

Investing in Value Today

A Closer Look at the Nasdaq AlphaDEX Large Cap Value Index

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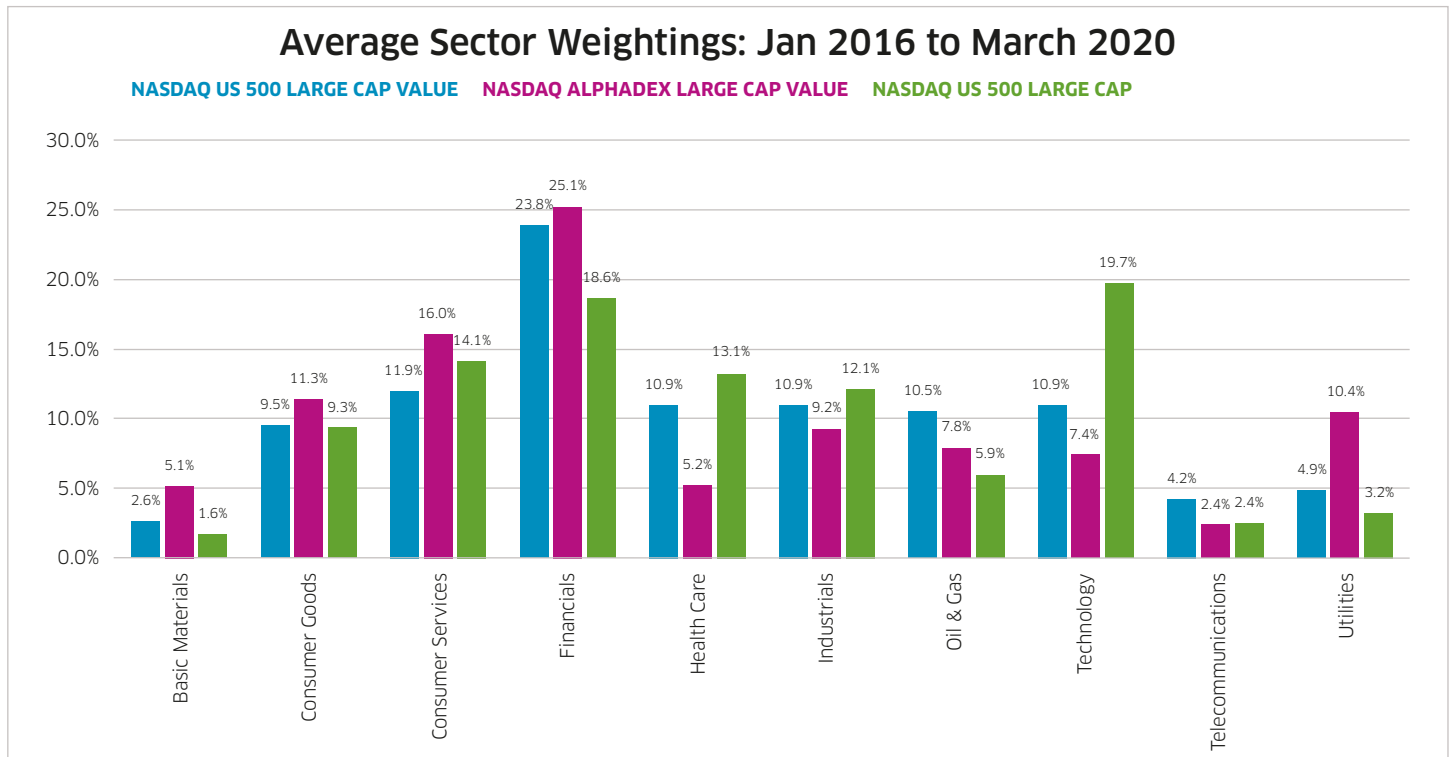
Despite sounding like a relatively straightforward investment strategy, Value is multifaceted, with considerable nuance. The most basic implementation of Value investing seeks out companies with low price-to-book ratios, with the belief that these “cheap” firms command a higher risk premium for a reason, and will ultimately deliver better-than-average returns in the future. While many such plain-vanilla products exist in the world of passive indexing and ETFs, they are almost uniformly lacking in one crucial area: screening out what are known as value “traps.” In other words, companies that are “cheap for a reason,” and present no compelling investment case based on their other financial and/or qualitative metrics.

The Nasdaq AlphaDEX Large Cap Value Index (launched on January 11, 2016) attempts to tackle this problem by introducing a more refined approach. Beginning with the constituents of the Nasdaq US 500 Large Cap Index, the index methodology ranks all 500 constituents on book yield (i.e., book value divided by price), cash flow yield (i.e., cash flow divided by price), and return on assets to determine a Value score; a similar process is conducted in parallel to determine a corresponding Growth score. AlphaDEX immediately eliminates the bottom 25% of scores altogether, which screens out the “weak” Value (and Growth) names. *This is in stark contrast to the vast majority of Value indexes, such as the Nasdaq US 500 Large Cap Value Index, which simply takes the top 50% of its benchmark’s constituents by their Value score, meaning its “weakest” Value constituent may be statistically indistinguishable from its “weakest” Growth constituent.*

The remaining stocks are placed into quintiles based on their selection score ranks, with the top quintile stocks receiving a combined total weight of 5/15ths, the second quintile getting 4/15ths, etc. until the bottom quintile receives only 1/15ths. While each stock is equally weighted *within* its quintile, the overall effect is to weight by Value score. This implies that, across indicators such as average market cap, sector concentration, and average constituent weighting, the portfolios generated by the AlphaDEX approach will be less correlated to the broader market than other, plain-vanilla Value indexes.

INDEX NAME	# OF CONSTITUENTS (AS OF 2/28/20)	LARGEST % WEIGHT	AVERAGE % WEIGHT	WEIGHTED AVERAGE MARKET CAP (\$BN)
AlphaDEX Large Cap Value	187	1.15	0.53	44.75
Nasdaq US 500 Large Cap	499	5.34	0.20	282.51
Nasdaq US 500 Large Cap Value	250	10.34	0.40	245.27

We can most directly observe the impact of these methodological differences by comparing the sector weightings of the AlphaDEX Large Cap Value Index to both the benchmark Nasdaq US 500 Large Cap Index as well as the Nasdaq US 500 Large Cap Value Index. Overall, AlphaDEX materially underweighted Health Care, and to a lesser extent, Technology as well as Oil & Gas. Conversely, AlphaDEX dramatically overweighted Utilities, with additionally notable overweights across Consumer Services / Products, and Basic Materials.



Summary

It is no secret across the investment industry that Value has underperformed most other *smart beta*, i.e. factor strategies repeatedly over the past decade. It has even led numerous prominent investors and pundits to declare the “death of value investing.” And while the explosion of smart beta indexes (and the ETFs that track them) has generated impressive allocations to Value during the same time period, its dramatic underperformance risks a wholesale stampede of assets out of this perhaps most well-known, and longest-running, factor strategy. So what is to be done? Consider allocating to a product that tracks an index with a more nuanced methodology, like the Nasdaq AlphaDEX Large Cap Value Index. Not only does its screening process weed out some of the weakest Value names within scope, but its unique weighting methodology also helps ensure a portfolio that is at once more balanced, differentiated from the broader market, and closer to a pure “weighting by the Value factor” approach.

For further analysis of value investing in the index space, please find our research piece here:

www.nasdaq.com/articles/investing-in-the-value-premium-2020-02-19

Products currently tracking this index include the First Trust Large Cap Value AlphaDEX Fund (Ticker: FTA).

Sources: FactSet, Innovator ETFs, Nasdaq Global Indexes.

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