VanEck®
Access the opportunities.

YOUR GUIDE TO

Exchange Traded Funds

ISSUE TWO

THE NEXT EVOLUTION OF INVESTING

Smart beta: transparent, intelligent and disrupting the status quo

Dear Investor

VanEck is pleased to provide you with the second edition of our guide to Exchange Traded Funds (ETFs), with a special focus on smart beta and sustainable investing.

Since the firm was founded in 1955, VanEck has prided itself on providing investors with access to new and exciting opportunities to grow and protect their wealth.

The firm was a pioneer in international investing, giving US investors an opportunity to access stock markets in Asia and Europe that were on the cusp of a post-war economic recovery. In the late 1960s VanEck launched the world's first gold equity fund, allowing investors to participate in the greatest gold bull market of all time.

Today, VanEck is one of the largest issuers of ETFs. ETFs have undoubtedly democratised and lowered the costs for investors to key investment markets.

Many investors have entrusted their wealth with active managers for many years. The times are changing. Innovation in financial markets and the accessibility to 'Big Data' have enabled the delivery of investment approaches such as smart beta which were once only the domain of large institutional investors. The rise of smart beta is empowering investors to achieve their desired outcomes and the ability to build portfolios that are more durable to inevitable market cycles.

At the same time investors are more conscious that their accumulated wealth can be invested with the objective to create a better society and to ensure a more sustainable future.

Sustainable investing is an approach that drives positive environmental, social and corporate responsibility outcomes alongside financial results.

It is an emerging and powerful trend driven by individuals and organisations that are forcing change among the world's largest asset owners and investors.

This is now becoming mainstream. Investor's values and their financial goals need not be mutually exclusive.

ETFs are at the forefront of enabling investors to drive better outcomes by allowing all investors to access smart beta investments to better manage their risk, including through sustainable investments that align with their values, all with the over-arching objective of growing their wealth.

We hope you find this guide useful and implore you to speak to your financial adviser or stock broker in assessing which ETFs are right for you. If you would like a copy of our first Guide to Exchange Traded Funds, please contact us on 02 8038 3300.

Arian Neiron

Managing Director & Head of Asia Pacific, VanEck

ETF fast facts

200

There are about 200 ETFs listed on ASX, which are traded in the same manner as shares.

$50b

Unprecedented growth in Australia: Investments in ETFs grew 25% in 2019, now exceeding more than $50 billion in funds under management.

SMSFs

Popular with investors, especially those with self-managed super funds (SMSFs), ETFs can add instant diversification and often have lower fees than actively managed funds.

63%

63% of financial professionals plan to increase their smart beta allocation in the next year.[1]

Source: 1. VanEck Australian Smart Beta Survey 2019.

Why smart beta = Smart investing

While ETFs have exploded in popularity in recent years, another revolution in investing has taken hold – the rise of 'smart beta'.

To understand smart beta, it's useful to understand the 'beta' and the 'smart' part of the term.

Beta is financial jargon for indices like the S&P/ASX 200. The S&P/ASX 200 Index is a market capitalisation index. This means the 200 companies included, and their percentage representation within that index, is determined by their size. In Australia, CBA is the largest company on ASX and represents approximately 8% of the S&P/ASX 200.

A smart beta index is constructed using a methodology different than the size of the company. The 'smart' description denotes that considerable thought has gone into constructing the index with an investment outcome in mind that differs from the market return. That outcome could be a focus on dividends, by owning an index of stocks that pay relatively high dividends, or a focus on achieving positive returns by owning companies perceived to be undervalued based on the ratio of their price relative to their earnings.

