



SOCIETY & FINANCE 16/8/2018

Yesterday wow, tomorrow pooh – Factor strategies in the European ETF market

AGNIESZKA GEHRINGER and KAI LEHMANN

- "Smart beta" ETFs are becoming increasingly popular in Europe. However, similar to their US counterparts, their performance to date is only average at best.
- None of the strategies examined is able to achieve sustainable excess returns compared to the benchmark index. More surprising is the fact that many "smart" approaches show comparatively high volatility.

Rise of the European "Smart Beta" market

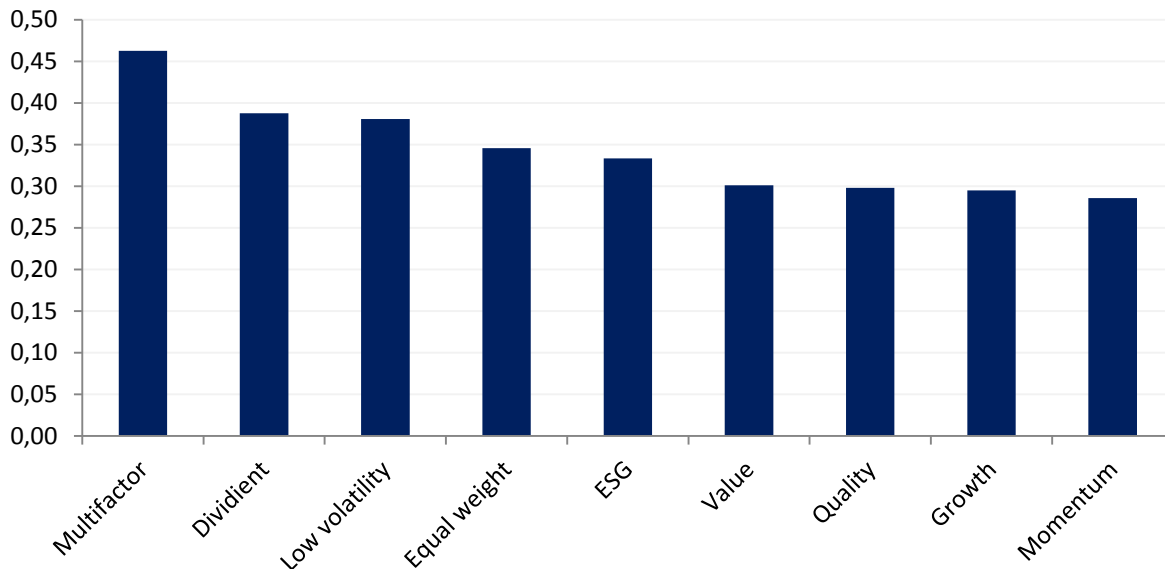
The market for so-called "smart beta" strategies has experienced considerable growth in Europe over the past few years. Since 2012, the investment volume of ETFs domiciled in European countries has grown at double-digit rates each year. While assets under management (AUM) amounted to just EUR 5 billion in 2012, some EUR 38 billion have already been invested in factor ETFs by the end of the first half of 2018. While growth is undoubtedly impressive, the share of factor strategies in the overall European ETF market is still quite manageable at around 10%. Similarly, compared to its US counterpart, the European smart beta market is relatively young and still very small. At the end of the first half of 2018, the volume of money invested in passive factor strategies in the USA

amounted to approximately EUR 640 billion, seventeen times the volume invested in Europe.

Given the strong growth of "smart" investment vehicles in the recent past, it is worth examining whether their increasing degree of popularity can actually be attributed to superior performance, or whether this is rather the result of the increased sales activities of ETF issuers. After all, these strategies, which are also described as pseudo-active, permit themselves to charge higher fees than traditional ETF solutions do. The latter have been subject to strong fee erosion as a result of increasing competitive pressure. While even less than 0.1 percent of fees are charged for some classic ETFs, the cost ratio for smart beta ETFs is often between 0.3 and 0.4 percent, as shown in **Figure 1**.



Figure 1: Total cost share of smart beta ETFs quoted in Europe, according to strategy, in percent



Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.

