ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Fidelity Brings ‘Smart Beta’ ETFs to Market

In mid-September, Fidelity debuted six exchange-traded funds (ETFs) representing its latest attempt to combine its reputation for active management with the growing popularity of ETFs. We reported on the fund giant’s SEC filing for these funds in May.

This expansion of Fidelity’s ETF offerings underscores the firm’s later—but, we think, savvier—entry into the non-commoditized passive market ETF niches. As we’ve discussed, in recent years, we’ve seen the firm launch multiple sector ETFs (including a real estate ETF) and actively managed bond ETFs. This new lineup extends their reach and demonstrates further how Fidelity plans to capitalize in the ETF field.

The funds—Core Dividend ETF (ticker: FDVV), Dividend ETF for Rising Rates (FDRR), Low Volatility Factor ETF (FDLO), Momentum Factor ETF (FDMO), Quality Factor ETF (FQAL) and Value Factor ETF (FVAL)—focus on a “factor” that impacts risk and return. Each carries a 0.29% expense ratio, lower than the 0.50% average expense ratio for similar funds.

Factor investing—also commonly referred to as “smart” or “strategic” beta investing—is based on identifying stocks with certain common characteristics that react in a similar way to certain market conditions. As of June 30, smart beta ETFs represented about $487 billion of the $2.3 trillion ETF market in the U.S., according to Morningstar.

There are five “factors” at play in Fidelity’s new products, some of which are fairly common in the factor ETF marketplace. They include dividends (stocks of companies that consistently pay dividends), low volatility (seeking stocks that are less volatile but generate comparable returns to the broad market); momentum (outperforming stocks that are considered likely to continue to do so over the medium term); quality (stocks that offer higher profitability, more reliable income and cash flows, and aren't excessively leveraged); and value (stocks at a cheap price relative to their fundamental value).

So how does Fidelity put the "smart" in smart beta? In what may seem like a confusion of investment philosophies, the firm's quantitative team actively designs and maintains proprietary target indexes for the ETFs to mimic. Indexing purists interested in these funds should be aware that due to the underlying factors, Fidelity's offerings will likely look and perform differently than a traditional broad market index fund or ETF—which is the point.

What Goes in the Indexes?

Over the past decade, Fidelity's quantitative research arm has refined its factor-investing approach and has leveraged that experience to design the six indexes underlying the new ETFs.

Without getting too deep in the weeds, here's how they work:

As is typical with quantitative approaches, Fidelity's research team starts with a universe of stocks and then screens it for the individual factors. In this case, the launching point is the top 1,000 U.S. stocks based on market capitalization (the market value of a company's outstanding shares). The two dividend-factor ETFs can also have up to a 10% allocation to companies among the top 1,000 stocks in developed markets overseas.

Next, Fidelity's research department scores the stocks based on the specific factors, and picks those that rank in the top 10% by sector. The team then constructs the index, using the market cap of each stock that made it through the prior cut to determine its position size, keeping the overall sector allocations "neutral" (i.e., in the same proportions as the universe) in five of the six ETFs. The exception is Core Dividend ETF, which allows greater allocations to the five sectors with the highest yield to deliver on its income objective.

Finally, each index is regularly reviewed and rebalanced: Momentum Factor ETF on a quarterly basis; Low Volatility Factor ETF, Quality Factor ETF and Value Factor ETF twice a year; and Core Dividend ETF and Dividend ETF for Rising Rates annually.

Most of the funds focus on factors that other smart-beta products already trade on, such as dividends, volatility, momentum and value. But Fidelity is offering an innovative new idea with its Dividend ETF for Rising Rates, which not only focuses on stocks of companies expected to pay or raise their dividends, but those that also have a positive correlation of returns to increasing 10-year U.S. Treasury yields.

Our view on Fidelity's factor ETFs remains the same as when they were first announced. The fund titan's entry into this segment of the market is as much smart business as smart beta. In the overcrowded but popular ETF universe, Fidelity is betting that its resources and reputation for active management can set it apart from competitors to come from behind and build market share. The strategies hold varying levels of appeal on paper—now that they've opened to investors, we will be interested to see how they perform as real-world investments.

Long-Time Fidelity Manager Hangs It Up
On September 14, Fidelity fund manager Tom Soviero announced that he would be retiring at the end of the year to spend more time with his family and on philanthropic efforts. Soviero, who has managed funds at Fidelity for 22 years, will use the next few months to help with his replacements' transitions.

Soviero steps away from the management of Fidelity's Leveraged Company Stock fund (and its Advisor class), Value Strategies fund (retail and Advisor classes) and VIP Value Strategies portfolio.

Fidelity named Mark Notkin the new portfolio manager of Leveraged Company Stock, and Harley Lank the manager of Advisor Leveraged Company Stock. Lank will also succeed Soviero on a similar fund for investors in Japan.

Notkin and Lank have been managing in the high-yield space for more than 20 years, investing throughout capital structures on everything from bank loans to ordinary stocks. Notkin believes security selection is a critical element of investment results; he has co-managed Fidelity's Strategic Income fund since 1999 and managed Capital & Income since 2003. Lank's management is characterized by bottom-up fundamental research with top-down analysis; he also manages Fidelity Advisor High Income Advantage, which he's overseen since 2009, and the high-yield sleeves of Fidelity's Puritan and Global High Income funds since 2011.

Matt Friedman was tapped as portfolio manager of the retail and Advisor classes of Value Strategies fund and the VIP Value Strategies portfolio. Friedman, who managed Value Strategies before Soviero, will continue his focus on long-term results achieved through a value-oriented selection process. He is also a member of Fidelity's Stock Selector Large Cap Group, which co-manages a handful of funds.

The investment objectives of the funds will not change after Soviero sets sail.

About Adviser Investments
Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. We advise more than 2,500 clients and have over $3 billion under management. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. In 2016, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts for the fourth consecutive

year. We have also been recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014, 2015 and 2016.

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