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Xpert Spotlight



Thought Leadership, Exchange Traded Funds

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The third quarter of 2017 saw our Russell 1000 multifactor fund deliver a small underperformance that was very similar to the first and second quarters. The headline numbers were: a fund return of 3.91% compared to the Russell 1000 Index's return of 4.48%, for an excess return of -0.57%.

Spotlight on DEUS' Q3 2017 performance: another quiet quarter

In a quarter this quiet there aren't too many interesting features to pick out at the stock or sector level, but as we do every quarter we will discuss factor performance as well as our best and worst performing positions at these two levels of attribution.

Q3 2017 factors

To date, this year has been both a little disappointing and a little puzzling from a factor perspective. Figure 2 shows that, of the five factors that our Russell 1000 Comprehensive Factor ETF (DEUS) tilts towards, just two of them are outperforming the market (defined here as the vanilla, market-cap Russell 1000 Index). This is true both year-to-date, and in the third quarter, where only Momentum and Quality are outperforming.

Figure 1: ETF (DEUS) 2017 performance¹

	Q3 2017	1 year	Since inception
NAV	3.91%	16.71%	12.92%
Market price	3.94%	16.74%	12.95%
Russell 1000 Index	4.48%	18.54%	12.98%

Source: Deutsche Asset Management 9/30/17. Gross/net expense ratio for DEUS is 0.19%. DEUS inception date is 11/23/15. **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. Market price returns are based on the midpoint of the bid/ask spread at 4pm ET and do not represent the returns an investor would receive if shares were traded at other times. ETF shares are bought and sold at market price (not NAV) and are not individually redeemed from the fund. To obtain the most recent month-end performance data visit www.Xtrackers.com or call 855-329-3837.**

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Figure 2: The performance of the Russell 1000 Index, the Russell 1000 Comprehensive Factor Index and the five single factor indexes (6/30/17–9/30/17)

Index	Q3 return	YTD return
Russell 1000 Index	4.48%	14.17%
Russell 1000 Comprehensive Factor Index	3.94%	12.86%
Russell 1000 Value Factor Index	4.45%	11.30%
Russell 1000 Volatility Factor Index	3.69%	12.48%
Russell 1000 Quality Factor Index	5.30%	19.08%
Russell 1000 Size Factor Index	3.80%	10.92%
Russell 1000 Momentum Factor Index	5.55%	14.43%

Source: Deutsche Asset Management 9/30/17. **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.

Q3 2017 factors (continued)

The first of these makes sense. The equity markets in the U.S. have ground higher this year, and it's logical in that environment that buying stocks with positive price trends would win as those positive price trends continue. However, as we noted in our last attribution of the second quarter, quality remains a puzzle. This factor puts the focus on firms with low leverage and high amounts of quality (high cash) earnings. Typically it has been a defensive factor that has outperformed in downturns, but of course this year so far has been anything but that.

Perhaps the biggest lesson that can be gleaned from Quality's outperformance is the merits of multifactor exposures. After all, if there is model risk around linking particular factors to particular economic and market cycles, there is surely exasperation risk in having them then perform differently than expected once the underlying trend has been correctly identified. It's partly for this reason that we have generally been advocates of taking multiple factor exposure into a fund and simply holding them over the long run.

Q3 2017 sector contributions

The best performing sector for the third quarter was industrials in which the fund had an average weighting of 18.52% vs. the 10.38% in the Russell 1000. The sector slightly outperformed the overall market, returning 4.68% during these three months.

DEUS has consistently had an overweight in the industrials sector because these stocks tend to have above average scores across the board. In other words they are just the type of stocks that mesh well with our multifactor approach.

As it has been on many occasions, our best performing sector was IT which DEUS significantly underweights. On average

it allocated about 13.81% to tech stocks in Q3 compared to the 22.61% that IT accounts for in the Russell 1000 (it's the biggest sector by more than 8%). However, once again IT performed well. It was the best performing sector in the third quarter, returning 8.60% and contributing to the underperformance of our fund because of its underweight position. Why does DEUS underweight these stocks? Well, historically the sector has performed poorly on Value, Quality, and Low Volatility, meaning that IT stocks have, on average, been more expensive, riskier and produced fewer quality profits.

Q3 2017 stock contributions

On the individual stock front, our biggest contributor was Lear Corporation (the maker of automobile parts, not Learjets) which we took from its 0.05% weighting in the Russell 1000 Index, to 0.67% in the fund. The stock returned 22.24% in the third quarter having announced improved revenue and margins at its 2Q earnings call in July. The reason for its significant overweight was the stock's scores at the June rebalance for Quality and Value where it was in the 86th and 99th percentiles, respectively. Essentially the strategy favors that it produces high quality earnings but on a valuation that was one of the best of the Russell 1000 stocks at the time (we define value as a composite of Price to Sales, Earnings and Cash flow).

As it has been a few times before, Apple was our biggest detractor. DEUS held an average weighting in the IT giant of around 0.10% over the quarter, vs. its 3.75% in the Russell 1000 Index.

As the biggest stock in the United States it necessarily scores as badly as possible on size and is heavily underweighted in the fund. Indeed, it's only its very large initial position that prevents it from being eliminated entirely.

Conclusion

The third quarter was the third in a row where the market ground higher, and DEUS returned a small underperformance. It left the fund lagging the market year-to-date by around -1.49% in what has been a challenging year for factor investing.

To summarize:

- The fund returned 3.91% in Q3 vs. the 4.48% of the Russell 1000.

- DEUS won to the Industrials sector, which it tends to overweight because of its generally strong factor scores across the board, and lost to its underweight in the IT sector, which scores poorly on Value, Quality, and Low Volatility.
- Once a again Apple was our biggest detractor as the tech giant continued to put in a stellar year. DEUS very heavily underweights the stock because of its large size.
- However, the fund won to its position in Lear Corporation, an automobile parts manufacturer that scores well on Quality and Value.

Enhance the core with our full suite of comprehensive factor ETFs

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

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. The **Russell 1000 Momentum Factor Index** is a benchmark designed to capture exposure to the momentum factor.

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