Around 44% of AUMs (EUR 16.7 billion) are invested in dividend ETFs (Figure 2).¹ This strategy remains clearly dominant in Europe, even though its relative share has declined in recent years. Compared to the US market, where the rate of dividend strategies has recently been around 20%, this approach continues to enjoy great popularity in the European market.² European investors seem to see high dividend yields as a substitute for low interest income.

While until recently the dividend strategy was the only one enjoying significant investment volumes in the area of passive factor investments, several other strategies have meanwhile

gained in importance. Particularly worth mentioning here are value and low-volatility strategies, which recently reached volumes of EUR 5 billion and EUR 4.7 billion, respectively. But also equal weight and multifactor strategies have experienced significant inflows, with AUMs at EUR 4.1 billion and EUR 4.0 billion respectively. Other strategies, such as the quality approach, the momentum approach or the targeted overweighting of companies that stand out positively in terms of ESG, still do not have significant market shares.

"Smart" performance tested

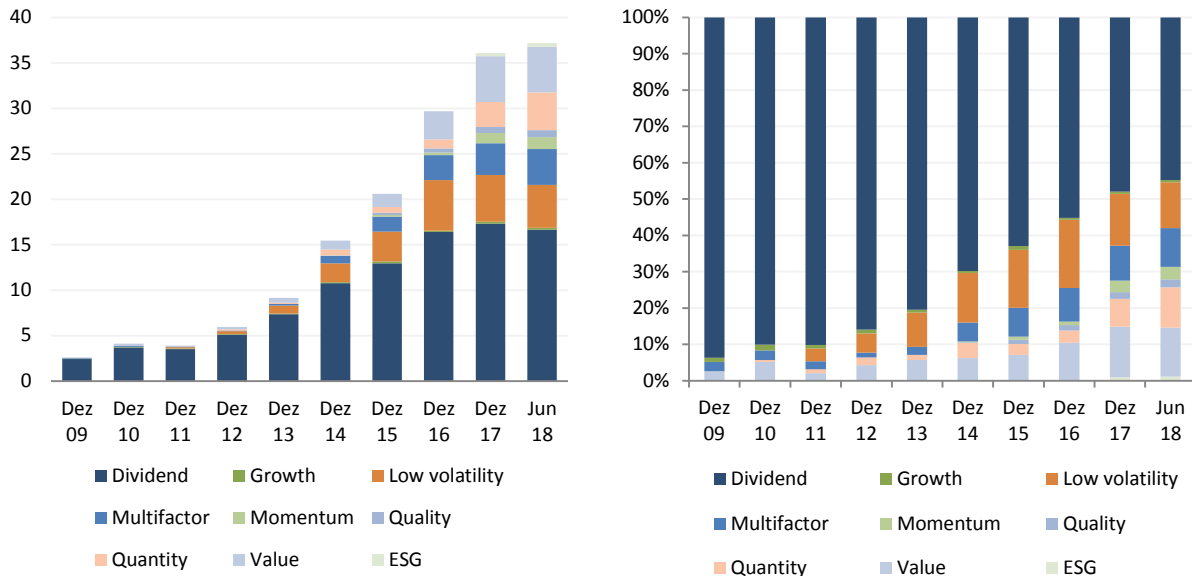
Despite the young age of the European "smart beta" ETF market, the price history, reaches in some cases a decade. This allows an indication as to whether the performance superiority over the broad market, which the ETF industry so actively advertises, actually shows up. In keeping with the ETF industry's promise, it should be possible to achieve an above-average return with every approach in almost every market phase.

¹ For a detailed description of single strategies, see Gehringer/Lehmann (2018): „Smart Beta ETFs – Euphemism par excellence“, available at: http://www.fvs-ri.com/files/18.03.08_smart_beta_de.pdf. For a detailed presentation of fund in- and outflows, see Figure A-1 in the Appendix.

² The respective shares pertaining to different ETF-strategies in the USA is shown in Figure A-2 in the Appendix.



Figure 2: AUM of different smart beta strategies in Europe in billion Euros and as shares over total



Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.

A study we had carried out beforehand on the basis of US data already showed that this promise could not be kept and that the strategies pursued tended to underperform the market on average. Is the European market perhaps doing better?

Table 1 shows the average annual returns (before costs) of the European smart beta ETFs and the average volatilities of the individual strategies in the calendar year.³ It turns out that none of the strategies are able to emerge as superior over the entire period under study.⁴ Although

³ The returns include any payouts from the perspective of a euro investor (total return). Volatility represents the annualized standard deviation of the daily, logarithmic, historical price changes of the past calendar year.

