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A Compelling Combination: Why Advisors Are Pairing Value and Low-Volatility Factors

By Nick Kalivas

My colleague, Dan Draper, recently wrote about the growing interest in factor-based investment strategies, as advisors and clients consider whether and how factor exchange-traded funds (ETFs) might fit into their portfolios. This week, we look at specific factors that may be significant over the next six to 12 months and examine some of their investment applications for advisors and investors.

As Dan noted, all asset classes carry broad forces, including volatility, momentum, size, value and quality, that can help protect against risk and contribute to returns. These underlying building blocks, or factors, can also be combined to help investors target different portfolio outcomes across a range of economic conditions. And it's no secret that today's economic conditions leave advisors in an uncertain investment environment, with both positive and negative trends to consider.

The economy, which has been recovering slowly and unevenly since the depths of the recession in 2009, is confronting a number of significant challenges. Financial markets are filled with uncertainty over European integration; European banks continue to struggle with profitability; China's deleveraging processes remain unclear, and geopolitical and terror risks are ever looming.

In the U.S., structural and regulatory hurdles to growth remain. Amid signs of rising inflation, the Federal Reserve continues to drag its feet in raising interest rates, despite having met its unemployment targets, and the upcoming presidential election is causing additional unease.

On the positive side, there is a strong chance that the growth rate in S&P 500 earnings made a trough in the second quarter of 2016 and we may rise from here into 2017. Sustained job growth, improved readings in the economy-weighted ISM Manufacturing Index, signs of decline in the inventory-to-sales ratio, the reduced dollar strength, and robust consumer spending are all favorable signs for potential future earnings growth.

Why Low Volatility and Value May Be Big Factors for 2016-2017

For advisors, better growth prospects and low interest rates argue for having equity exposure, and this opens the door to combining factors that are inversely related in order to construct more resilient portfolios.

The low-volatility factor, for example, has tended to react well in periods of sluggish growth, characterized by falling or low interest rates, high or rising market volatility, high to rising credit risk, and weak market conditions as supported by the low volatility anomaly*. In contrast, the value factor has historically liked periods of strong or accelerating growth and rising interest rates.

Forecasts of a strengthening economy heading into 2017 might therefore be positive for a value tilt and weigh on the low-volatility factor. The multitude of risks that remain, however, would argue for hazard management through a continued exposure to low volatility.

The inverse trend between these two factors suggests that combining a low-volatility index and a value index would be an interesting portfolio solution. The low-volatility factor could be used to mitigate or manage economic and political risks, while the value factor might benefit portfolio returns if the economy does find firm footing and accelerate in 2017.

Identifying Factors in an Uncertain Economy

Low-volatility and value factors also display a relationship to trends in the VIX, or the CBOE Volatility Index. Popularly referred to as the fear index, the VIX represents a measure of the implied volatility of S&P 500 index options. A falling VIX tends to put pressure on excess returns derived from low volatility, while benefiting excess returns from the value factor.

Likewise, a rising VIX may lift the excess returns of low volatility, while adding pressure on any excess returns of the value factor. Although there is no certainty to the relationship between these factors and the VIX, it does underscore how the environment can impact factor returns and provides advisors with another source of data for identifying trends.

When evaluating factor-based ETFs, advisors need to be mindful of how factor exposures align with the investment goals of their clients. Over time, the top performers among factor-based funds change, and investors need to be aware that a given factor's performance may not match expectations.

Keeping these caveats in mind, advisors may find that combining investment factors that display inverse trends, such as low volatility and value, can potentially result in compelling risk-adjusted returns through higher returns, lower risk or both. Deploying these options may then enable their clients to chart an appropriate course through the uncertain economic and political terrain that lies ahead.

**Source: Research Affiliates. "Making Sense of Low Volatility Investing". Li. January 2013; Source: Chow T., Hsu J., Kuo L., Li F., "A Study of Low Volatility Portfolio Construction Methods", The Journal of Portfolio Management, Volume 40 Number 4, Summer 2014*

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There are risks involved with investing in ETFs, including possible loss of money. Shares are not actively managed and are subject to risks similar to those of stocks, including those regarding short selling and margin maintenance requirements. Ordinary brokerage commissions apply. The Fund's return may not match the return of the Underlying Index. The Fund is subject to certain other risks. Please see the current prospectus for more information regarding the risk associated with an investment in the Fund.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments focused in a particular industry are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

Diversification does not guarantee a profit or eliminate the risk of loss.

Stocks of small- and mid-sized companies tend to be more vulnerable to adverse developments and may be more volatile than larger, more established companies. Investments in real estate related instruments may be affected by economic, legal, or environmental factors.

There is no guarantee that low-volatility stocks will provide low volatility.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

S&P 500® Low Volatility Index is compiled, maintained and calculated by Standard & Poor's and consists of the 100 stocks from the S&P 500® Index with the lowest realized volatility over the past 12 months.

The VIX Index is a theoretical calculation and cannot be traded. The VIX Index measures the 30-day forward volatility of the S&P 500 Index as calculated based on the prices of certain put and call options on the S&P 500 Index. An investment cannot be made into an index.

The ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys.

Inventories / Sales Ratios (Retail) - The inventories / sales ratios show the relationship of the end-of-month values of inventory to the monthly sales. These ratios can be looked at as indications of the number of months of inventory that are on hand in relation to the sales for a month. For example, a ratio of 2.5 would indicate that the retail stores have enough merchandise on hand to cover two and a half months of sales.

Excess return refers to excess return generated by one index, strategy or investment factor over another.

Momentum is the rate of acceleration of a security's price or volume.

Quality is the strength of a company as measured by various metrics.

Risk-adjusted returns is a measure of how much risk is taken on by a security to produce a certain level of return.

Size refers to the magnitude of an offering, an order, or a trade.

Value is the monetary, material or assessed worth of an asset, good or service. The value factor aggregates stocks that are trading at less than their intrinsic values – usually identified by lower-than-average price-to-book or price-to-earnings ratios, and/or high dividend yields.

Value tilt is a portfolio that has a greater percentage of value than a total stock market portfolio or a majority of value holdings.

Volatility is the annualized standard deviation of index returns.

The low volatility portfolios are non-diversified and can invest a greater portion of their assets in securities of individual issuers than a diversified fund. As a result, changes in the market value of a single investment could cause greater fluctuations in Share price than would occur in a diversified fund. This may increase the low volatility portfolios' volatility and cause the performance of a relatively small number of issuers to have a greater impact on the low volatility portfolios' performance.

Investing in securities of small and medium capitalization companies involves greater risk than customarily associated with investing in larger, more established companies.

There is no assurance that the strategies mentioned in this material will be achieved.

Factor investing is investment strategy in which securities are chosen based on attributes that have been associated with higher returns.

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