VictoryShares™

Life isn't binary. Neither is your portfolio.

Strategic beta bridges the gap between active and passive, but one size does not fit all.

SMART BETA, DUMB NAME

Strategic beta—often called smart beta—refers to a group of indexes and related investment products that aim to provide an alternative to traditional market-cap weighting strategies of passive investments. The universe of these products is growing rapidly and covers such a diverse array of investment philosophies that it calls into question whether it's "smart" to lump all these strategies into the same bucket. Investors should be savvy to the broad nature of this category of investments and, importantly, understand the underlying rules and approach used by each strategic beta index and corresponding product prior to any allocation decision.

THE ACTIVE VERSUS PASSIVE debate is not black and white. There are many flavors of both active and passive management, and thus the competition between the two—as often framed by pundits—is a tad simplistic. Significantly more contemplation is required. Rather than a myopic focus on labels, astute goals-based investors should step back to: 1) consider their near- and long-term objectives and 2) determine how different approaches can work in tandem to move toward that goal.

Only in a more holistic context can investors begin to assemble portfolios with the appropriate building blocks (i.e. investment products) that may offer the greatest probability for success. In all likelihood, investors will find that there's room for both passive and specialized active strategies, as well as some potentially promising approaches that bridge the gap between the two.

One such blended approach that's gaining popularity, and in some cases notoriety, is strategic beta. The strategic/smart beta category has grown rapidly for its potential to deliver on the coveted benefits of skilled active management, primarily alpha[1] generation and risk reduction, but in a wrapper that also has some of the attractive attributes of passive approaches, not the least of which are low relative costs. It's easy to see why that might appeal to investors.

However, it's important to remember that strategic beta is not "one" thing. It should not be viewed as an asset class. In reality, the strategic beta umbrella covers a diverse array of approaches. Used appropriately, it has the potential to effectively supplement both skilled active management and traditional passive strategies that may help solve for any number of vexing investor challenges. But care is required because allocating to strategic beta is not a simple asset allocation decision. Rather, selecting individual strategic beta products and incorporating them in a portfolio is a careful process made in the context of specific investor goals and risk budgets.

Three legs of a stool

Within the active versus passive debate, investors are trying to balance three critical components: return, risk, and cost. In terms of returns, more is better. In terms of risk and costs, less is more. This potential combination is the lure of strategic beta and the reason for its soaring popularity.

"Strategic beta provides a disciplined, active-like approach to indexing in a cost-effective manner, and it does a good job at balancing those three legs of the stool," explains Mannik S. Dhillon, President of VictoryShares and Solutions with Victory Capital. "It allows for transparent exposure to a portfolio of preferred factors[2] and intuitive tilts. And as a strategic tool,

1 Alpha refers to the excess returns of a fund relative to its benchmark index.

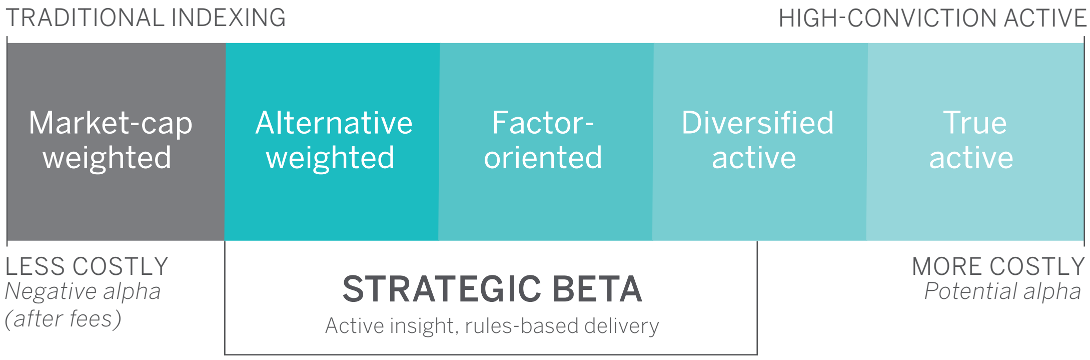
2 Factors refer to widely accepted investment characteristics or attributes that investors often seek to isolate in an effort to capture higher returns.

