PIMCO

STRATEGY SPOTLIGHT

September 2017

PIMCO RAFI Dynamic Multi-Factor ETFs: A Timely Solution for Smart Beta Investors

AUTHORS

Robert Arnott
Founder and Chairman
Research Affiliates

Christopher Brightman
Chief Investment Officer
Research Affiliates

Equity markets have had an incredible run since the global financial crisis, but with prospects for lower returns and the persistent failure of traditional stock pickers to beat their benchmarks, investors are seeking strategies that provide the potential for more reliable outperformance. Many may consider smart beta strategies, which can offer the potential for higher returns and can serve as a complement to traditional approaches in a diversified equity allocation. Yet the increasingly disparate smart beta and factor landscape can be overwhelming, and as with any investment approach, there are risks of both underperformance and performance-chasing.

To help investors harness the potential benefits of smart beta while addressing these challenges, PIMCO has partnered with smart beta pioneer Research Affiliates to launch a suite of equity exchange-traded funds (ETFs). The PIMCO RAFI Dynamic Multi-Factor ETFs seek to provide diversification and structural sources of potential returns through an innovative methodology that introduces "buy-low, sell-high" discipline to factor investing. Incorporating the latest research from Research Affiliates, the PIMCO RAFI Dynamic Multi-Factor ETFs offer a differentiated solution for smart beta investors that seeks to address some key pitfalls of typical multi-factor approaches.

In this Q&A, Research Affiliates Founder and Chairman Rob Arnott and CIO Chris Brightman discuss the rationale for launching the RAFI Dynamic Multi-Factor strategies and what sets them apart in an increasingly fragmented market.

Q: Why did Research Affiliates decide to launch the RAFI Dynamic Multi-Factor strategies?

Arnott: At Research Affiliates, we aim to introduce a strategy only if we believe it represents a truly new product (as with our Fundamental Index, a forerunner of today's smart beta approaches) or significantly advances an existing product area (as with All Asset, which took global tactical asset allocation into real return and liquid alternatives markets). Nor do we intend to introduce a strategy unless we're confident that it could meaningfully improve investors' potential long-term outcomes.

As most investors familiar with us know, Research Affiliates' strategies are made available to investors only when partners, like PIMCO, use them to create investable products – so it doesn't make sense for us to launch "me too" strategies. We introduce new strategies if we believe the conventional wisdom or existing solutions are missing something important and that we can offer something much better. In creating the RAFI Dynamic Multi-Factor strategies, we were looking to address two key issues with typical multi-factor approaches:

- **The factor portfolios often don't provide robust sources of excess returns**. By marrying five key factors – value, momentum, quality, low volatility, and size – with our RAFI Fundamental Index, RAFI Dynamic Multi-Factor seeks to provide a more reliable engine for potential alpha.
- **The factor portfolios are generally weighted equally, regardless of valuation**. But we believe relative valuation matters. By actively considering valuations when determining portfolio weights, we seek to reduce exposure to the most expensive factors.

The impetus behind the RAFI Dynamic Multi-Factor strategies is compelling: By combining multiple sources of excess return into one diversified portfolio, we seek to maintain modest risk relative to a cap-weighted benchmark, while at the same time offering a powerful opportunity for excess returns. We are confident that these strategies provide investors the potential benefits of a multi-factor approach while seeking to avoid their typical flaws.

Q: How does the design of RAFI Dynamic Multi-Factor seek to address the problems you've identified with other multi-factor strategies?

Brightman: Smart beta approaches in general aim to deliver well-documented means for producing excess returns, generally through simple, transparent, low-cost index products. We believe multi-factor strategies – a fast-growing segment within the smart beta category – can potentially provide a smoother path to outperformance by diversifying across several sources of expected excess return. These considerations all informed the design of the RAFI Dynamic Multi-Factor strategies.

Let's begin with the choice of factors. We selected five robust factors that, based on our research, academics and practitioners expect to provide persistent opportunity for excess return. **Value** and **momentum** seek to capture the predictability of stock prices – long-term mean reversion following short-term momentum. **Quality** measures the health of the business underlying a stock. An allocation to **low volatility** seeks to help reduce risk. And **size** comes into play because these factors tend to be more effective when applied to smaller, less efficiently priced stocks – so small companies may provide higher returns within a smart beta strategy.

Within each geographic region we create five simple smart beta portfolios corresponding to these five factors. We seek to populate the value portfolio with the cheapest stocks; the momentum portfolio with stocks that have the strongest recent price trends; the quality portfolio with the most profitable firms, whose management demonstrates disciplined capital allocation; and the low volatility portfolio with the lowest-risk stocks. To construct our size factor portfolio, we employ each of the other four factor strategies across the universe of small companies.

As the RAFI name implies, we weight and rebalance the stocks within each portfolio according to the *fundamental* size of the underlying companies, thereby providing a rebalancing return at the individual stock level. The momentum portfolio is an exception; here we set weights according to market capitalization in an effort to better capture price trends.

Finally, we construct multi-factor portfolios by allocating to the five factor portfolios. We then dynamically weight our five factor portfolios to construct the RAFI Dynamic Multi-Factor strategy.

Q: Why do you think the PIMCO RAFI Dynamic Multi-Factor ETFs are an attractive option for investors?