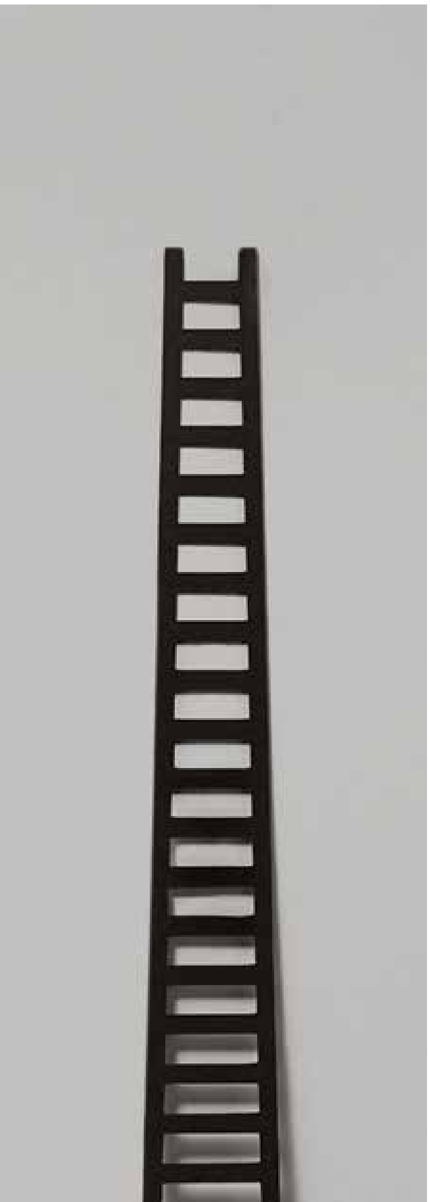
The smart beta trend has grown into a multi-billion dollar industry globally as more sophisticated investors have realised that allocating capital to passive funds using alternative weightings to market capitalisation could give them better returns for the same amount of risk.

Smart Beta is often described as combining the best of active investing, in which there is a targeted outcome, with passive investing, which is rules based, transparent and cost effective.

Many tried and tested smart beta strategies are available for investors to access via ETFs that track such indices. In fact, the popularity of smart beta strategies means this sub-sector is growing at a faster rate than the broader ETF market, or the active asset management industry.

THE NEXT EVOLUTION OF INVESTING

Investing can often be thought of as both a science and art while the outcomes achieved can be attributed to a combination of both skill and luck. That dynamic has not changed for as long as individuals have been trying to grow their wealth, however investing as a discipline has evolved over the past fifty years.



Nowadays all investors can utilise the tools that were once only utilised by large institutions and investment professionals.

Prior to the 1960s, the abilities of a professional investor or an 'active' manager were assessed in simple terms – that is – 'did the investment go up in value and by how much?'

A breakthrough of sorts came when Nobel Laureates Harry Markowitz and William Sharpe developed modern portfolio theory. A by-product of the theory was the creation of a measure for the broad share market return that could be achieved by simply investing in all the shares on issue in proportion to their size. This broad market return became known as 'beta.'

Later, the market return or 'beta' was measured by market capitalisation weighted indices such as the S&P500 or the S&P/ASX 200 in Australia.

These indices provided a barometer to assess how much value active managers actually added, both in terms of their ability to generate a return that was better than the broader market and the investment risk they took on to achieve the return.

The additional return above the market became known as 'alpha'. While a Sharpe Ratio - the amount of return generated by the investor for each unit of risk taken to achieve it – became an accepted measure of risk adjusted returns.

A milestone development in investment was the creation of index tracking mutual funds in 1967 by Jack Bogle.

Bogle offered the first mutual fund which allowed investors to earn the returns of the market by tracking market capitalisation weighted indices.

Prior to that point, indices served the sole purpose of assessing the skill of active investment managers. The creation of index tracking funds meant individuals and institutions could actually choose to invest in the market at low cost.

While index tracking funds were slow to catch on, there are now trillions of dollars of funds tracking market capitalisation weighted indices. That has increased the importance of indices.

But the investing evolution continued in the 80s and 90s as more academic research analysed sub-sets of market returns which could be used to assess managers.

For instance, so-called 'value' managers sought to select stocks that were priced below their fair value based on market prices and accounting measures.

'Growth' managers meanwhile sought to select stocks that were increasing their earnings at an above average rate.

Both processes could be replicated at low cost using rules that created alternative indices. Comparing returns to these indices revealed how skilful 'value' and 'growth' managers were, relative to easily replicable rules that represent their broad process.

The bar in measuring how skilful a manager was, or how much 'alpha' they were able to generate, was raised once again. Not only did they have to beat the broad market, they also had to demonstrate they could generate better returns than a rules-based application of their style.

In the 2000s, the discipline of investing made further advancements as research sought to uncover a broader range of factors or characteristics beyond growth and value that could achieve better returns than the market.

These 'persistent drivers' of stock returns include selecting stocks based on the size and sustainability of their dividend, their 'quality' as measured by returns on equity and consistency of earnings and 'momentum' as stocks that gained in price lured more buyers leading to further gains.

The increased sophistication of research further dissected the extent to which the skill of active managers was adding value relative to the broader market and relative to easily replicable 'factors'.

The rise of 'factor' based investing spawned the term 'smart beta'.

Over time more investors have shown a willingness to track indices beyond those based on market capitalisation as a means of managing risk or seeking higher returns.