⁴ It should be noted, however, that although the ETFs of the respective categories are based on the same strategy, the individual ETF refer to a different corporate universe. This can result in different or even opposite returns, especially if the ETFs have different geographical focus. However, a correlation analysis between the individual members within the respective strategies shows that the correlations are clearly positive on average. For the AUM distribution according to geographic focus, see Figure A-3 in the Appendix.

the multifactor approach is the most successful over the entire period, with an average annual return of 12.1 %, there are big differences from year to year and especially in the last few years the returns have developed slightly below average.

The same applies to the growth approach, which as a whole achieves a respectable average return of 11.8%, but in 2014 underperformed all other approaches.⁵ The weakest performance would have been achieved by an investor with the quality strategy, where the annual performance is 9.6%. However, the period under review here covers only three years and thus does not include the relatively strong stock market years 2013 and 2014. The same applies to the momentum strategy, which nevertheless achieves an average annual return of 11.8%. All in all, it can be stated that the results obtained are not persistent. Thus, the term "strategic"

⁵ However, it should be noted that only two ETFs have been included in this product category, which undoubtedly reduces the informative value here.



Table 1: Average returns (before costs) and volatilities (in parenthesis) of "smart beta" ETFs over the observation period, in percent

	Ø	2017	2016	2015	2014	2013	2012	2011	2010	2009
Dividend (n=54)	11.4 <i>(18.0)</i>	6.8 <i>(11.2)</i>	12.8 <i>(19.8)</i>	4.4 <i>(20.8)</i>	15.2 <i>(14.3)</i>	13.4 <i>(14.4)</i>	14.6 <i>(16.0)</i>	-6.0 <i>(23.0)</i>	17.0 <i>(19.2)</i>	38.3 <i>(35.1)</i>
Growth (n=2)	11.8 <i>(17.9)</i>	13.4 <i>(10.5)</i>	6.3 <i>(18.1)</i>	14.0 <i>(22.1)</i>	4.0 <i>(15.2)</i>	19.7 <i>(14.2)</i>	33.3 <i>(17.4)</i>	-14.2 <i>(23.2)</i>	16.2 <i>(20.1)</i>	14.7 <i>(22.9)</i>
Low volatility (n=21)	10.8 <i>(13.4)</i>	8.5 <i>(9.1)</i>	5.5 <i>(15.9)</i>	10.8 <i>(18.8)</i>	23.2 <i>(11.4)</i>	13.6 <i>(12.0)</i>	10.9 <i>(12.9)</i>			
Multifactor (n=35)	12.1 <i>(17.3)</i>	9.2 <i>(11.3)</i>	7.7 <i>(20.4)</i>	6.5 <i>(21.5)</i>	14.8 <i>(15.1)</i>	21.5 <i>(14.1)</i>	14.3 <i>(14.6)</i>	-9.3 <i>(21.2)</i>	22.2 <i>(18.5)</i>	47.9 <i>(28.6)</i>
Momentum (n=7)	11.8 <i>(15.0)</i>	14.3 <i>(10.4)</i>	6.1 <i>(16.8)</i>	13.9 <i>(20.3)</i>						
Quality (n=10)	9.6 <i>(14.5)</i>	9.7 <i>(9.6)</i>	8.6 <i>(17.7)</i>	11.9 <i>(19.7)</i>						
Equal weight (n=6)	10.8 <i>(15.9)</i>	9.9 <i>(10.5)</i>	6.6 <i>(21.1)</i>	11.1 <i>(19.2)</i>	6.8 <i>(13.7)</i>	23.4 <i>(11.8)</i>	24.1 <i>(17.4)</i>			
Value (n=19)	10.8 <i>(18.0)</i>	9.7 <i>(11.2)</i>	13.1 <i>(21.6)</i>	3.4 <i>(20.9)</i>	10.6 <i>(14.3)</i>	22.0 <i>(13.7)</i>	18.4 <i>(21.0)</i>	-15.0 <i>(29.1)</i>	1.8 <i>(21.7)</i>	36.9 <i>(34.8)</i>

Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.

beta, often used instead of "smart", does not seem to fit either.

