Do you know what you're betting on?

Smart beta strategies are growing in popularity and can be a good way to gain systematic exposure to an investment strategy or theme. But as with all investment strategies, it is important that investors fully understand the exposures that they are taking on.

Our analysis of three of the most prominent US equity income smart beta indices shows that in addition to selecting higher yielding stocks, these indices have significantly different industry sector exposures compared to the broader market. Such relative sector bets are a consequence of the methodology used to select and weight the stocks, and can significantly influence returns. By including risk management principles within the index construction, we think it is possible to control sector positioning and more accurately target the income exposure that is desired.

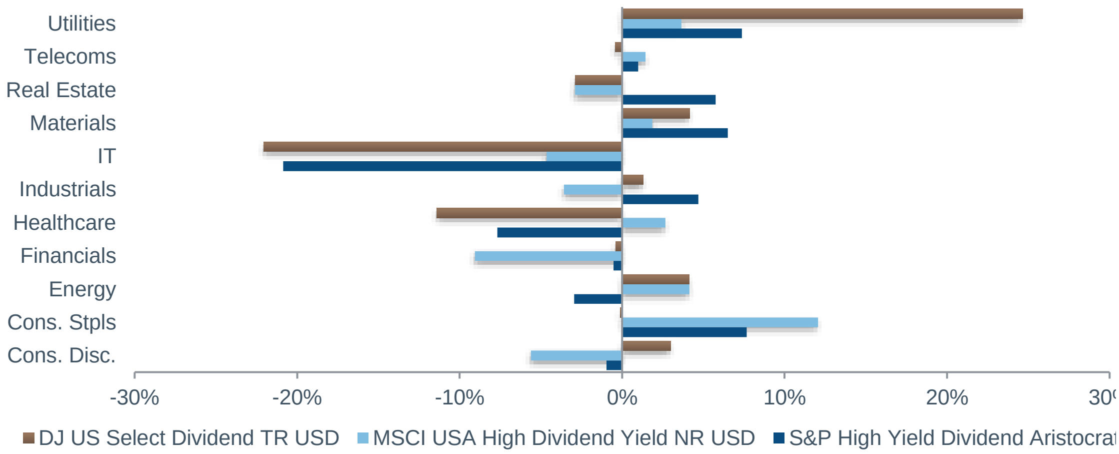
The law of unintended consequences

There are a number of smart beta indices which seek to provide exposure to high dividend yielding US stocks. These indices usually maintain significantly different sector exposures to the broader market, as represented by a market capitalisation weighted index such as the S&P 500. The indices used by the leading European domiciled ETFs following this strategy are:

- S&P High Yield Dividend Aristocrats Index
- MSCI USA High Dividend Yield Index
- Dow Jones US Select Dividend Index

Chart 1 shows that these three indices have substantial sector weight deviations from the S&P 500 index as at the end of December 2017.

Chart 1: US income indices sector weights diverge from S&P 500



Source: Fidelity International / Morningstar Direct as at 29/12/17. Relative weights may vary over time. Based on DJ US Select Dividend Index vs S&P 500 Index, MSCI USA High Dividend Yield Index vs S&P 500 Index, S&P High Yield Dividend Aristocrat Index vs S&P 500 Index.

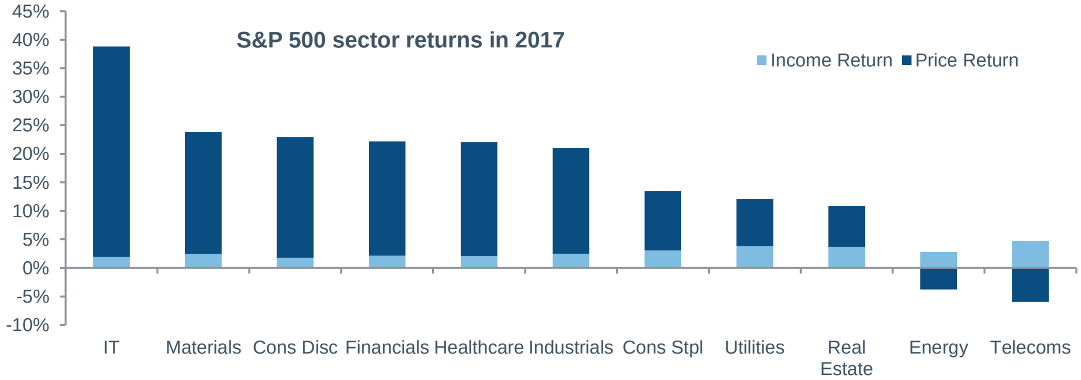
This can lead investors to taking inadvertent positions in sectors.

