

Indexing 360°

Choosing the right alternative beta index

UBS ETF **Market Matters**

Investing in the passive space is about selecting the benchmark index that meets investors' objectives as well as choosing the right passive product (e.g. the best ETF). Of these two, choosing the right benchmark is typically of greater importance and can result in a performance differential of +/- 500 bps per annum.

For example, the recently developed generation of factor indices have (historically) provided the largest outperformance relative to market cap benchmarks, outpacing sectors, themes or style-indices.

However, not all factor indices are created equal. For example, the MSCI EMU Prime Value in its live track record has delivered an excess return of 500 bps compared to the market cap MSCI EMU parent index and has beaten all competing value indices. Similarly, the MSCI USA Total Shareholder Yield, which captures both dividend and buyback yield, has outperformed most comparable benchmarks.

The choice for an investor in the passive space is two-dimensional. First, an investor has to decide on the right benchmark from a wide array of opportunities, which include market cap-weighted, sector, smart-beta, SRI, theme and other indices, not to mention those with embedded currency hedged overlays. These provide good flexibility as building blocks for passive as well as active portfolio management. Second, an investor needs to decide on the most appropriate passive product for a given index. While there is an extensive number of passive fund alternatives tracking each of the seemingly similar indices offering exposure to, European value for example, we argue that choosing the right underlying benchmark easily outweighs the merits of selecting one ETF over another.

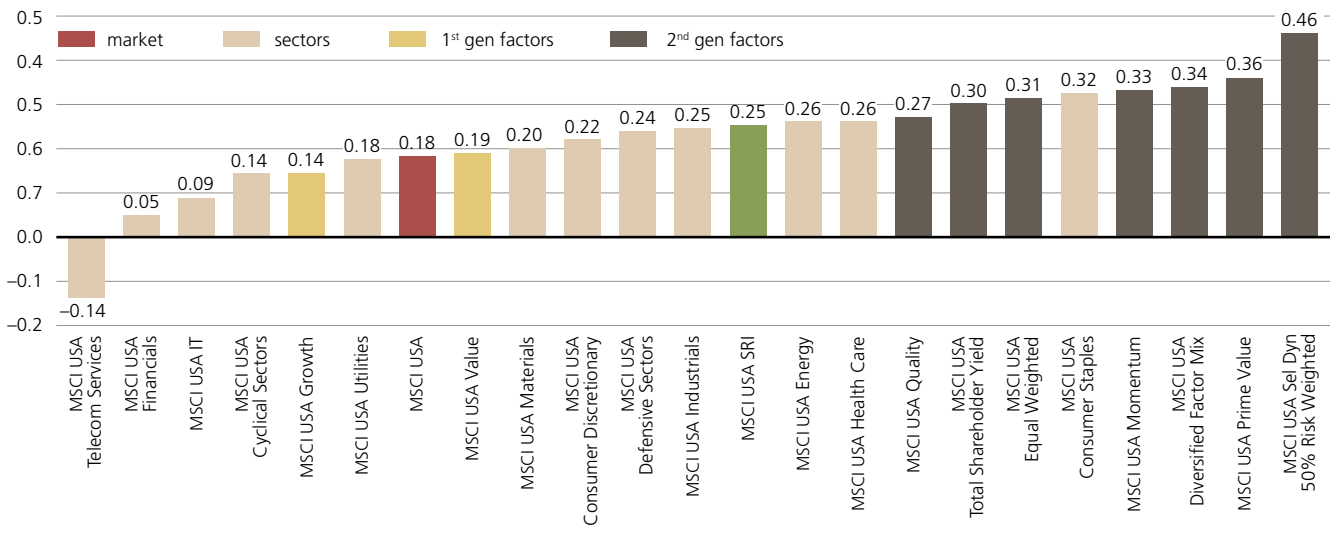
Investment outcomes

Choosing the right passive product (e.g. the ETF with the lowest tracking error and/or tracking difference) for a given index typically makes a difference of a few basis points per annum (up to 15–20 bps before fees for the most developed and the most liquid markets). That is because products from major providers are generally priced competitively and are managed according to robust portfolio management processes including tax efficiencies (optimal domicile for withholding taxes). However, investment outcomes are far more dependent on the choice of the right index (strategy) itself, which can bring in +/-500 bps in performance differential.