The fact that the factors are subject to a certain cyclicity may be less surprising than the observation of a sometimes quite high volatility in certain factors. For example, the multifactor approach is often promoted with an improved risk-return profile based on a combination of different criteria. However, the data do not seem to confirm this, as the value fluctuations here are relatively high. The same applies to ETFs that focus on stocks with particularly high dividends. Due to the comparatively more continuous return profile, these should have a lower susceptibility to fluctuation. However, the volatility of the dividend strategy, together with the value strategy, is higher than in any other of the approaches examined.

In the next step, we aimed at examining how the individual strategies have fared against the respective benchmark. The benchmark is represented by the broad, classically market capitalization-weighted index from which the respective tracking index and thus the respective ETF

portfolio is derived. For example, the ETF iShares DivDAX UCITS ETF DE follows the DivDAX Index as the tracking index. Since the DivDAX Index is derived from the DAX Index⁶, the standard market capitalization-weighted DAX Index is the benchmark. This is determined individually for each ETF. **Table 2** shows the average annual returns and volatilities of the benchmark indices, as in the previous table.

A comparison of the values shows that the average return on ETF strategies (before costs) is roughly at the same level as the broad indices. This is not surprising, as the strategies reflect the broad market due to their diversity and contrariness. ETFs that focus on high dividends, low volatility, quality and a low valuation (value) performed weaker than their respective benchmarks, as did the multifactor strategies that have become popular in recent years. On the other hand, ETFs which increasingly rely on growth companies performed better than their benchmarks. The same applies to the momen-

⁶ The DivDAX Index contains the 15 stocks from the DAX Index with the highest dividend yield.



Table 2: Average returns and volatilities of the respective benchmarks over the observation period, in percent

	Ø	2017	2016	2015	2014	2013	2012	2011	2010	2009
Dividend	12.3 <i>(17.2)</i>	11.0 <i>(9.4)</i>	9.2 <i>(19.1)</i>	8.3 <i>(16.8)</i>	13.5 <i>(12.4)</i>	17.8 <i>(13.3)</i>	20.1 <i>(21.9)</i>	-8.1 <i>(22.3)</i>	16.8 <i>(19.6)</i>	31.4 <i>(39.0)</i>
Growth	11.1 <i>(19.0)</i>	10.1 <i>(9.1)</i>	10.3 <i>(18.8)</i>	11.8 <i>(17.9)</i>	5.0 <i>(14.9)</i>	24.9 <i>(14.7)</i>	20.7 <i>(25.7)</i>	-14.3 <i>(24.6)</i>	3.6 <i>(21.4)</i>	29.0 <i>(35.3)</i>
Low volatility	11.8 <i>(13.1)</i>	10.4 <i>(8.6)</i>	9.2 <i>(17.7)</i>	8.4 <i>(15.2)</i>	18.7 <i>(11.1)</i>	16.7 <i>(11.5)</i>	15.1 <i>(20.7)</i>			
Multifactor	12.7 <i>(15.3)</i>	9.8 <i>(9.0)</i>	10.2 <i>(17.5)</i>	7.0 <i>(15.1)</i>	18.3 <i>(10.7)</i>	18.0 <i>(11.1)</i>	14.9 <i>(18.4)</i>	-3.0 <i>(20.0)</i>	23.1 <i>(17.3)</i>	35.1 <i>(35.9)</i>
Momentum	9.7 <i>(11.5)</i>	9.7 <i>(8.2)</i>	8.7 <i>(16.5)</i>	11.0 <i>(12.4)</i>						
Quality	9.8 <i>(12.2)</i>	9.8 <i>(8.4)</i>	9.3 <i>(17.4)</i>	11.0 <i>(12.4)</i>						
Equal weight	10.4 <i>(13.2)</i>	8.6 <i>(8.4)</i>	8.0 <i>(17.4)</i>	11.4 <i>(15.5)</i>	7.8 <i>(12.7)</i>	21.4 <i>(12.0)</i>	18.9 <i>(20.4)</i>			
Value	11.1 <i>(15.0)</i>	9.7 <i>(8.8)</i>	8.6 <i>(18.9)</i>	10.0 <i>(17.3)</i>	11.1 <i>(12.4)</i>	21.5 <i>(11.8)</i>	17.9 <i>(19.7)</i>	-7.6 <i>(20.1)</i>	11.8 <i>(18.4)</i>	32.6 <i>(34.1)</i>

Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.