For example, as at the end of December 2017, the DJ US Select Dividend index had an allocation to utilities that was 25% higher than the S&P 500 index. The allocation to information technology was 22% lower than the S&P 500 index. That constitutes a sizeable relative bet that utilities will outperform and IT will underperform the broader stock market, over and above the intended exposure to higher-yield stocks. Effectively, investors hold an implicit bet on sector disparities. In this case, if utility stocks lag IT stocks, the underperformance due to sector positioning could undo any potential outperformance from the intended equity income strategy.

Chart 2 shows sector returns in the S&P 500 in 2017, and how sector weight deviations can influence performance;

- S&P High Yield Dividend Aristocrats, on 29 December 2017, was underweight in IT (-20%), which was the year's best performer (total return 38.8%), while overweight real estate (6%), which was the third's worst performer (total return 10.9%)
- MSCI USA High Dividend Yield, on 29 December 2017, was overweight consumer staples (12%), which returned 13.5% and underweight financials (-9%), which returned 22.2%
- DJ US Select Dividend, on 29 December 2017, had a large overweight to utilities (25%) and an underweight to IT (-22%). The utilities overweight added less overall portfolio return than the large underweight to IT detracted from it, given the stellar performance of IT but relatively weak performance of utilities. So the foregone total return from the underweight to IT relative to the S&P500, more than cancelled out the gain from the overweight to utilities.

Chart 2: Indices can be overexposed to underperforming sectors



Source: DataStream, Morningstar Direct, 29 December 2017.

Why do these sector discrepancies exist? The simple answer is that it boils down to different sectors having differing yield profiles, and selecting the higher-yielding stocks without considering sector exposure naturally concentrates exposure to the highest-yielding sectors.

Index design is key

Each of these indices is designed to provide exposure to higher-yielding US equities. However, within the index construction process there are numerous decisions to be made which can have significant implications for the investment outcome.

- The S&P High Yield Dividend Aristocrats Index selects stocks which have increased dividend payments for the last 20 years and then weights these according to their indicated dividend yield. As the sector to which the stocks belong is not considered as part of the selection or weighting, this results in sector imbalances relative to the broader market. For example, as at the end of December 2017, the allocation to IT stocks was underweight of 21% versus the S&P 500.

- The DJ US Select Dividend Index applies a series of earnings-based screens and then picks the 100 stocks which pass these screens and have the highest dividend yield. These stocks are then weighted according to their indicated dividend yield. The approach results in some significant relative sector allocations. As at the end of December 2017, IT and healthcare are underweight by 22% and 11% respectively, while utilities are overweight by 25% versus the S&P 500.
- The MSCI USA High Dividend Yield Index uses a series of screens including dividend sustainability and quality screens. The index then selects stocks which have a yield of at least 1.3 times the yield of the MSCI USA index. The stocks are then weighted according to their market capitalisation. At the end of December 2017, companies in the consumer staples and healthcare sectors combined accounted for an overweight of 15% versus the S&P 500, while financials are underweight by -9%.

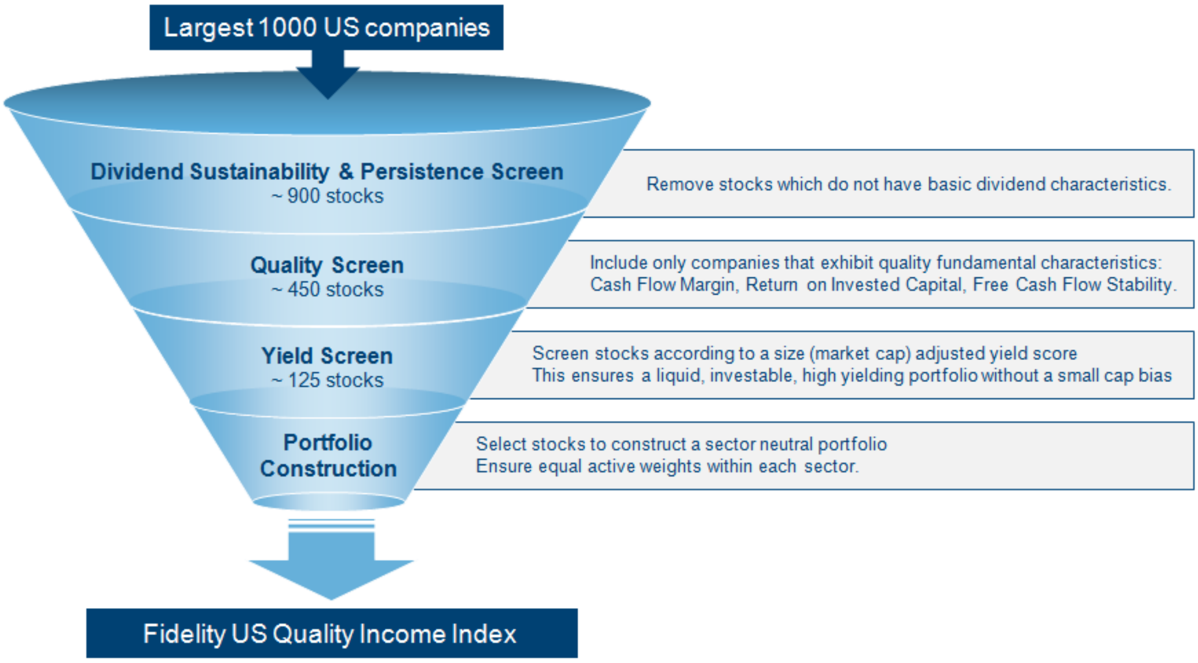
Source: Fidelity International, Morningstar Direct, 29 December 2017.