A comparison of Sharpe ratios of selected indices covering the MSCI USA universe (Figure 1) reveals several patterns in (historical) performance. Sharpe ratios of most sectors (sand) are fairly close to the market cap benchmark MSCI USA (red) since the sum of all sectors is the market. The

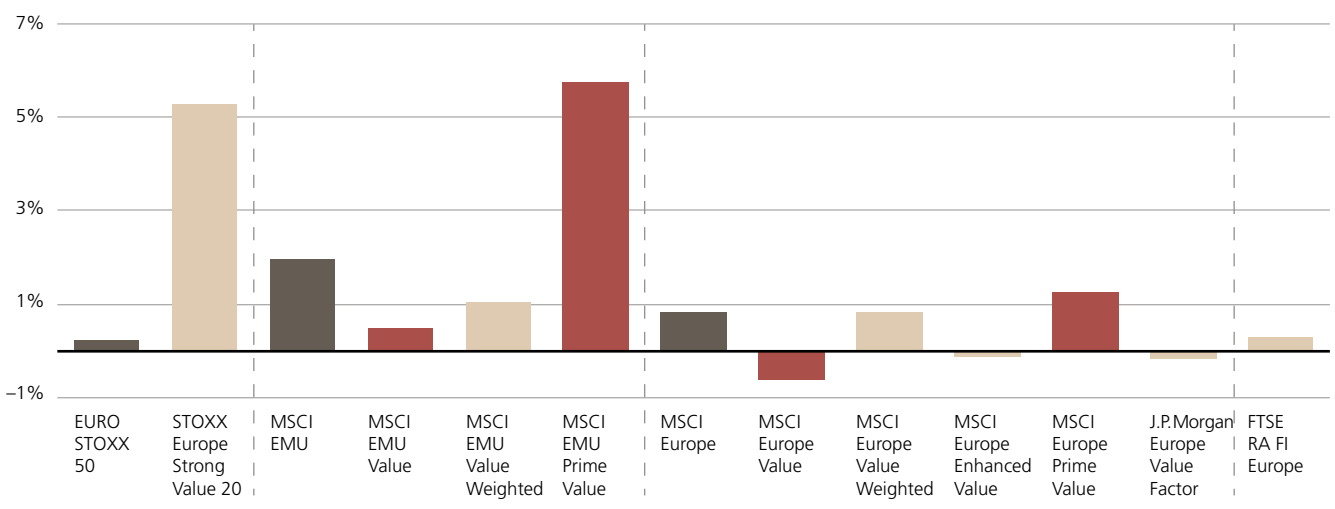
style indices (yellow) are also close to the benchmark as they only provide modest factor tilts (value vs. growth) and these two are simply the market cap weighted index separated into a growth half and value half. In contrast, the best Sharpe ratios are provided by the newest generation of factor indices (brown), which offer strong exposure to specific factors by only selecting stocks with the highest factor scores. For example, the low volatility factor (MSCI USA Select Dynamic 50% Risk Weighted Index) had the highest Sharpe ratio of 0.46 (known as the 'Low Volatility anomaly') which translates into a historical excess return of c. 250bps p.a. In general, the long-term performance (Dec '98 – Feb '17, including back-tested data), demonstrates that the newest generation of factor indices can be successful at capturing premia associated with well-defined equity factors: low volatility, value, momentum, size, yield, quality.

Figure 1: Performance of selected MSCI indices covering USA universe. (TR Net in USD, Dec '98 – Feb '17)



Source: Bloomberg, MSCI, UBS Asset Management, data as of 28 February 2017.

Figure 2: Average excess returns (annualized) of selected value indices in the live period for MSCI EMU Prime Value. (TR Net in EUR, March '15 – Feb '17)



Source: Bloomberg, MSCI, UBS Asset Management, data as of 28 February 2017.