Example: A "smart beta" ETF, formed according to the dividend factor, tries to follow the yield development of the so-called tracking index as closely as possible. This tracking index weights companies according to their dividend strength. The benchmark index, on the other hand, is based on the classic weighting of companies according to their market capitalization. For example, the DAX Performance Index is the benchmark for smart beta ETFs that follow the performance of the DivDAX Index.

Table 3: Average return differential between ETFs and their respective benchmark, in percent (before costs)

	Ø	2017	2016	2015	2014	2013	2012	2011	2010	2009
Dividend	-0.9	-4.3	3.5	-3.9	1.8	-4.4	-5.5	2.1	0.2	7.0
Growth	0.7	3.4	-4.0	2.2	-1.0	-5.2	12.7	0.1	12.6	-14.3
Low volatility	-1.0	-1.9	-3.8	2.4	4.5	-3.1	-4.2			
Multifactor	-0.8	-0.6	-3.0	-0.4	-5.4	3.4	-0.6	-6.3	-0.9	12.7
Momentum	2.1	4.7	-2.6	2.8						
Quality	-0.2	-0.1	-0.7	0.8						
Equal weight	0.5	1.3	-1.5	-0.2	-0.9	2.0	5.1			
Value	-0.3	0.0	4.5	-6.6	-0.5	0.4	0.5	-7.3	-10.0	4.4

Source: Flossbach von Storch Research Institute, Bloomberg, Stand August 2018.

tum strategy and the equilibrium approach. With the exception of the momentum approach, the average yield deviations between the ETFs and the respective benchmark lie within a range of one percentage point, as **Table 3** shows. Although the results should be interpreted with caution due to the observation period, which in some cases only covers three years, the picture gained previously seems to be

confirmed: none of the strategies examined is associated with a strategic return advantage or return disadvantage.⁷

It is worth noting that the designation of the ETFs is not "smart alpha" but rather "smart

⁷ Gehringer/Lehmann (2018): „Smart Beta ETFs – Euphemism par excellence“, available at: http://www.fvs-ri.com/files/18.03.08_smart_beta_de.pdf.



beta". This suggests that the superiority of this product category should not necessarily be reflected in sustainable excess returns but rather in a lower risk - understood as lower volatility. However, the volatility of ETFs exceeds that of traditional market indices, with the exception of the growth strategy. It is also noteworthy that even strategies that focus on particularly volatile stocks show a higher range of fluctuation in retrospective than in the corresponding benchmark. This is partly due to the inherently weaker diversification of the ETF portfolios, which by construction have a smaller number of stocks than the market-wide index on the base of which they are constructed.

Conclusions

Our analysis has shown that European "smart beta" ETFs as a whole could not deliver either sustainable excess returns or lower volatility. It is true that a certain degree of factor exposure does at times lead to a significant deviation of the ETF's return from that of the benchmark.