The increased sophistication in identifying drivers of stock returns and measuring manager skill has coincided with advances in allowing investors to access those returns.

ETFs have become an accepted and growing part of investors' toolkits by allowing them to buy and sell exposure to the performance of an entire index in a single trade on an exchange. The offerings of ETFs have extended well beyond market capitalisation weighted indices to include smart beta funds.

As some of the world's largest institutions have become more sophisticated in assessing the true skill of active managers and the value of the fees they are charged, more capital is shifting to factor based or smart beta investing.

Individual investors are also becoming more aware of the value of smart beta both as an alternative to active managers and to market capitalisation weighted indices.

Today, smart beta is an established part of portfolios for the world's largest investors. VanEck's recent fourth annual Smart Beta Survey showed that 46% of financial advisers are currently using smart beta in their portfolios with an additional 26% of respondents evaluating them. Of those using smart beta, 93 percent are satisfied with their investment. ■

THE SMART BETA ADVANTAGE

Access the benefits of active management with the lower fees and transparency of passive investments.

VanEck has made a number of smart beta strategies available to Australian investors via our ETFs. These have not only proved popular with investors but achieved the desired outcomes of diversification, outperformance and risk management.

Smart beta provides a lower cost alternative to active managers that charge a higher fee to attempt to outperform the market.

The evidence to date that supports the case that active managers provide good value to individual investors is not compelling.

The most recent SPIVA® Australian Scorecard conducted by S&P Dow Jones Indices (SPIVA is an acronym for Standard & Poor's Indices Versus Active) showed that in the last year, 93 per cent of Australian active fund managers could not beat the returns of the S&P/ASX 200. Over three, five, ten and 15 years, the number was more than 80 per cent. Those are high numbers.

VanEck conducted further research, reproducing a US academic study to determine if Australian active managers were charging fees to investors that justified the performance they were delivering over and above an outcome that could be achieved by a low cost smart beta strategy.

The study found that 65 per cent of active managers should be 'disrupted' because the same or better outcome could be achieved at a lower cost from a smart beta strategy. ■

+

Popular with investors and achieves the desired outcomes of diversification, outperformance and risk management.

+

A lower cost alternative to active managers that charge a higher fee to attempt to outperform the market.

+

93 per cent of Australian active fund managers did not beat the returns of the S&P/ASX 200 in the last year.

Applying smart beta to the S&P/ASX 200

Among the most popular smart beta strategies in Australia is the VanEck Vectors Australian Equal Weight ETF (ASX: MVW). The fund simply seeks to track an index of the largest and most liquid Australian listed companies, which are weighted equally rather than based on their market capitalisation.

The S&P/ASX 200 index is one of the most concentrated in the world with the top 20 companies accounting for more than 60 per cent of the index, while four of the top five holdings are banks. Financials make up over 30 per cent of the index.

The equal weight index which MVW tracks, offers an alternative to the highly concentrated S&P/ASX 200 index by firstly selecting only the most liquid stocks, then weighting them equally. This results in a portfolio of around 86 companies with reduced exposure to highly concentrated sectors such as financials and resources.

The long term performance of the equal weight index demonstrates better risk characteristics than the market capitalisation weighted S&P/ASX 200.

That means the better performance is not the result of greater risk-taking, it is the result of better diversification in the smart beta approach compared to the market capitalisation equivalent.

Given the particularly high concentration of the Australian share market, this simple smart beta approach is an attractive alternative to the broader share market and actively managed funds that tend to be close to the benchmark rather than manage their inherent risks and therefore struggle to outperform.

As an example, larger companies whose shares trade all the time on ASX, such as CBA and BHP, have high liquidity. There are always so many buyers in the market that shares such as these can be sold on ASX quickly at a fair price.

Smaller companies tend to be less liquid. There are relatively few people willing to buy them so market forces allow them to extract an 'illiquidity discount' from anyone who needs to sell. For sellers, illiquidity pushes the price down, often below fair value. ■

MVW has been awarded the winner of *Money* magazine's Best of the Best Australian Share ETF for two years running in 2018 and 2019.

WHY IS LIQUIDITY IMPORTANT?

+ A liquid investment can be readily acquired and converted to cash.
+ A liquid investment can be bought or sold at a fair value without a significant premium or discount to its fair value.

Aligning your values to your investments

Sustainable investing is almost as old as investing itself.

The Quakers and Methodists in the 18th century believed in the abolition of slavery and the ills of alcohol and gambling, and refused to make investments that contradicted these principles.

