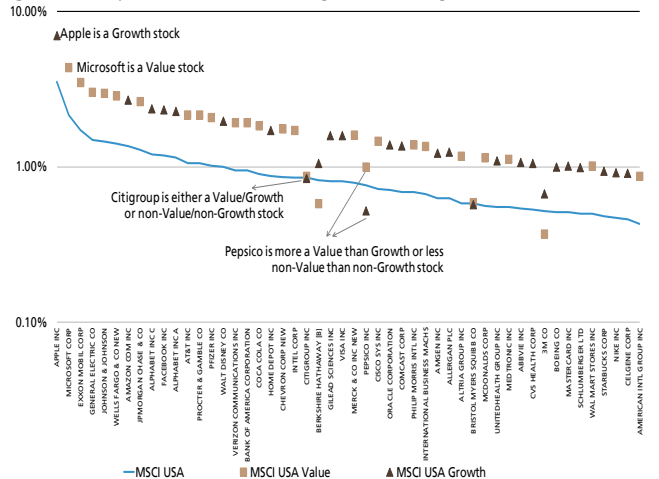
Growth and value *style* indices enable investors to: i) measure the risk/return profile of these relative to standard benchmarks; ii) assess growth and value manager skills; iii) gain exposure to growth and value strategies through the use of index-based products such as exchange-traded funds (ETFs). CRSP, MSCI, Russell, S&P Dow Jones, amongst others, provide indices for style-oriented investors. The typical ratios applied to identify value stocks include price-to-book, price-to-earnings, price-to-sales or dividend yield. For growth stocks, ratios include growth in earnings, growth in sales, investments-to-asset ratios, and similar. The applied fundamental ratios usually have an equal importance; price-to-book is as relevant as price-to-earnings, etc. Relative to value investors, growth investors are willing to pay higher valuation multiples for the expected future growth. The first generation of style indices (e.g. MSCI Value and MSCI Growth, S&P Value and S&P Growth) divides each respective parent index approximately equally into growth and value sets, to cover complete market capitalization. This notion of symmetry results in *overlaps*, when a stock has features of either styles or none. In this case, the value/growth or non-value/non-growth stock gets allocated (proportionately) to both sets, subsequently diluting the desired tilt. Importantly, the first generation indices weight underlyings simply by their (free-float adjusted) market capitalisation, thus 0.5xValue plus 0.5xGrowth equals the Market. **Figure 2** shows an example for the MSCI USA indices. The non-overlapping stocks have, on average, double the weight relative to the parent index. For example, Apple classified as a growth stock has 7% weight in the MSCI USA Growth index compared to 3.5% in the MSCI USA, whilst Microsoft identified as a value stock has 3.4% weight in the MSCI USA Value index relative

Figure 1: Relative performance of Value and Growth indices (monthly total return net in USD; Dec '74 = 100)



Source: MSCI, UBS AM, as of 30 October 2015.

Figure 2: Top 50 constituents (weights in %, log-scale)



Source: MSCI, UBS AM, as of 30 October 2015.

Table 1: Methodology overview

Attribute	MSCI Value	MSCI Enhanced Value	MSCI Prime Value
Ratios	Price-to-Book Value Price-to-Forward Earnings Dividend Yield	Price-to-Book Value Price-to-Forward Earnings Enterprise Value-to-Cash Flow	Price-to-Book Value Price-to-Trailing Earnings Price-to-Sales Price-to-Cash Earnings
Specialties		Sector neutrality relative to parent index	Quality checks on earnings, sector agnostic, 5% issuer cap
Weighting	Market cap-weighted	Composite Z-Score Value-weighted	Composite Z-Score Value-weighted
Coverage	~50% of parent market cap	~25-30% of parent market cap	~25-30% of parent market cap

Source: MSCI Global Investable Market Value and Growth Index Methodology, Dec. 2007; MSCI Enhanced Value Indexes Methodology, Apr. 2014, MSCI Prime Value Indexes Methodology, Apr. 2015. For more details on the fundamental ratios, please refer to the MSCI Fundamental Data Methodology.

to 1.7% in the MSCI USA. The overlapping stocks are present both in the value and the growth set; for example, Citigroup has 0.9% weight in all three indices considered. Another implication of equal split and market cap weighting is extremely strong (virtually 100%) correlation with the parent index. More recent index developments focus on how to purify exposure by applying different weighting schemes, as well as by providing a higher exposure to the preferred systematic return factor.