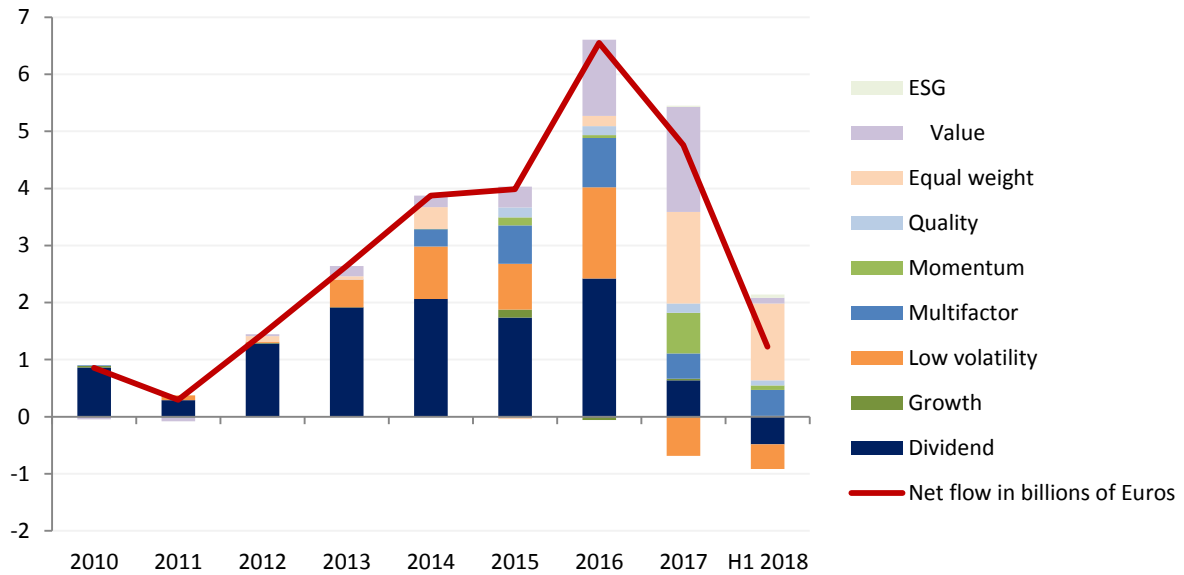
However, a temporary underperformance or superiority is usually soon thwarted by a contrary development. For example, the relative superiority of multifactor strategies over other approaches is no longer discernible in the recent past. The fact that the inflows into these strategies nevertheless continue is probably due in part to the successful marketing activities of ETF issuers, who continue to charge comparatively high fees for this approach.

Critical ETF investors should be aware that the promise of persistent superiority implied by the term "smart" is a fallacy, as it is not inherently sustainable across the various ETF strategies. Factor ETFs should therefore at best play a tactical role in any portfolio construction.



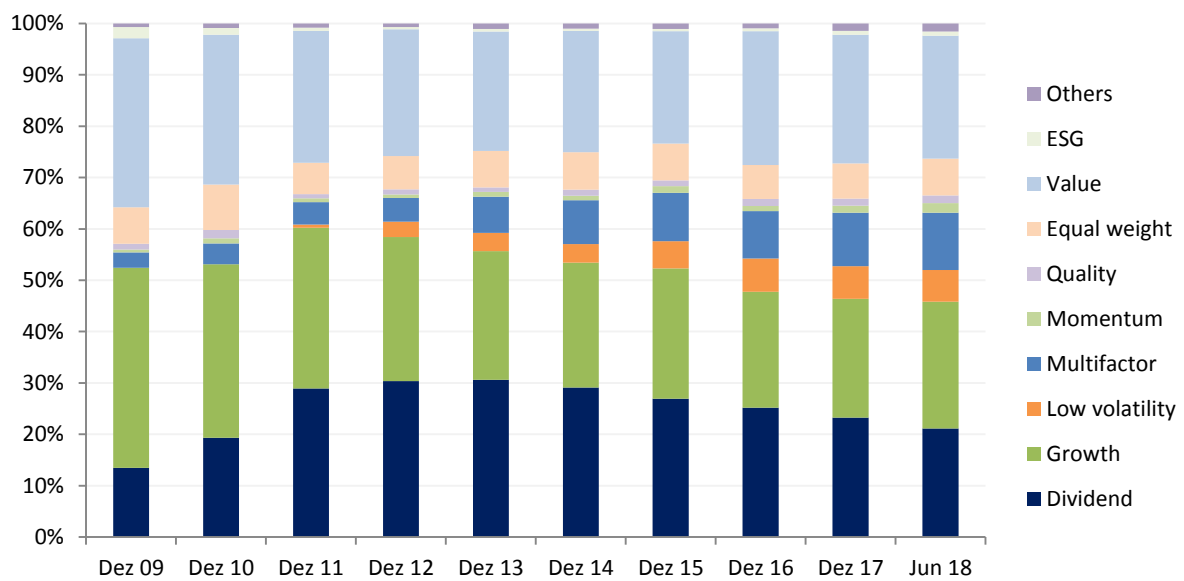
APPENDIX

Figure A-1: In- and outflows of different "smart beta" strategies in Europe in billions of Euros



Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.

