

Strategy Insights

June 2017

## Xpert Spotlight



### Thought Leadership, Exchange Traded Funds

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The second quarter of 2017 saw Russell 1000 Comprehensive Factor ETF (DEUS) deliver another small underperformance to the Russell 1000 Index. The headline numbers were: a return to the fund of 2.54% compared to the Russell 1000 Index's 3.06%, for a negative excess return of -0.51%

#### Spotlight on DEUS' Q2 2017 performance: another quiet quarter

Curiously, not only was the second quarter similar to the first from a performance perspective, but, in a few cases, some of the reasons for the underperformance were also the same. In this short note, we'll review what happened to the five factors that the fund includes, and then look at one or two of the most interesting sector and stock level results.

#### Q2 2017 factors

DEUS offers investors a starting universe of the Russell 1000 Index stocks which are then over or underweighted according to their scores on five factors:

#### Contributors

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Figure 1: ETF (DEUS) 2017 performance

	Q2 2017	Since inception
NAV	2.54%	12.37%
Market price	2.51%	12.39%
Russell 1000 Index	3.06%	12.07%

Source: Deutsche Asset Management 6/30/17. Gross expense ratio for DEUS is 0.19%. DEUS inception date is 11/24/15. **Performance data quoted represents past performance and does not guarantee future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance data visit [www.deutsche-etfs.com](http://www.deutsche-etfs.com) or call 855-329-3837.**



Figure 2: The performance of the Russell 1000 Index, the Russell 1000 Comprehensive Factor Index and the five single factor indexes (3/31/17–6/30/17)

Index	Q2 return
Russell 1000 Index	3.06%
Russell 1000 Comprehensive Factor Index	2.61%
Russell 1000 Value Factor Index	2.10%
Russell 1000 Volatility Factor Index	2.89%
Russell 1000 Quality Factor Index	4.11%
Russell 1000 Size Factor Index	2.04%
Russell 1000 Momentum Factor Index	2.65%

Source: Deutsche Asset Management 6/30/17. **Performance is historical and does not guarantee future results.** Index returns assume reinvestment of all distributions and do not reflect fees or expenses. It is not possible to invest directly in an index.

### Q2 2017 factors (continued)

Value, Size, Momentum, Quality and Low Volatility. In other papers we have gone into considerable detail about the rationale for these factors, and our methodology for combining them, but here we'd simply like to observe that each of them is expected to outperform the Russell 1000 Index on a risk-adjusted basis, both individually, and when combined.

With that in mind it's clear to see from the below table that the second quarter was not a good one for most of these factors. Indeed four of the five produced a return that was below that of the Russell 1000 Index (the vanilla market-cap benchmark against which they are evaluated). Only Quality, a factor that emphasizes the carefully defined profitability of a firm, produced market-beating performance. Typically, Quality is thought of as a defensive factor (i.e. it tends to outperform during market downturns), and of course, that wasn't the case during the second quarter. But this simply highlights the fact that a finding from a longer run relationship won't, of course, necessarily apply in the short run.

### Q2 2017 sector contributions

Despite the tendency for our fund to have had often quite different sector weights to the Russell 1000 Index for Q2, our sector level differences were fairly muted overall—ranging from an underweight in IT of –8.48%, to an overweight in Industrials of 7.45%. That said, it's always worth looking at the best and worst performances at the sector level.

Taking the best performer first, we benefitted again in the second quarter, as we did in the first, to a significant underweight in the Energy sector. DEUS had an average weight in Energy of 0.72% during these three months, and the same number for the Russell 1000 Index was 5.98%. Since we won to this underweight, it follows of course that Energy must have been down, as indeed it was, returning –7.09%.

As we mentioned last quarter, DEUS tends to underweight the Energy sector because of the Low Volatility and Size factors, which accords with intuition given the sensitivity to some of the large-cap oil majors to a volatile commodity price.

Our worst performing sector was Healthcare, where another underweight (we had 7.75% on average vs. the Russell's 13.53%) ran into an above-market return of 7.23%. Why did DEUS underweight the Healthcare sector? The answer is that of all the sectors, Healthcare has tended to have one of the worst scores for Value (which we define as a composite of price-to-sales, price-to-earnings and price-to-cash flow).

### Q2 2017 stock contributions

Switching to individual stocks, our two biggest detractors for the quarter were Amazon (0.01% of the fund) and Microsoft (0.03% of the fund). These two stocks had average weights of 1.77% and 2.47% in the Russell 1000 Index in Q2 and both had a market-beating three months returning 9.19% and 5.25% respectively. However, precisely because they are some of the biggest stocks in the Russell 1000 Index they also, necessarily, receive some of the worst scores for the Size factor (the bigger the stock the more it is penalized when it comes to size). The result is that the two stocks are effectively removed from DEUS with very small holdings of just a basis point or two. Hence the underperformance to these two stocks.

Our third biggest detractor at the stock level was Foot Locker. This time we were overweight the stock, taking it from about 0.04% in the Russell 1000 Index to 0.37% in DEUS. Unfortunately it returned –33.84% in the second quarter when the stock slid following a disappointing earnings call in May. Why did the fund take this view on the stock? At the December rebalance (all of our multifactor funds rebalance semi-annually), Foot Locker scored in the 96% percentile for Quality and around, or a little better than, average in the other four factors.