Factor indices: concentrating towards pure factor exposure

The newest generation of indices (also known as alternative beta or smart beta) aim to purify exposure to better fit the investment objective. This is achieved by a more stringent selection and ranking criteria, and by weighting the most suitable stocks according to their strength in capturing the tilt, still forming a *long-only* portfolio. In this section, we review examples of some recent developments, including the MSCI Enhanced Value and the MSCI Prime Value. **Table 1** provides a brief methodological overview, highlighting key differences.

- The dividend yield is removed from both the enhanced and prime value indices (due to the development of a new generation of yield-focused indices, e.g. MSCI Total Shareholder Yield), whilst the set of valuation ratios has become enriched;
- The enhanced and prime value indices have certain specialties; enhanced value aims to have the same sector break-down as the parent index (relative sector neutrality), whilst prime value caps single issuer's weight at 5% and carries out wide-ranging quality checks (via return-on-equity, leverage and volatility in earnings), aiming to select undervalued but healthy stocks;
- The enhanced and prime value indices provide more concentrated exposure (narrower universe) and weight selected stocks in line with their value strength (beyond market cap);
- The prime value has a more defensive nature due to quality checks regarding profitability measures, whilst the enhanced value has a more pro-cyclical nature by looking into the economic value of a company, including the cash it produces.

Value investing does not equal value investing

The wide range of available value-orientated indices requires investors to understand key differences, as listed above, when deciding which value strategy is more suitable. The different construction methods (Table 1) result in different index compositions, relative to the standard market cap benchmark (i.e. MSCI USA); **Figure 3** shows constituents.

- The enhanced and prime value sets are more selective, with their stock weights not necessarily decreasing when market capitalisation decreases (value-based weighting scheme);
- Some enhanced and prime value stocks have a significant *active* weight. For example, Cisco has a weight of 4.5% in the enhanced value set relative to 0.8% in the standard market cap index (multiplier of 5.6x), whilst Walmart has 2.8% weight in the prime set compared to 0.5% in the standard set (5.6x);
- The enhanced and prime value sets are largely non-overlapping due to the difference in their construction process.

Figure 4 shows the relative performance of value indices relative to the market cap benchmark. The first generation MSCI Value index has a period of lengthy outperformance (2000-2006), followed by an ongoing period of underperformance. The enhanced and prime indices have shown significant outperformance, including most recent years. The MSCI USA Prime Value index has generated 3.4% annualised excess return (relative to MSCI USA) over this period, followed by MSCI USA Enhanced Value with annualised 3.1% excess return, whilst the MSCI USA Value has had virtually no excess return, **Figure 5** shows the trailing drawdowns, relative to the market cap benchmark, highlighting that the enhanced and prime sets featured relatively lower losses in stress periods. For example, the broad market experienced a max drawdown of -51% (Oct. '07 to Feb. '09), whilst prime value set had a lower loss and quicker rebound (Figure 5). These examples show that value investing does not equal value investing and investors need to consider whether more opportunistic or more quality value to add.