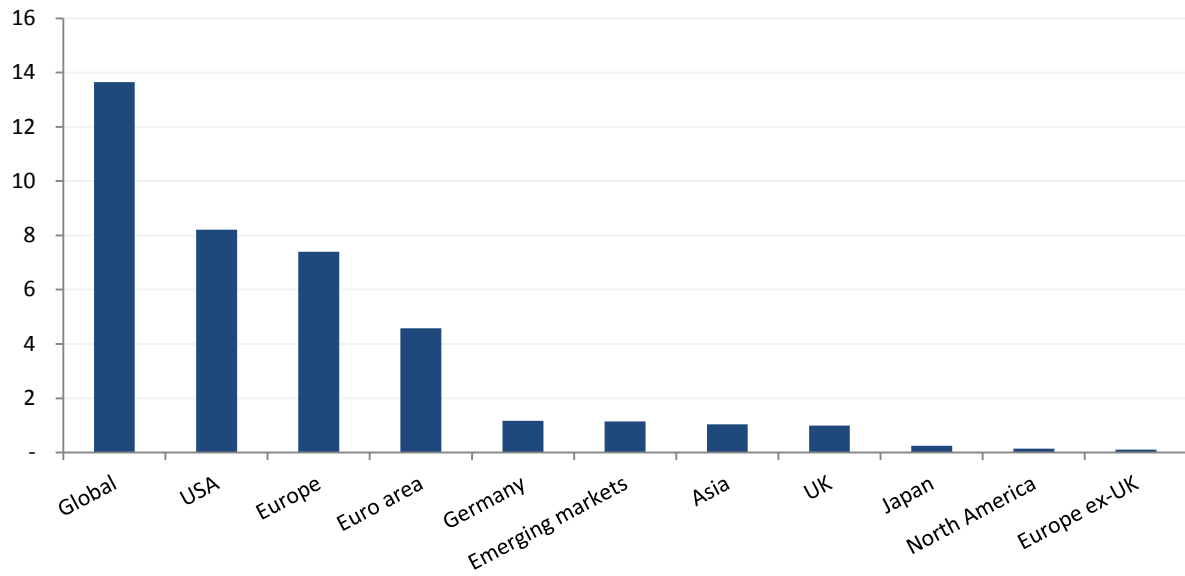
Figure A-2: Shares of respective "smart beta" strategies in the USA



Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.



Figure A-3: Geographic distribution of AUM in Europe in billions of Euros (as of 30.06.2018)



Source: Flossbach von Storch Research Institute, Bloomberg, as of August 2018.



LEGAL NOTICE

The information contained and opinions expressed in this document reflect the views of the author at the time of publication and are subject to change without prior notice. Forward-looking statements reflect the judgement and future expectations of the author. The opinions and expectations found in this document may differ from estimations found in other documents of Flossbach von Storch AG. The above information is provided for informational purposes only and without any obligation, whether contractual or otherwise. This document does not constitute an offer to sell, purchase or subscribe to securities or other assets. The information and estimates contained herein do not constitute investment advice or any other form of recommendation. All information has been compiled with care. However, no guarantee is given as to the accuracy and completeness of information and no liability is accepted. **Past performance is not a reliable indicator of future performance.** All authorial rights and other rights, titles and claims (including copyrights, brands, patents, intellectual property rights and other rights) to, for and from all the information in this publication are subject, without restriction, to the applicable provisions and property rights of the registered owners. You do not acquire any rights to the contents. Copyright for contents created and published by Flossbach von Storch AG remains solely with Flossbach von Storch AG. Such content may not be reproduced or used in full or in part without the written approval of Flossbach von Storch AG.

Reprinting or making the content publicly available – in particular by including it in third-party websites – together with reproduction on data storage devices of any kind requires the prior written consent of Flossbach von Storch AG.

© 2018 Flossbach von Storch. All rights reserved.

SITE INFORMATION

Publisher: Flossbach von Storch AG, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com, *Directors:* Dr. Bert Flossbach, Kurt von Storch, Dirk von Velsen; *Registration:* No. 30 768 in the Commercial and Companies Register held at Cologne District Court; *VAT-No.* DE200075205; *Supervisory authority:* German Federal Financial Services Supervisory Authority, Marie-Curie-Straße 24 – 28, 60439 Frankfurt / Graurheindorfer Straße 108, 53117 Bonn, www.bafin.de; *Authors:* Dr. habil. Agnieszka Gehringer and Dr. Kai Lehmann; *Editorial deadline:* August 13, 2018