Modest Style Bets, Modest Price

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Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF (GSLC) offers exposure that's similar to the S&P 500 but tilts toward stocks with characteristics that have historically been associated with market-beating performance. These include low valuations, strong momentum, high profitability, and low volatility. This approach diversifies risk because each factor tends to work well at a different time. While the fund's factor tilts are modest, it has a low expense ratio to match, which gives it a reasonable chance to beat the market over the long term.

The portfolio is divided into four equally weighted sleeves that each tilt toward stocks with a different characteristic of interest. This simple approach is transparent, though a more integrated approach would probably be a bit more efficient. Each sleeve gives over- or under-weightings to stocks from the large-cap selection universe based on the degree to which they exhibit the targeted style characteristic. The fund scales these active bets to give each sleeve a 4% target tracking error to its selection universe. Consequently, stocks with factors that introduce greater tracking error, like low volatility, receive lower active weightings. Together, these active bets partially offset one another, allowing the overall portfolio to maintain a 2% tracking-error target.

The resulting portfolio looks a lot the S&P 500's. It includes more than 420 stocks out of 500 eligible names, with an active share of 29%, as of this writing. These holdings have a smaller average market capitalization than the constituents of the S&P 500. However, they tend to trade at similar valuations. This is because the fund's momentum and quality sleeves pull the portfolio toward pricier names, while its value sleeve leans in the other direction.

This strategy was launched in September 2015, so it has not yet established a meaningful record. From its inception through September 2016, the fund's realized tracking error to the S&P 500 was slightly above 2%, and it lagged that index by 2.6 percentage points. While it won't always beat the index, the fund should come out ahead over the long term.

Fundamental View

There has historically been a positive relationship between low valuations, strong recent performance (momentum), and high profitability and future returns in nearly every market studied over long horizons. And stocks with low volatility have tended to produce better risk-adjusted returns. There are plausible risk-based and/or behavioral stories behind the success of each factor.

The risk story is the most compelling for the value effect. Value stocks tend to have less-attractive prospects than their more expensive counterparts and may offer higher expected returns as compensation for their risk. But behavioral biases could also contribute. Investors may extrapolate past growth--or lack thereof--too far into the future, which could cause slow-growing value stocks to become undervalued. Behavioral biases are likely behind momentum. Investors may initially underreact to new information, causing market prices to adjust more slowly than they should. Once a trend is established, investors may pile into the trade, pushing prices away from fair value, potentially leading to the long-term reversals associated with the value effect. Momentum is a good complement to value because one tends to work well when the other doesn't.

Profitability and low volatility are more defensive. A possible explanation for the former's success is that investors may not appreciate the long-term sustainability of highly profitable firms' earnings power, which can cause them to become undervalued, even though these stocks don't necessarily trade at the lowest valuations. The low-volatility effect can arise because investors who care about benchmark-relative performance (like most active managers) may tilt toward riskier securities and away from safer (less volatile) ones to boost their returns. The neglected, low-volatility stocks could become undervalued relative to their risk, allowing them to offer attractive risk-adjusted performance.

While each of these factors has a strong long-term record, they all go through periods of underperformance. Putting them together in a portfolio diversifies risk. But the fund's sleeve approach dilutes its exposure to each factor. That's because many stocks that score well on one dimension (like value) don't score well on the others. And because each sleeve only represents 25% of the portfolio, the fund has only modest exposure to each factor.

The fund constructs its value and momentum sleeves differently than many of its peers. Within the value sleeve, the managers limit the fund's industry tilts relative to the selection universe, arguing that such bets are not rewarded. They measure momentum based on returns adjusted for market sensitivity and stock volatility. This gives the fund a cleaner read on strong performance that is specific to a stock that may be more likely to persist.

Turnover here should be moderate, partially because many of the adjustments across the four sleeves offset each other. In order to further reduce turnover, each sleeve applies a buffer around the target active weightings for each security, so that it doesn't trade until the style characteristics materially change.

Portfolio Construction

The fund employs full replication to track the Goldman Sachs ActiveBeta U.S. Large Cap Equity Index. The selection universe for the index includes the largest 500 U.S. stocks. From this pool, the fund tilts toward stocks with strong value, risk-adjusted momentum, quality (gross profits/total assets), and low-volatility characteristics. The portfolio is subdivided into four equal-sized sleeves, each of which has a different factor focus.