How to choose the best value index

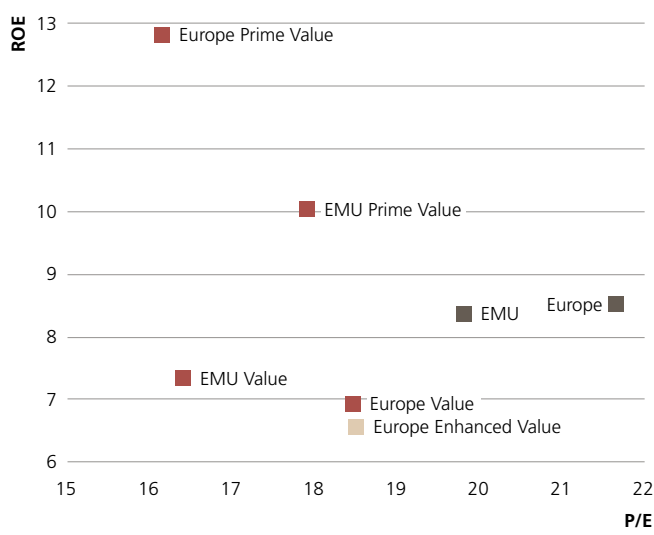
While factors have outperformed over the last two decades, not all factor indices are created equal. In fact, the disparities in returns across the same factor styles can be substantial. This depends on the underlying criteria employed to capture factor exposure. For example, in [Figure 2](#), we present live track performance of indices designed to capture value, which are tracked by ETFs listed in Europe for a recent two-year period. It is seen that the STOXX Europe Strong Value 20 has a good Sharpe ratio, but it is a highly concentrated index of only 20 stocks. Within the MSCI EMU universe, the clear winner is the MSCI EMU Prime Value, which delivered excess returns of c. 500 bps p.a., i.e. the best overall performance amongst different value factors considered. Furthermore, Prime Value wins the comparison within the MSCI Europe universe. So what makes this concept work so well?

High quality stocks at discount prices

The distinguishing feature of the Prime Value concept is that it selects relatively “cheap” stocks, but only from a universe of higher quality ones. The idea of adding quality checks to value investing is not new. In 1973, Benjamin Graham argued in his book *The Intelligent Investor* that equity investors: “... apply a set of standards to each [stock] purchase, to make sure that he obtains (1) a minimum quality in the past performance and current financial position of the company, and also (2) a minimum of quantity in terms of earnings and assets per dollar of price.” Prime Value uses a quality screen based on Return-on-Equity, Debt-to-Equity and Earnings-Variability, while assessing relative valuation based on Price-to-Book, Price-to-Earnings, Price-to-Sales and Price-to-Cash Earnings. The index aims to select a number of companies that cumulatively add up to 25% of the market cap of the parent index, which ensures strong factor exposure and good investibility. The index is also sector-unconstrained in extracting value, which has potential to harvest a higher value premium than sector-constrained indices such as the MSCI Enhanced Value index.

Prime Value succeeds at selecting stocks with good profitability (quality) and low valuations. [Figure 3](#) shows that while the Return-on-Equity of MSCI EMU and MSCI Europe is around 8.5%, MSCI Europe Prime Value and MSCI EMU Prime Value have ROEs of 10% and almost 13%, respectively. At the same time, P/E ratios for MSCI EMU and MSCI Europe are respectively, 20x and 22x, while MSCI Europe Prime Value and EMU Prime Value have lower P/Es at, 18x and 16x respectively. Note that MSCI Enhanced Value presents itself here far less favorably with a much lower ROE and higher P/E compared to the MSCI Prime Value index. This example demonstrates the necessity of looking carefully at different index concepts with a similar objective.

Figure 3: Valuation and profitability across selected MSCI indices.



Source: UBS Asset Management, data as of 28 February 2017.

An important aspect in selecting the right index is the underlying economic rationale. The one behind Prime Value aims to select companies that are undervalued, but of good quality. The low prices of these stocks is likely attributable to investors’ systematic biases or constraints. Such companies are deemed to be a true bargain and might allow for better risk-adjusted returns¹. At the same time, the Prime Value’s quality filter aims to limit its exposure to companies that are cheap due to their poor financial health and macroeconomic risks, in which case the price discount primarily represents risk compensation.