The traditional mindset

Investors and advisors have historically made allocation decisions through a binary lens:

The new reality

Strategic beta, which bridges the gap between active and passive investing, comes in many shades and can play an important role in an investor's portfolio:



I think it can enhance a passive allocation and counterbalance some of the inherent biases and other limitations of cap-weighted indexing, while striving to deliver alpha at lower costs than active strategies."

On the active-passive spectrum, Dhillon considers strategic beta to be more of an active product, but grounded in rules that can be vetted by history in different market environments. These types of rules-based strategies make sense, he argues, as they offer the potential for attractive returns and reduce risk at lower relative costs. "It's active intuition with passive delivery," he says.

Active management still seems to make sense in more inefficient or niche areas of the equity market where managers can exploit information inequalities and otherwise leverage their skill. However, in some highly liquid, large-cap market sectors, it's becoming increasingly difficult to consistently outperform popular benchmarks, to say nothing about convincing investors that they should deploy their fee and risk budgets to such active strategies. This is likely to remain the case as long as the performance of the top-heavy constituents of cap-weighted indexes continue to drag-up performance. When that changes, sentiment might also shift with regard to investors' embrace of all things passive.

"Strategic beta provides a disciplined, active-like approach to indexing in a cost-effective manner..."

Mannik S. Dhillon, CFA, CAIA

President of VictoryShares and Solutions

"I feel the velocity and volume of information and data in general have made it difficult for the closet-indexers of the past to maintain an edge, but there are still active specialists building high-conviction portfolios across all parts of the cap spectrum that are worth considering," says Dhillon.

Daring to be different

The name strategic beta may be relatively new, but the actual concept is not. Investors have realized that in order to capture alpha—excess returns over a benchmark, such as a traditional cap-weighted index—they must dare to be different than the index. It's that simple. Historically, that has meant using a quantitative or qualitative active approach and investing in vehicles that allocate substantially to stocks or bonds that are not part of a benchmark, or at a minimum to weight those constituents alternatively.

Investors also have historically attempted to exploit the established characteristics or factors that power equity risk premiums. That's not new either. Sophisticated investors have been trying for years to capture alpha by selectively tilting toward small size, quality, or growth, among others.

"But what if you combine the two approaches—developing an index that not only favors certain factors, but also assembles constituents in ways dissimilar to cap-weighting?" asks Dhillon. "And what if you could do all this in a disciplined and transparent manner, and for a reasonable cost less than many active strategies?"

Solving for an outcome

So while institutional investors conceptually have been employing non-cap weighted approaches for decades, some continue to take a blanket approach to smart beta searches.

"It's not unusual to see RFPs[3] that view strategic beta as a single category," explains Dhillon. "But that doesn't make any sense to me because I don't view strategic beta as an asset class. Rather, I think it's imperative to work backwards and begin with an investment goal, and then embark on a search for the right strategy. For example, if you want to increase your exposure to emerging markets, why start with a preconceived notion that you want to invest in active or passive in isolation? All approaches should compete against one another.

"In fact, I would advocate for taking an outcome-oriented approach for just about any segment of the portfolio," he continues. "What's the obsession with naming the bucket, regardless of whether it's active, passive or something in between? Let's solve for an outcome and then select the best strategy for the job."

This point cannot be overemphasized. For starters, investors and their advisors need to determine what each portfolio is lacking. There needs to be a clear understanding of the challenges at hand and the desired outcome. Bypassing this critical first step and arbitrarily trying to fill an allocation bucket with random strategic beta funds can have unwanted ramifications. Such a short-sighted approach could skew the portfolio with sector

3 Request for Proposals, often used to solicit information from and evaluate investment managers.

biases or inadvertently double down on unintended factor exposures. The result could be a drag on the overall portfolio or movement away from the desired goals.