In the 1960s, some American investors avoided companies that produced the weapons for the Vietnam War, while the civil rights movement led more investors to question the social responsibilities of the companies they invested in.

Then the environmental disasters of the 1980s and increased attention of global warming forced more investors to consider the long term environmental impact of their investments.

The cost of negligence, such as the $US61 billion paid by BP after the Deepwater Horizon oil rig disaster in 2010 led more investors to realise that companies that damage society and the environment could actually destroy their personal wealth too.

Recently Facebook's Cambridge Analytica scandal highlighted the risks associated with corporations not having the same practices as the public expected.

As investors have become aware of the risks associated with potentially harmful activities, they have developed a greater appreciation for the value in identifying and investing in businesses that take their social responsibilities more seriously.

Sustainable investing as we know it today fulfils two objectives for socially minded investors.

1. The first is what the Quakers and Methodists sought to achieve. That is to avoid investing in certain companies whose conduct and activities were inconsistent with their values and beliefs. This includes companies involved in activities such as gambling, alcohol, tobacco and civilian firearms.

It is relatively easy to identify these "negative screens" through publicly available information such as annual reports that disclose companies' sources of profit. This form of sustainable investing, in which certain investments are avoided, is typically referred to as socially responsible investing (or SRI).

2. The second objective, is to take environmental, social and governance (ESG) factors into account. These three factors can be used to better assess and manage risk with the aim of generating long term returns from socially responsible investments.

Identifying and measuring ESG factors is less simple. Some factors, such as carbon emissions, can be measured if companies report this data. But other factors such as labour standards, workplace diversity, risk controls, management competency and environmental impacts are harder to identify.

Identifying, measuring and tracking these risks has become increasingly important to allow investors to invest in so-called ESG leaders and avoid the ESG laggards. While some investors assess ESG risks on their own, there are several well-resourced firms that specialise in analysing and tracking the ESG risks of listed companies. This analysis forms the building blocks of ESG investment strategies.

The evidence that adherence to ESG principles may enhance rather than detract from returns has further fuelled the rise of sustainable investing.

Despite the long history of sustainable investing however, there have been few investment offerings that have been able to combine both SRI and ESG investing.

That is changing. Smart beta is now at the forefront of the sustainable investing revolution. Smart beta's systematic rules based approach to investing can allow investors to access investments that grow their wealth and align with their values through a process of exclusion and inclusion filters. ■

Going Green WITH SMART BETA

While there is an increased demand among investors to make sure their wealth is allocated to companies that better match their values, identifying suitable investments among hundreds of listed shares, can be daunting.

Investors face the dual purpose of not only avoiding companies that don't align with their values but seeking companies that most align with them and that have good ESG performance.

VanEck created the VanEck Vectors MSCI Australian Sustainable Equity ETF (ASX:GRNV) with this intention - to be both exclusive and inclusive of companies based on SRI and ESG factors.

GRNV was therefore created to screen out certain businesses and include others to create a best of breed ESG focused Australian equities ETF.

The ETF tracks the MSCI Australia IMI Select SRI Screened Index and follows a four step process. The first step is to screen out companies that are involved in certain activities such as firearms, alcohol, gambling, fossil fuels, tobacco, soft drinks, and nuclear power.

The index also excludes companies identified by MSCI's research team as being involved in controversies relating to environmental, social or governance issues, or in respect of human rights.

Once the index process has screened out companies, it will then only invest in companies that are amongst the highest ranking ESG performers, based on MSCI's assessment.

While GRNV, like all ETFs, tracks a rules-based index, investors benefit from the fact that not only is it a smart beta index but it is derived from the world leading MSCI's ESG-Research unit.

This specialist research division employs over 185 analysts to oversee the business activities of companies around the world and assess them based on broad ranging and deeply penetrating ESG risks criteria. Their findings are incorporated into the rankings referenced by the index.

Among GRNV's largest holdings are Telstra, Goodman Group and CSL. ■

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Access the opportunities.

"… given Australia's extreme concentration, where the top 20 stocks comprise near 60% of the S&P/ASX 200 Index… this fund holds one quarter of the portfolio in its top 20 stocks. That diversification has some appeal."

Morningstar Global Fund Report for MVW | 23 October 2018

Keep it equal and gain the advantage

ASX code: MVW

Your Australian equity portfolio is likely to be dominated by banks and large resources, even if you're in a professionally managed fund. MVW is a unique ETF. It allocates equally to 86 stocks from all sectors of the Australian market, giving you true diversification to the Australian economy.

Back to back winner

Learn more at vaneck.com.au or speak to your financial adviser or stock broker.