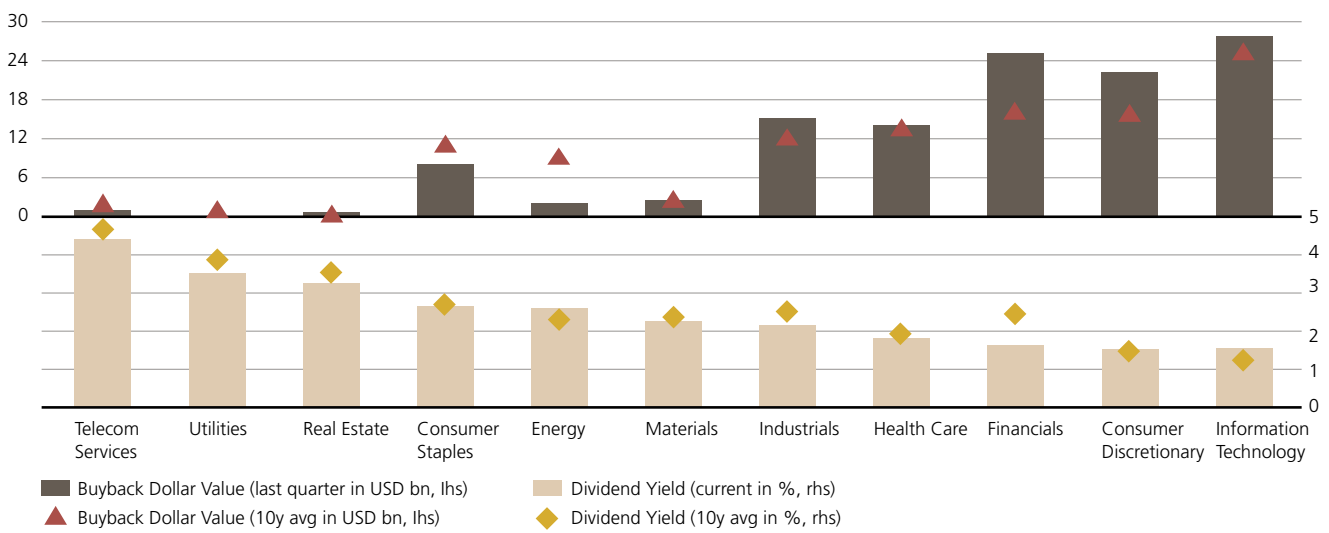
¹ For further discussions on factor premia sources, see “Lower for Longer: The Case for Factor Investing”, UBS Asset Management, November 2016.

How to invest in equity yield

Dividend strategies in the equity markets have become very popular with investors and the passive offering in this space is quite wide. They are part of a broader concept of carry or yield investing which is based on the observation that assets generating higher yields tend to outperform. The profits generated by the company can be returned to shareholders either by paying out dividends or conducting a share buy-back program. The two ways of returning capital should be roughly equivalent assuming no major inefficiencies of capital markets. Hence, when an investor wants to pursue an equity yield strategy, it makes more sense to take a holistic view and incorporate both dividends and buybacks. Focusing on either one of them would also lead to substantial sectorial biases as certain industries tend to pay out dividends (e.g. utilities) while others focus on buybacks (e.g. IT companies), see [Figure 4](#).

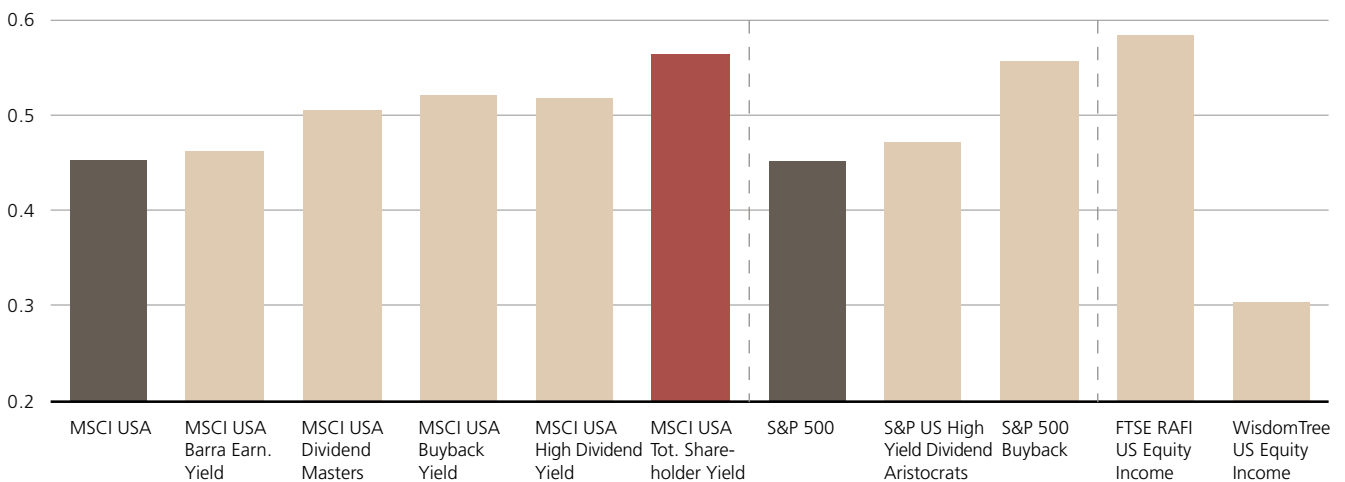
The MSCI Total Shareholder Yield accounts for both the dividend and buyback yields in stock selection. Of course the yield should come from companies' profits and not as a result of debt accumulation. Yield investors want to invest in companies which generate enough profits to return them to shareholders. The MSCI Total Shareholder Yield accounts for that as well by incorporating as a criteria the debt reduction-accumulation yield relative to equity market capitalization of each company. To sum up, MSCI Total Shareholder Yield is an index that ranks stocks using a composite score based on dividend, buyback and debt-reduction yields to account for all sources of yield. The resulting performance of this index has historically been very impressive compared to key competing frameworks ([Figure 5](#)). In fact, the MSCI USA Total Shareholder Yield outperformed its parent index by more than 100 bps p.a.