¹ Graham, B. and Dodd, D. (1934): "Security Analysis", New York: McGraw Hill

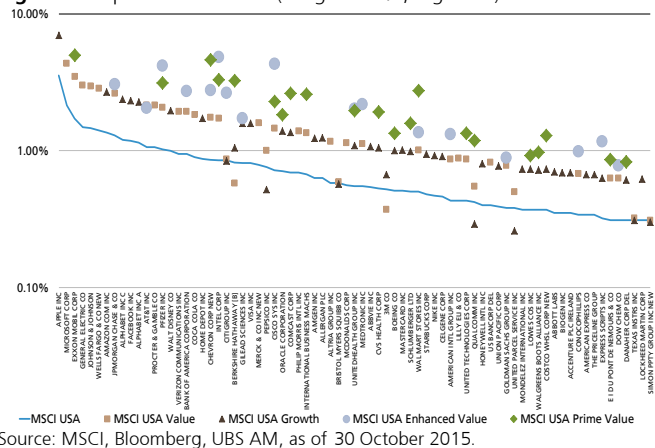
Table 2: Prime Value UBS ETFs

Fund name	TER (ex ante)	AUM (in GBP)	Base currency	Replication	Distribution	Domicile	Launch	ISIN	Bloomberg
UBS (IE) ETF Factor MSCI USA Prime Value UCITS ETF	0.25%	2	USD	Full Physical	Yes	Ireland	26.08.2015	IE00BX7RR706	UC96 LN
UBS (LU) ETF Factor MSCI EMU Prime Value UCITS ETF	0.28%	5	EUR	Full Physical	Yes	Luxemburg	18.08.2015	LU1215452928	UD03 LN

Source: UBS Asset Management. Data as of 30 October 2015.

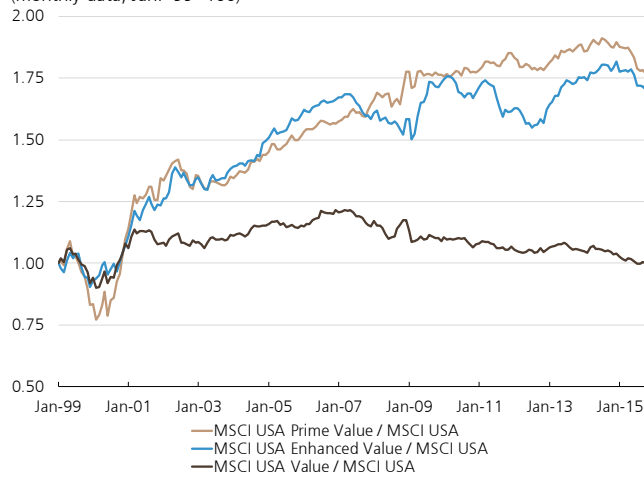
For more information on UBS Factor ETF, see [UBS ETF Factor Investing Product Profile](#).

Figure 3: Top 75 constituents (weights in %, log-scale)



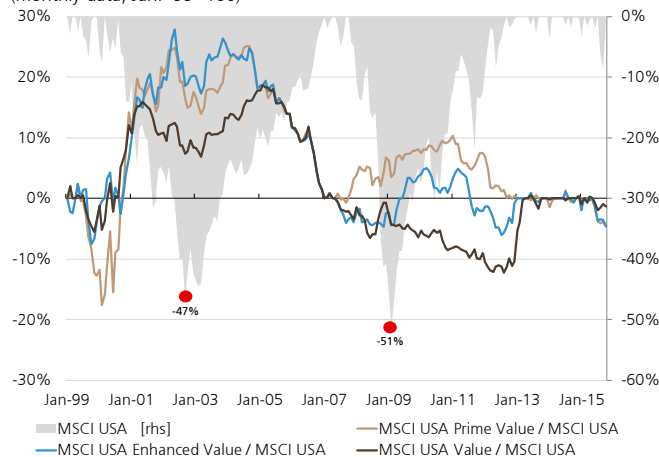
Source: MSCI, Bloomberg, UBS AM, as of 30 October 2015.

Figure 4: Relative performance (total return net in USD) (monthly data, Jan. '99=100)



Source: MSCI, UBS AM, as of 30 October 2015.

Figure 5: Relative drawdown (monthly data, Jan. '99=100)



Source: MSCI, UBS AM, as of 30 October 2015.

Past performance is not a reliable indicator for the future.

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For more information on UBS ETFs: www.ubs.com/etf

2013



- ETF Provider of the Year
- Excellence in Asset Management Global



- etfexpress**
AWARD WINNER 2013
- Best Europe Equity ETF Manager



- Best Equity Fund for Swiss Large Cap Stocks

2014



- ETF Provider of the Year
- Excellence in Asset Management Global



- etfexpress**
AWARD WINNER 2014
- Best Mixed ETF Manager



- Best American Equity
- Best Thematic Equity

2015



- ETF Provider of the Year
- Excellence in Asset Management Global



- etfexpress**
AWARD WINNER 2015
- Best Europe Equity ETF Manager



- Best ETF Europe Equity – Eurozone
- Best ETF Europe Equity – Single Country
- Best ETF Pacific Equity
- Best Thematic Equity



- Best Tracking Difference

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