Smarter construction

By considering the yield of stocks relative to their sector, it is possible to provide exposure to equity income without an inherent sector bias. The Fidelity US Quality Income Index applies a series of screens to assess dividend sustainability and to identify good-quality stocks, based on their cash flows and profitability. The index methodology then selects the highest yielding stocks **within each sector**.

The constituents are then weighted by their market capitalisation plus an 'equal active' overweight. The equal active overweight distributes an equal excess weighting to all the selected stocks within a sector so that the total sector weight is the same as the starting universe. This approach controls stock specific risk and maintains the sector exposures of the boarder market.

Chart 3: Systematic investing through Fidelity indices to avoid sector biases

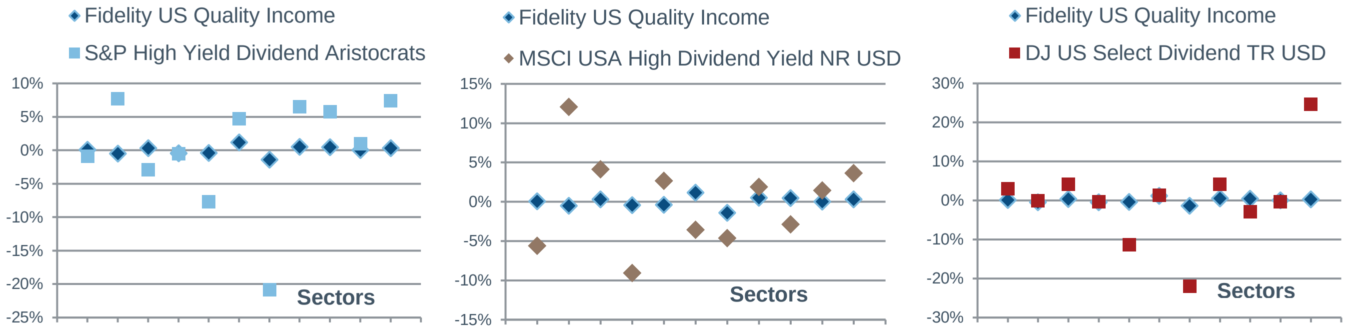


Source: Fidelity International, December 2017.

What does the data show?

The risk controls built into the index methodology produce significant changes in sector allocations versus other indices. Chart 4 compares the sector allocation deviations of the Fidelity US Quality Income Index from the S&P 500 sector weights against each of the other indices in turn, demonstrating the impact that index construction can have on industry weighting. **The approach enables investors to take quality income exposure without significant relative sector positions**.

Chart 4: Risk controls reduce sector biases compared to other indices



Source: Fidelity International, Morningstar Direct, 29 December 2017, Sector allocation deviations from the S&P 500 sector weights.