Figure 4: Buyback dollar value and dividend yield across sectors in the US market.



Source: Factset, UBS Asset Management, data as of February 2017.

Figure 5: Sharpe ratios of selected Yield indices (TR Net in USD vs 1M USD Libor, March '07 – Feb '17)



Source: Bloomberg, MSCI, UBS Asset Management, data as of 28 February 2017.

Past performance is not indicative of possible future returns.

Make sure you have the right index

Passive investing is about choosing the right underlying index and the right tracking product. The recent development in the index space creates a wealth of investment opportunities which may result in substantial differences in performance. It is critical to understand index construction methodology, its performance in back-test and in live period, and ideally across geographies. With the right index selection (and product from a high quality provider), there is a room for significant return enhancement.

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Fund Name	Fee	AuM (GBPm)	NAV ccy	Repl-ication	Distri-bution	ISIN	Bloomberg
UBS ETF (IE) DJ Global Select Dividend UCITS ETF	0.30%	23	USD	Physical	Yes	IE00BMP3HG27	GLDVD SW
UBS ETF (LU) Factor MSCI EMU Low Volatility UCITS ETF	0.28%	49	EUR	Physical	Yes	LU1215454460	UD02 LN
UBS ETF (LU) Factor MSCI EMU Low Volatility hedged CHF UCITS ETF	0.38%		CHF	Physical	No	LU1215454973	ELOVS SW
UBS ETF (LU) Factor MSCI EMU Low Volatility hedged GBP UCITS ETF	0.38%		GBP	Physical	Yes	LU1215455350	ELOV LN
UBS ETF (LU) Factor MSCI EMU Low Volatility hedged USD UCITS ETF	0.38%		USD	Physical	No	LU1215455277	ELOVU SW
UBS ETF (LU) Factor MSCI EMU Prime Value UCITS ETF	0.28%		EUR	Physical	Yes	LU1215452928	UD03 LN
UBS ETF (LU) Factor MSCI EMU Prime Value hedged CHF UCITS ETF	0.38%	22	CHF	Physical	No	LU1215453496	EPVLS SW
UBS ETF (LU) Factor MSCI EMU Prime Value hedged GBP UCITS ETF	0.38%		GBP	Physical	Yes	LU1215453819	EPVL LN
UBS ETF (LU) Factor MSCI EMU Prime Value hedged USD UCITS ETF	0.38%		USD	Physical	No	LU1215453736	EPVLU SW
UBS ETF (LU) Factor MSCI EMU Quality UCITS ETF	0.28%		EUR	Physical	Yes	LU1215451524	UD04 LN
UBS ETF (LU) Factor MSCI EMU Quality hedged CHF UCITS ETF	0.38%	53	CHF	Physical	No	LU1215452092	EQLTS SW
UBS ETF (LU) Factor MSCI EMU Quality hedged GBP UCITS ETF	0.38%		GBP	Physical	Yes	LU1215452332	EQLT LN
UBS ETF (LU) Factor MSCI EMU Quality hedged USD UCITS ETF	0.38%		USD	Physical	No	LU1215452258	EQLTU SW
