# A Promising Quality Value ETF

This low-cost strategy carves an edge by targeting stocks with strong profitability and low valuations.

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There are good reasons some stocks trade at higher valuations than others. Often differences in valuations reflect differing expectations of future cash flows, not necessarily differences in expected returns. Pairing valuations with a measure of future expected cash flows should more cleanly isolate differences in expected returns and improve performance. That's what Avantis U.S. Equity ETF (AVUS) attempts to do.

This fund tilts toward stocks with attractive valuations and profitability, which gives it a good chance to beat the market over the long term. This low-cost strategy earns a Morningstar Analyst Rating of Bronze.

Avantis was founded in 2019, as a subsidiary of American Century Investments, by several former Dimensional Fund Advisor employees. Many of Avantis' investment strategies, including this one, attempt to build on the success of DFA's investment approach with some incremental improvements and more competitive pricing.

This strategy offers broad exposure to U.S. stocks of all sizes. It starts with each stock's market-cap weighting and adjusts them to give overweightings to stocks with low valuations (based on price/book) and high profitability and underweighting to stocks with the opposite characteristics. This dual focus captures the price investors pay and proxies for the value they get. This is based on the observation that current profitability is a good predictor of future cash flows. For any given valuation, stocks with higher profitability should provide higher expected returns. Similarly, if stocks have similar profitability, those with lower valuations should have higher expected returns.

Current profitability and book value aren't perfect proxies for intrinsic value. Profits can be affected by accounting choices and unusual expenses. Similarly, book value may not be comparable across different companies, owing to differences in accounting choices, acquisitions, and reliance on tangible versus intangible assets. To improve these metrics, the fund's managers focus on cash-based operating profitability (removing accruals) and remove goodwill from book value to mitigate exposure to serial acquirers. While these adjustments aren't a panacea, they help, as does the portfolio's broad diversification.

This fund doesn't swing for the fences. Its active share against the Russell 3000 Index is currently only 27%. And it isn't dependent on individual stock or sector bets. It doesn't significantly overweight value stocks either, as more profitable companies tend to trade at higher valuations, placing the portfolio in large-blend territory. While this fund looks a lot like the broad market, its modest tilts toward cheaper and more profitable stocks should help it carve an edge.

## Process

This strategy effectively tilts toward stocks with attractive valuations and profitability, which should offer higher returns than the market over the long term. This dual focus paints a more complete picture of expected returns than considering either valuations or profitability alone. Adding to its appeal, this strategy effectively diversifies risk and mitigates turnover. It earns an Above Average Process Pillar rating.

The fund's managers start with a broad universe of U.S. stocks of all sizes. They tilt the portfolio toward stocks trading at low multiples of book value (adjusted to remove goodwill) and high profitability, using a cash-based measure of operating income that removes accruals. To achieve these tilts, the managers scale each stock's weightings in the portfolio based on the strength of their value and profitability relative to the others in the eligible universe. The target weightings are linked to market capitalization. However, stocks with stronger value and profitability characteristics receive larger market-cap multipliers, leading to larger overweightings, while those that look less attractive on those metrics are underweighted.

This is designed as a low-turnover strategy. Linking the target weightings to stocks' market caps helps, but there are also buffers in place around those targets to mitigate unnecessary turnover. The managers may also use momentum as a reason not to trade, holding off on increasing exposure to stocks with strong negative momentum or trimming positions with strong positive momentum. To further reduce exposure to stocks with negative momentum, the managers use prices lagged three months in their price/book metric.

This is a rules-based strategy, but it isn't tethered to an index. The managers have some discretion about which names they trade on a given day to reduce transaction costs.

**Portfolio**

This is a well-diversified portfolio that includes nearly 2,000 stocks. The top 10 of those represent under a fifth of the portfolio. This helps mitigate exposure to firm-specific risk. That's by design. Individual security weightings are capped at 3%, or the stock's market's cap weighting in the market, if greater.

Similarly, the fund doesn't depend on big sector bets. Most of its sector weightings are close to those of the Russell 3000 Index, though the portfolio is slightly underweight the real estate sector and slightly overweight industrial stocks. While focusing on price/book or profitability alone tends to lead to persistent sector tilts, their sector biases largely offset when they are combined.

Outside the utilities sector, there are no sector-relative adjustments in the fund's stock selection approach. However, Avantis treats utilities stocks differently, on the premise that they have lower expected returns than other types of stocks. Accordingly, the fund applies a sector-relative approach in the utilities sector, which reduces its exposure to that sector compared against what it would be without that adjustment.

The portfolio nets out in the large blend Morningstar Category. This is because highly profitable stocks tend to trade at higher valuations than their less profitable counterparts, which keeps the fund from significantly overweighting value stocks. While the managers don't explicitly overweight smaller stocks, this portfolio tends to have a smaller market-cap orientation than the Russell 3000 Index. That's because the fund applies smaller tilts in the mega-cap market than it does among smaller-cap stocks, where the payoff to value and profitability has historically been greater.

**People**

This portfolio management team is small but capable. However, the team's small size could magnify the impact of turnover. And the systems that it built to run its portfolios haven't been around long. This team warrants an Average People Pillar rating.

Daniel Ong, Mitchell Firestein, Ted Randall, and Eduardo Repetto are the fund's named portfolio managers. All four joined Avantis in 2019 and previously worked at DFA. Repetto is the chief investment officer of Avantis. He previously served as co-CEO and co-CIO of DFA. Firestein, Randall, and Ong are dedicated portfolio managers. The four managers jointly manage all the firm's strategies, and there is no specialization on the team.

The team leverages much of the infrastructure at American Century, including a central trading desk, data collection, and compliance teams. However, Avantis built out a new portfolio management system, which helps automate the managers' workflow and improve efficiency. This allows managers to spend less time on routine tasks and focus on cost-efficient execution. They update the portfolio daily and give the traders some flexibility about which trades to execute on any given day to reduce transaction costs.

All four managers have considerable investments in this strategy. Repetto has more than $1 million invested. That said, there is no direct link between fund performance and manager compensation. To some extent that's fair, because the managers don't have much discretion over the composition of the portfolio.