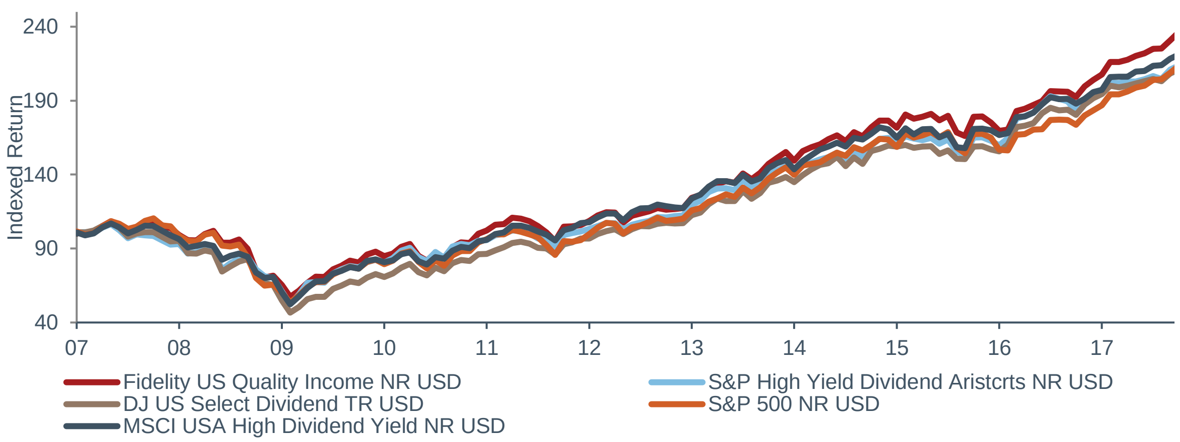
What is the result?

Past performance and simulated past performance are not a reliable indicator of future returns. Fund performance and index performance may vary. The value of investments can go down as well as up and you may get back less than you invested.

Chart 5 shows the 10-year back tested performance of the Fidelity US Quality Income Index compared to the S&P High Yield Dividend Aristocrats, MSCI USA High Dividend Yield and the DJ US Select Dividend indices. The selection and weighting approach of the Fidelity US Quality Income Index has resulted in improved returns and reduced volatility relative to the broader market (as represented by the S&P 500 index) and the other dividend-focused indices. Tracking error relative to the S&P 500 index is significantly reduced due to the risk controls in place.

The 12 month yield of the Fidelity US Quality Income Index was 2.6% as at the end of December 2017. This is above the S&P 500 and comparable with the other dividend-focused indices.

Chart 5: Historical track records of income indices



Performance Statistics (31 Dec 2006 to 31 Dec 2017)	Fidelity US Quality Income Index *	S&P 500 Index	S&P High Yield Dividend Aristocrats Index	DJ US Select Dividend Index**	MSCI USA High Dividend Yield Index
Annualised Return (% p.a.)	8.6	7.5	7.6	7.5	7.9
Annualised Volatility (% p.a.)	14.0	14.6	14.8	14.7	13.6
Tracking Error (% p.a.)	2.4	-	7.7	8.3	5.8
Max Drawdown (%)	-47.1	-51.4	-50.5	-56.6	-51.1
Yield (% last 12 months)	2.6	1.9	2.6	3.5	2.9

Past Index Performance - Annualised Return (% p.a.)

- The Fidelity US Quality Income UCITS ETF launched on 27.03.2017

	31.12.12 - 31.12.13	31.12.13 - 31.12.14	31.12.14 - 31.12.15	31.12.15 - 31.12.16	31.12.16 - 31.12.17
Fidelity US Quality Income Index *	32.2	13.7	-0.7	16.5	21.4
S&P 500 Index	31.5	13.0	0.7	11.2	21.1
S&P High Yield Dividend Aristocrats Index	29.5	13.3	-1.2	19.6	15.4
DJ US Select Dividend Index**	29.1	15.4	-1.6	22.0	15.4
MSCI USA High Dividend Yield Index	27.6	13.8	-0.3	15.1	18.4

Source: Fidelity / Bloomberg / Morningstar Direct 31/12/17. Fidelity US Quality Income ETF has been launched on 27/03/2017. Basis: income reinvested in USD. Risk metrics based on monthly performance. Tracking error vs. S&P 500 Index. *Based on the backtested track record of the Fidelity US Quality Income Index. **Total Return Index used. The yields quoted for the indices are sourced from Bloomberg. The yield is calculated as the sum of the gross dividends per share amounts that have gone ex-dividend over the prior 12 months, divided by the current stock price.

Conclusion

There are an increasing number of smart beta products available to investors. These can be useful tools to access investment themes but investors need to fully understand the positions that the products are taking and the risks that they are exposed to.

Our analysis reveals the sector disparities that can result from various US equity income strategies. Investors need to be sure that such sector positions are aligned with their own sector views. If this is not the case, or if they wish to avoid sector biases altogether in their exposure to income-paying stocks, it may be preferable to control sector positioning relative to the broader market.

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