UBS ETF (LU) Factor MSCI EMU Total Shareholder Yield UCITS ETF	0.28%		EUR	Physical	Yes	LU1215455947	UD05 LN
UBS ETF (LU) Factor MSCI EMU Total Shareholder Yield h. CHF UCITS ETF	0.38%	10	CHF	Physical	No	LU1215456325	ETSYS SW
UBS ETF (LU) Factor MSCI EMU Total Shareholder Yield h. GBP UCITS ETF	0.38%		GBP	Physical	Yes	LU1215456754	ETSY LN
UBS ETF (LU) Factor MSCI EMU Total Shareholder Yield h. USD UCITS ETF	0.38%		USD	Physical	No	LU1215456671	ETSYU SW
UBS ETF (IE) Factor MSCI USA Low Volatility UCITS ETF	0.25%	45	USD	Physical	Yes	IE00BX7RQY03	UC95 LN
UBS ETF (IE) Factor MSCI USA Low Volatility hedged CHF UCITS ETF	0.35%		CHF	Physical	No	IE00BX7RR250	ULOVS SW
UBS ETF (IE) Factor MSCI USA Low Volatility hedged EUR UCITS ETF	0.35%		EUR	Physical	No	IE00BWT3KJ20	ULOVE SW
UBS ETF (IE) Factor MSCI USA Low Volatility hedged GBP UCITS ETF	0.35%		GBP	Physical	Yes	IE00BXDZNF85	ULOV LN
UBS ETF (IE) Factor MSCI USA Prime Value UCITS ETF	0.25%	26	USD	Physical	Yes	IE00BX7RR706	UC96 LN
UBS ETF (IE) Factor MSCI USA Prime Value hedged CHF UCITS ETF	0.35%		CHF	Physical	No	IE00BX7RRC57	UPVLS SW
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UBS ETF (IE) Factor MSCI USA Prime Value hedged GBP UCITS ETF	0.35%		GBP	Physical	Yes	IE00BXDZNH00	UPVL LN
UBS ETF (IE) Factor MSCI USA Quality UCITS ETF	0.25%	95	USD	Physical	Yes	IE00BX7RRJ27	UC99 LN
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UBS ETF (IE) Factor MSCI USA Quality hedged EUR UCITS ETF	0.35%		EUR	Physical	No	IE00BWT3KN65	UQLTE SW
UBS ETF (IE) Factor MSCI USA Quality hedged GBP UCITS ETF	0.35%		GBP	Physical	Yes	IE00BXDZNK39	UQLT LN
UBS ETF (IE) Factor MSCI USA Total Shareholder Yield UCITS ETF	0.25%	83	USD	Physical	Yes	IE00BX7RRT25	UD01 LN
UBS ETF (IE) Factor MSCI USA Total Shareholder Yield h. CHF UCITS ETF	0.35%		CHF	Physical	No	IE00BX7RRY77	UTSYS SW
UBS ETF (IE) Factor MSCI USA Total Shareholder Yield h. EUR UCITS ETF	0.35%		EUR	Physical	No	IE00BWT3KQ96	UTSYE SW
UBS ETF (IE) Factor MSCI USA Total Shareholder Yield h. GBP UCITS ETF	0.35%		GBP	Physical	Yes	IE00BXDZNM52	UTSY LN
UBS ETF (IE) MSCI USA Select Factor Mix UCITS ETF	0.30%	8	USD	Physical	Yes	IE00BDGV0308	USFM LN

Source: UBS Asset Management, data as of 1 June 2017

Find all product details here:

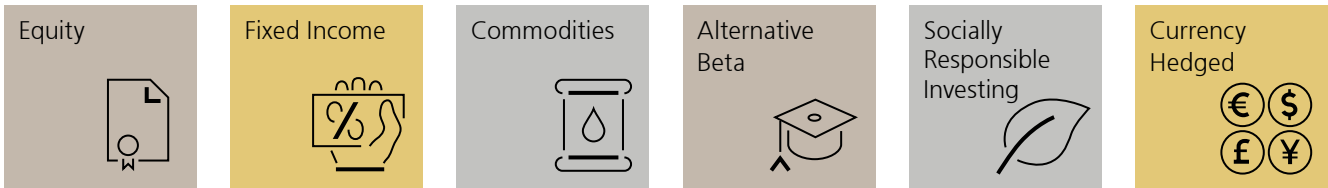
[UBS ETF Product Overview](#)

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