Portfolio construction primer

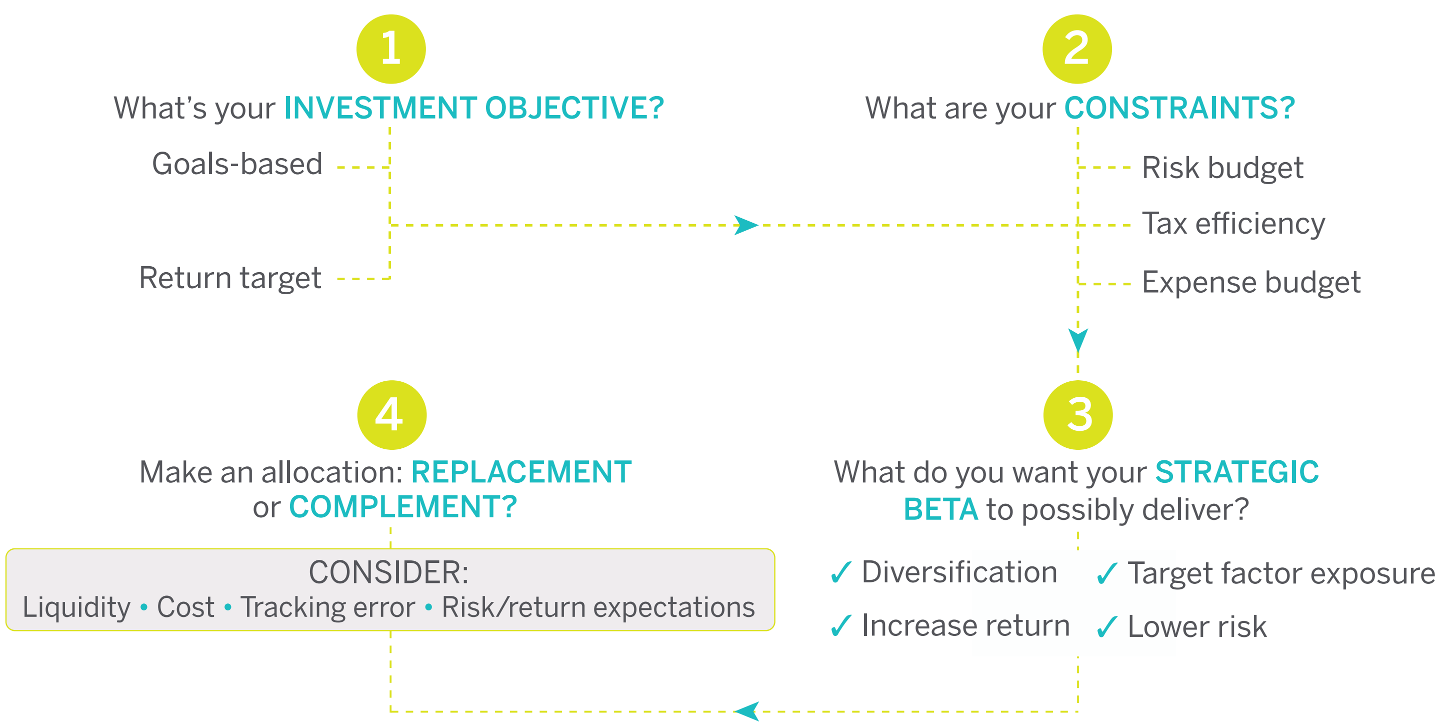
If investors accept the appeal of relatively lower-cost, rules-based strategies to either replace some core allocations or as a complement to solve for a specific goal, the logical next question becomes: How exactly does it actually fit in a portfolio? Unfortunately, the answer is not a simple formula or percentage based on age or years to retirement as with rudimentary allocation decisions. The answer always depends on each investors' defined objective or the inherent limitations of an existing portfolio.

Consider the approaching retirement conundrum facing many investors. An average 50-year-old (depending on his or her current net-worth, trajectory of earnings, savings and spending) may need to achieve a return of eight percent per year to reach a given nest egg milestone, which in turn may allow for a comfortable retirement lifestyle. That would not be an uncommon scenario today, though achieving that goal appears to be getting more challenging given where we are in the cycle and lower forward return expectations for both stocks and bonds. If that investor has a simple "diversified" 60/40 portfolio of equities and fixed income, where will that investor make up the anticipated shortfall?

The challenge that this investor needs to solve for here is excess return (and possibly income in a few years), but

"To balance that fee budget, investors might consider replacing some active equities allocation with a slice of strategic beta."

Strategic beta decision tree



This material is hypothetical and presented for illustrative purposes only.

within the context of acceptable risk and cost parameters. In other words, it's probably not suitable to ratchet up the leverage on this portfolio as retirement approaches. And in the same manner, it might preclude an overweight position in potentially higher-returning frontier or emerging market equities, or an all-in approach on MLPs[4] or emerging market debt funds for income. In addition, investors should not forget the implications of volatility and correlation of assets[5] in the portfolio.