Arnott: Many investors are transitioning from high-cost traditional active managers to less-expensive factor strategies in search of more reliable excess return potential at lower fees. However, switching to a factor strategy necessitates a couple of decisions. Which factor or factors should you select? And how much should you allocate to each factor?

The recent explosion in factor strategies has been astounding. Fueled by easy access to data, product providers have introduced a multitude of new factors to differentiate their products, and academics are continually discovering new factors (and publishing their findings). In fact, so many factors have been introduced that researchers Campbell R. Harvey and Yan Liu felt the (we think justifiable) need to write a paper explaining how to make sense of all of the factor papers their fellow academics were publishing.[1]

Given this proliferation of options, factor selection is no trivial exercise. At Research Affiliates, we have chosen to focus only on the handful of factors – value, momentum, quality, low volatility, and size – that we believe best capture the potential for discrete future excess returns. In our view, adding more factors would only introduce redundancy and make the prospects for outperformance less certain.

Surprisingly, most multi-factor providers simply equally weight their factor portfolios, regardless of the valuation or recent performance of those factors. We see a big problem with this approach. In our view, factors that are cheap relative to their historical norms are better positioned for excess returns, and vice versa. For this reason, we settled on a novel methodology for weighting each of the factor portfolios that pays attention to valuation – and to seek to avoid the tendency to trade too early, we paired this valuation-based approach with a momentum component.

Taken together, we believe these attributes make the RAFI Dynamic Multi-Factor strategies a compelling option for smart beta investors.

Q: What sets RAFI Dynamic Multi-Factor apart from other multi-factor strategies?

Brightman: We believe our strategy differs from others in the market in two important ways.

First, as the RAFI name implies, we weight and rebalance stocks according to the *fundamental* size of the company, whereas most others anchor on capitalization weights. Our research demonstrates that fundamental weighting provides greater potential for excess returns, and a dozen years of live performance for the RAFI Index backs this up. Such systematic, contrarian rebalancing provides a clear point of differentiation from other multi-factor strategies and offers a potential performance tailwind.

Second, to our knowledge RAFI Dynamic Multi-Factor is the only multi-factor strategy available through a U.S. listed ETF that dynamically weights its factor allocations. In an effort to boost expected returns, we aim to be overweight cheaper factors with positive recent price trends and underweight expensive factors with negative price trends. Nonetheless, we maintain at all times a significant allocation to each factor to avoid overconcentration in any individual factor and to help ensure broad diversification.

We believe our thoughtful approach to multi-factor investing creates the potential for excess returns through both our factor portfolio construction and our dynamic allocation to the individual portfolios. Additionally, our use of multiple factors aims to provide a smoother ride by reducing tracking error. We believe this combination of excess return potential and modest tracking error from diversification makes RAFI Dynamic Multi-Factor an attractive strategy for smart beta investors that is truly distinct from typical multi-factor solutions.

[1] See "Lucky Factors," published 22 November 2014.

PIMCO

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the Fund's prospectus, which may be obtained by contacting your PIMCO representative. Please read the prospectus carefully before you invest.

The terms "cheap" and "rich" as used herein generally refer to a security or asset class that is deemed to be substantially under- or overpriced compared to both its historical average as well as to the investment manager's future expectations. There is no guarantee of future results or that a security's valuation will ensure a profit or protect against a loss.

Past performance is not a guarantee or a reliable indicator of future results.

A word about risk: Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in **foreign-denominated and/or -domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Model Risk** is the risk that the investment models used in constructing the Underlying Index may not adequately take into account certain factors and may result in a decline in the value of the Underlying Index and, therefore, the Fund. **Management and Tracking Error Risk** is the risk that the portfolio manager's investment decisions may not produce the desired results or that the Fund's portfolio may not closely track the Underlying Index for a number of reasons. **Derivatives** may involve certain costs and risks, such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

Exchange Traded Funds ("ETF") are afforded certain exemptions from the Investment Company Act. The exemptions allow, among other things, for individual shares to trade on the secondary market. Individual shares cannot be directly purchased from or redeemed by the ETF. Purchases and redemptions directly with ETFs are only accomplished through creation unit aggregations or "baskets" of shares. Shares of an ETF are bought and sold at market price (not NAV). Brokerage commissions will reduce returns. Investment policies, management fees and other information can be found in the individual ETF's prospectus.

Premiums (when market price is above NAV) or discounts (when market price is below NAV) reflect the differences (expressed as a percentage) between the NAV and the Market Price of the Fund on a given day, generally at the time the NAV is calculated. A discount or premium could be significant. Data in chart format displaying the frequency distribution of discounts and premiums of the Market Price against the NAV can be found for each Fund at www.pimcoetfs.com.

Smart beta refers to a benchmark designed to deliver a better risk and return trade-off than conventional market cap weighted indices. PIMCO's **liquid alternative strategies** are without the principal lock-ups of traditional private equity funds and hedge funds and include separate accounts whose holdings can be liquidated at a client's request subject to current market conditions, mutual funds that can be liquidated at NAV on a daily basis and ETFs that can be liquidated on the secondary market under normal market conditions. There is no guarantee that a security will be able to be liquidated in a timely fashion or when it would be most advantageous to do so.

PIMCO Investments LLC, distributor, 1633 Broadway, New York, NY, 10019 is a company of PIMCO.

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com
blog.pimco.com

CMR2017-0828-286891

PC234_53953