Each sleeve sizes its active weightings in order to target a 4% tracking error to its market-cap-weighted selection universe. In contrast to the other sleeves, which start with this market-cap-weighted universe, the low-volatility sleeve applies its active weightings to an equally weighted version of this universe. The managers argue that this is prudent because the low-volatility effect is stronger among smaller stocks. The value sleeve also differs from the others. It rescales its sector weightings to match those of its selection universe, on the premise that value-based sector bets are not rewarded over the long term. The fund casts a wide net, typically including at least 80% of the stocks in the selection universe. It reconstitutes quarterly and applies buffer rules to mitigate unnecessary turnover.

Fees

At 0.09%, the fund's expense ratio is among the lowest in the large-blend Morningstar Category and a fraction of what other multifactor funds charge. This fee is on par with what the biggest S&P 500 ETF (SPDR S&P 500 ETF (SPY)) charges. Goldman initially launched this fund with a 0.24% expense ratio and a 0.15% fee waiver, but it has made the 0.09% fee permanent and removed the waiver, which is a good sign.

Alternatives

AQR Large Cap Multi-Style (QCELX) (0.49% expense ratio) applies an integrated approach to target stocks with strong value, momentum, and quality characteristics. This can improve efficiency because the entire portfolio is focused on all three factors, which should give the fund more-potent exposure to its targeted factors than GSLC. And stocks that score well on multiple dimensions may have higher expected returns than those that look good on only one dimension. This fund is only available to individual investors through select financial advisors and platforms, like a 401(k).

IShares Edge MSCI Multifactor USA (LRGF) (0.35% expense ratio) also takes an integrated approach to provide exposure to stocks with strong momentum, low valuations, quality, and small size. It uses a complex constrained optimizer to achieve that objective. Like the AQR fund, LRGF offers more-aggressive style tilts than GSLC. Its value tilt is particularly noticeable, and this orientation pulls the fund into the large-value Morningstar Category.

DFA US Core Equity 1 (DFEOX) (0.19% expense ratio) offers broader exposure to the U.S. stock market than its multifactor peers. It tilts toward stocks with low valuations, small market capitalizations, and high profitability. These tilts are anchored to each stock's market capitalization, which helps keep turnover low. This fund is only available to individual investors through select financial advisors and platforms. Investors who don't have access to this fund might consider John Hancock Multifactor Large Cap ETF (JHML) (0.35% expense ratio), which tracks a DFA index and applies a similar approach among large-cap stocks.

GSLC BRONZE RATED BY MORNINGSTAR

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Goldman Sachs ActiveBeta® U.S. Large Cap Equity ETF

Average Annualized Returns (%) as of 12/31/16			
	1 Year (%)	Since Inception (%)	Total Expense Ratio (%)
GS ActiveBeta® U.S. Large Cap Equity ETF (NAV)	8.63	8.57	0.09%
GS ActiveBeta® U.S. Large Cap Equity ETF (Market Price)	8.70	8.64	

The returns represent past performance. The Fund's investment return and principal value will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted above. Please visit our Web site at: www.GSAMFUNDS. com/ETFs to obtain the most recent month-end returns. Performance reflects cumulative total returns for periods of less than one year and average annual total returns for periods of greater than one year. Since inception returns for periods of less than one year are cumulative. All Fund performance data reflect the reinvestment of distributions. Total returns are calculated assuming purchase of a share at the market price or NAV on the first day and sale of a share at the market price or NAV on the last day of each period reported. The Total Returns Based on NAV and Market Price do not reflect brokerage commissions in connection with the purchase or sale of Fund shares, which if included would lower the performance shown above.

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The Goldman Sachs ActiveBeta® U.S. Large Cap Equity ETF seeks to provide investment results that closely correspond, before fees and expenses, to the performance of the Goldman Sachs ActiveBeta® U.S. Large Cap Equity Index (the "Index"), which delivers exposure to equity securities of large-capitalization U.S. issuers. The Fund's equity investments are subject to market risk, which means that the value of the securities in which it invests may go up or down in response to the prospects of individual companies, particular sectors and/or general economic conditions. Because the Fund may **concentrate its investments** in an industry or group of industries to the extent that the Index is concentrated, the Fund may be subject to greater risk of loss as a result of adverse economic, business or other developments affecting that industry or group of industries. The Fund is not actively managed, and therefore the Fund will not generally dispose of a security unless the security is removed from the Index. **Performance may vary substantially from the performance of the Index** as a result of transaction costs, expenses and other factors.

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Exchange-Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed, or sold, may be worth more or less than their original cost. ETFs may yield investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. Please see GSAMFUNDS.com/ETFs for additional risk considerations.

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