Smart ETF Analysis

South Africa Quality ETF

Analyst: Orin Tambo, CFA

Fund information		Market data as at 05 February 2019	
Launch date	26 September 2019	Spot price	838c
Trading symbol	STXQUA	12-month high	R10.86
Fund size (@ 05 Feb 2019)	R156m	12-month low	780c
Total expense ratio p.a.	0.40%	Ave monthly volume	209,000
Risk rating	High	Index price: earnings ratio	N/A
Benchmark	S&P Quality South Africa Index	Index dividend yield	3.11%

Fundamental Analysis

Given the heightened uncertainty and a subdued outlook for local equities, we think some of the "smart beta" funds on the JSE are going to become handy. For example, funds that are focused on lower volatility (Absa NewFunds Low Volatility) and value (Absa NewFunds Value Equity) can help to stabilise portfolio risk in choppy markets. In this article we analyse the Satrix SA quality ETF, another smart beta fund which is also worth considering in today's economic environment.

But before analysing the Satrix ETF, let's look at what "smart beta" is and why these funds have become so popular. Smart beta is an index strategy which selects and weights portfolio holdings based on investment characteristics other than market capitalisation. While most traditional funds select and weight constituents based on their size, smart beta tilts portfolios towards stocks that exhibit certain investment characteristics such as quality, value and low volatility.

Other than diversifying a portfolio, smart beta funds offer investors exposure to profitable investment strategies that were previously accessible only to active fund managers. And they offer that exposure at a fraction of the cost of actively managed funds.

But what probably propelled them to popularity is the prospect of outperforming the market without assuming excessive risk. Several empirical studies show that some smart beta strategies outperform the broad market index in the medium to long term.

However, not all smart beta funds are worth investing in. A study by Beck, Hsu, Kalesnik, & Kostka (2016) which won the coveted Chartered Financial Analysts Journal Graham & Dodd Award of Excellence for 2016, found that only a handful of investment characteristics are robust in that they outperform consistently in different markets and in differing market conditions.

This means investors should carefully analyse the philosophy behind the strategy and conduct a thorough background study before adding a smart beta to a portfolio.

Our focus for this week, the Satrix SA Quality ETF, selects its constituents on the basis of their quality metrics. It calculates the score as a composite of profitability, liquidity and financial leverage ratios. The fund takes the top 20% of the S&P South Africa composite universe with the highest aggregate quality scores. Weightings are based on the counter's market capitalisation in the S&P South Africa composite universe, subject to security and sector constraints.

The concept of quality investing originated in the bond markets where both the quality and price of potential investments are determined by ratings. The same concept is now being applied to equity markets. Benjamin Graham, considered the founding father of value investing, was the first to recognise the quality issue among equities back in the 1930s. Since then many scholars have found evidence that portfolios sorted on factors such as profitability and earnings quality generated high risk-adjusted returns relative to a market benchmark portfolio such as a top 40 fund.

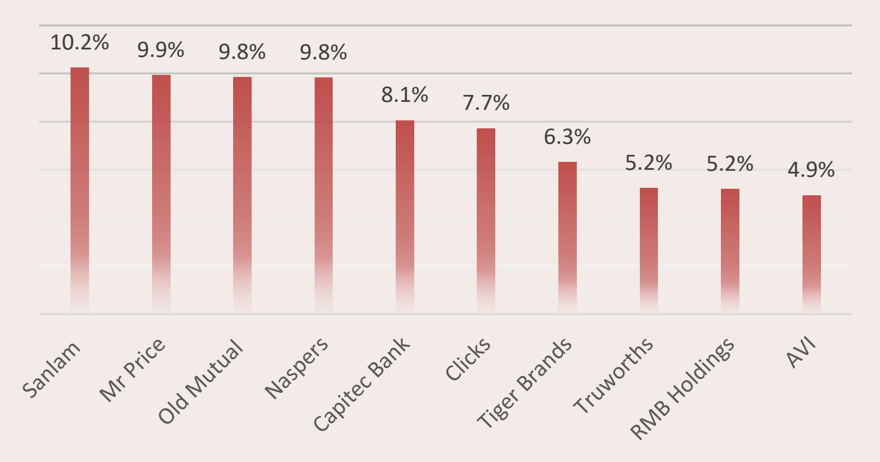
The main downside of portfolios based on quality factors is that they tend to underperform relative to the broader market in a protracted and trending bull market. Beck (et al., 2016) also found that a quality factor portfolio has weak robustness.

In terms of suitability, we think the Satrix SA Quality ETF will appeal to long-term investors who can stomach variability in the short term. As a single factor smart beta, it is vulnerable to market cycles. To counter that weakness, Satrix SA Quality should be added to an already diversified fund, or to a portfolio of smart beta funds already tracking other factors such as momentum, value and size.

Top holdings and methodology

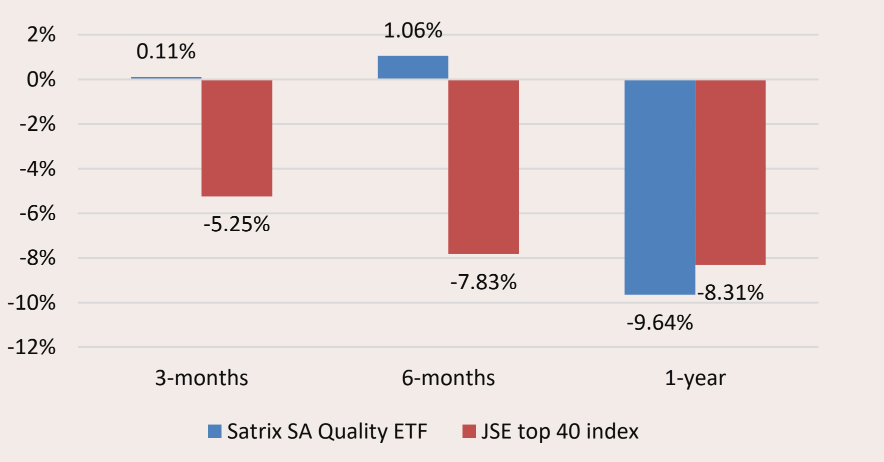
The Satrix Quality SA ETF tracks the S&P Quality South Africa Index, which tracks high-quality stocks in the South African market by quality score. This quality score is based on a company's return on equity and its accruals and financial leverage ratios. The fund is well diversified across sectors and securities.

Index top holdings at 31 December



Historical performance

Net asset value performance to end-December



The Satrix SA Quality ETF has so far failed to live up to expectations. It lost 9.64% during the year to end-December, which is worse than the loss of 8.31% recorded by the top 40 index. However, the fund is significantly ahead of the market over the past three- and six-month periods.

Suitability

In terms of suitability, we think Satrix SA Quality ETF suits long-term investors who can stomach return variability in the short term. As a single-factor smart beta fund, the ETF is vulnerable to market cycles.

Fees

The ETF has a total expense ratio of 0.4%, which we think is a bit steep for a local fund.

Alternatives

There are no like-for-like alternatives for the Satrix SA Quality ETF.

References: *Beck, N., Hsu, J., Kalesnik, V. & Kostka, H. 2016. Will Your Factor Deliver? An Examination of Factor Robustness and Implementation Costs. Financial Analysts Journal, 72(5): 52–83. www.cfapubs.org 16 November 2017.*