So what are the options here? Adding a few slices of various strategic beta products to the portfolio, depending on the specific approach of each fund and the investor's risk tolerance, might be appropriate. For example, an investor could replace some passive core equities allocation with a slice of a strategic beta that combines fundamental criteria and volatility weighting in an effort to outperform traditional cap-weighted indexing. This opens the possibility to a capturing some alpha, acknowledging that expenses for this portfolio slice will be slightly-to-modestly higher than the high single-digits of basis points charged by some of the most efficient S&P 500® Index funds.

To balance that fee budget, investors might also consider replacing some active equities allocation with another slice of strategic beta—possibly a fund that offers investors a rules-based approach to capture potential alpha from small-cap stocks—but at a cost that may be significantly lower than typical actively managed funds.

"...it's critical to compare strategies on a risk-adjusted basis rather than on absolute performance."

From an overall portfolio perspective, these slices might also be used to tilt the portfolio and help balance those three components of risk, cost and return in a way that may position the investor to achieve his or her stated goal.

"What you want is to be able to take more risk somewhere without throwing the whole portfolio off plan," Dhillon continues. "A strategic beta product might offer a chance to potentially capture some excess returns or income by exploiting a set of factors, for example, and doing so at a lower cost than your typical active fund. And in turn, this might even allow you to reallocate risk or fees to niche products or other areas of the portfolio."

Ultimately, incorporating strategic beta is not a binary decision. Investors will need to look within before determining whether the potential benefits have a place in their individual portfolio. Investors should expect the typical strategic beta product to cost a bit more than the few basis points of the largest passive funds, but these products also should be more cost-effective than other active approaches that endeavor to deliver alpha. And in terms of evaluation, it's critical to compare strategies on a risk-adjusted basis rather than on absolute performance. Relative is the key word here when contemplating the costs, risks, and return potential of strategic beta. VS

4 Master limited partnerships are tax-advantaged investments, often focused on income generation but also considered to carry elevated risks.

5 Correlation of assets refers to how types of investments move in relation to one another.

Seven steps to strategic beta

Following this seven-step process should enable investors to incorporate strategic beta products effectively into their overall investment portfolios:

1. Without fail, the process always begins at the conclusion. In other words, what is the desired outcome? Absent this critical first step, any allocation process may be doomed.

2. To achieve the desired goal, understand exactly how the strategy is daring to be different than the benchmark? Are there factor tilts or potential sector biases associated with this strategy?

3. How intuitive is the methodology? Step back and forget the actual math and science, and instead consider if the concept makes sense.

4. Study history. Though it's no guarantee of future performance, it may help illustrate how the methodology is forecast to work in various market environments.

5. How will this allocation impact the overall risk profile of the portfolio? Will this strategy improve the diversification and lower correlation between strategies for the entire portfolio?

6. Does this allocation impact the fee budget for the overall portfolio? Remember, the benchmark for costs should not be zero, but rather measured relative to peer strategies. If a strategy offers potential alpha, the costs should be measured relative to other active approaches that aim to deliver excess returns.

7. Finally, conduct manager due diligence. Does the manager have experience managing products that track the respective indexes effectively? After all, you invest in a product, not the index.

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An investor should consider the fund's investment objectives, risks, charges and expenses carefully before investing or sending money. This and other important information about the fund can be found in the fund's prospectus, or, if applicable, the summary prospectus. To obtain a copy, visit www.victorysharesliterature.com. Read the prospectus carefully before investing.

Investing involves risk, including the potential loss of principal. Diversification and asset allocation do not guarantee a profit or protect from loss in a declining market. There is no guarantee that a strategic beta strategy will be successful. There can be no assurance that performance will be enhanced or risk will be reduced for funds that seek to provide exposure to certain quantitative investment characteristics ("factors"). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses. The annual management fees of ETFs may be substantially less than those of active mutual funds. Buying and selling shares of ETFs will result in brokerage commissions, but the savings from lower annual fees can help offset these costs. Active funds typically charge more than index-linked products for the increased trading and research expenses that may be incurred.

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