## Q2 2017 stock contributions (continued)

Let's focus on this for a moment. In December, a factor-based analysis of Foot Locker put the stock in the 96% percentile for Quality. Six months later, after a Q1 earnings call that analysts clearly didn't like, the stock was in the 98% percentile for Quality. So, effectively, a quant lens is saying that the stock continues to deliver good profitability that is not merely the result of leverage. The market though took issue with what it heard on the earnings call in May, and with a later announcement in June suggesting that a major supplier of Foot Locker may be looking to increase its online sales instead. The other factors were largely unchanged apart from two intuitive changes—the stock now exhibits worse Momentum, and better Value, as a result of the downward move in the stock price. However, the stock is still heavily favored in the fund. Its weight in the portfolio at the end of the quarter was 0.34% vs. 0.03% for the benchmark. Clearly, when it comes to man vs. machine, athletic footwear is a bone of contention. We'll watch with interest how this plays out and report back in future attributions.

Two other interesting features of multifactor investing can be gleaned from this Foot Locker story. The first is that our multiplicative, or "tilt-tilt" methodology, is often prepared to significantly over (or under) weight stocks that have high scores on our five factors. In taking Foot Locker, for example, from 4 basis points to 37 basis points, it has applied a more than 9x overweight. The second point is that factor investing is always at the mercy of idiosyncratic (stock specific) risk. And the way that it tries to mitigate against this is through diversification. (Of course, diversification cannot protect against loss.) Unlike the inch-wide, mile-deep approach of traditional fundamental analysis, factor investing instead invokes a law of large numbers, ensuring that the weights of multiple stocks are changed according to their factor scores. The expectation is that, in the long-run, the "quality" signals of the factors will dominate against the "noise" of idiosyncratic risk.

Turning to the more positive side of the ledger, our two biggest individual stock level contributors were Yum China Holdings and AT&T. The former is a stock that we took from 0.06% in the benchmark to about 0.33% in the fund. It returned 44.96% during the quarter. Conversely, AT&T was taken from 1.15% in the benchmark to 0.03% in the fund. So what did DEUS see in these two stocks that it was prepared to significantly overweight one and almost eliminate the other?

At the December rebalance (the one that set the initial weights for the following six months), Yum China scored very well for Quality and averagely for the other four factors. AT&T on the other hand, as one of the bigger stocks in the Russell 1000 Index, scored very poorly on Size which accounted for most of its underweight.

## Conclusion

In a similar vein to the first quarter of 2017, Q2 also represented a relatively muted underperformance for DEUS, our Russell 1000 Comprehensive Factor fund, against the Russell 1000 Index.

To summarize:

- The fund returned 2.54% in Q2 vs. the 3.06% of the Russell 1000. It's important to keep in mind though that DEUS has a lower beta than the market, it has about 90% of the systematic market risk that an investor takes on with a Russell 1000 investment.
- DEUS tends to underweight the Energy and Healthcare sectors, because of their poor scores on Size and Low Volatility, in the case of Energy, and on Value, in the case of Healthcare.
- We had some significant winners and losers at the individual stock level, and it's interesting and informative to consider the lens through which factor-based approaches look at stocks.
- However, it's important to keep in mind that they are also long-term strategies which try to eke out alpha from exposures to characteristics that we argue are attractive (cheapness, small size, positive price trends, profitability, and low volatility).

Enhance the core with our full suite of comprehensive factor ETFs

DEUS	Deutsche X-trackers Russell 1000 Comprehensive Factor ETF	Large-cap domestic equities
DESC	Deutsche X-trackers Russell 2000 Comprehensive Factor ETF	Small-cap domestic equities
DEEF	Deutsche X-trackers FTSE Developed ex US Comprehensive Factor ETF	Developed international equities
DEMG	Deutsche X-trackers FTSE Emerging Comprehensive Factor ETF	Emerging market equities

**Alpha** refers to returns in excess of a benchmark's return. **Beta** measures a security's sensitivity to the movements of the fund's benchmark or the market as a whole. A beta of greater than one indicates more volatility than the benchmark or market, while a beta of less than one indicates less volatility. One **basis point** equals 1/100 of a percentage point. **Overweight** means the fund holds a higher weighting in a given sector or security than the benchmark. **Underweight** means the fund holds a lower weighting. The **Russell 1000 Comprehensive Factor Index** is a benchmark designed to capture exposure to five factors – Quality, Value, Momentum, Low Volatility and Size. These factors represent common factor characteristics for which there is a broad academic and practitioner consensus, supported by a body of empirical evidence across different geographies and time periods. The **Russell 1000 Index** tracks the performance of the 1,000 largest stocks in the Russell 3000 Index, which consists of the 3,000 largest U.S. companies as measured by market capitalization. The **Russell 1000 Momentum Factor Index** is a benchmark designed to capture exposure to the momentum factor. The **Russell 1000 Quality Factor Index** is a benchmark designed to capture exposure to the quality factor. The **Russell 1000 Size Factor Index** is a benchmark designed to capture exposure to the size factor. The **Russell 1000 Value Factor Index** is a benchmark designed to capture exposure to the value factor. The **Russell 1000 Volatility Factor Index** is a benchmark designed to capture exposure to the volatility factor.

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DEUS has an inception date of 11/24/15 respectively. DEUS since inception NAV 12.37%, market price of 12.39%. DEUS' 1yr NAV 14.13%, market price 14.03%. *Performance data quoted represents pas performance and does not guarantee future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain the most recent month-end performance data visit [www.deutsche-etfs.com](http://www.deutsche-etfs.com) or call 855-329-3837.*

**Carefully consider the fund's investment objectives, risk factors, charges and expenses before investing. This and other information can be found in the fund's prospectus, which may be obtained by calling 1-855-329-3837, or by viewing or downloading a prospectus from [www.deutsche-etfs.com](http://www.deutsche-etfs.com). Read the prospectus carefully before investing.**

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