Can low-volatility ETFs help reduce client risk?

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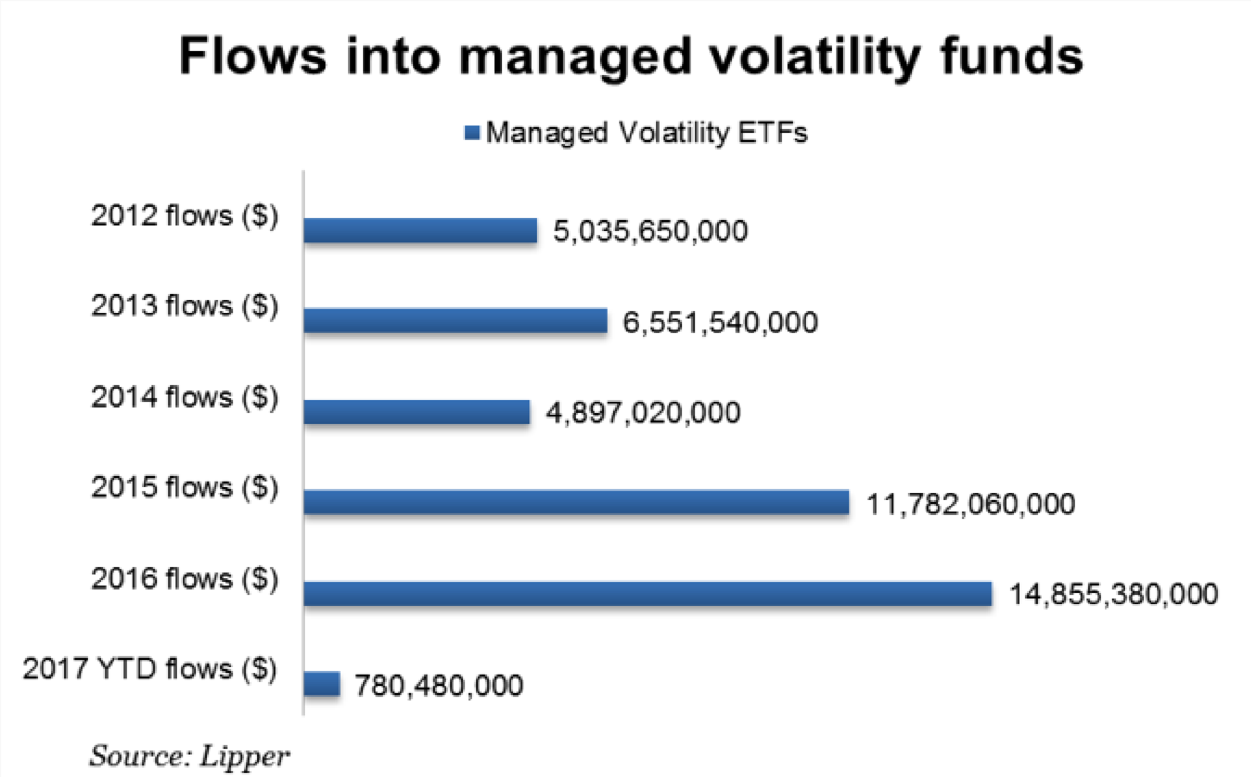
Ask any fellow adviser about how they construct portfolios for their clients and it's likely they'll talk about the myriad ways they try to reduce risk. With 2008 still in the backs of people's minds, many clients do indeed want investments that can stay cool under pressure. It's no surprise, then, that low-volatility ETFs — funds that hold defensive, dividend paying stocks to help mitigate market ups and downs — are seeing strong inflows.

In the first four months of 2017, managed volatility ETFs have seen more than $780 million in net inflows, nearly half of the $14.8 billion these funds made in all of 2016. Since 2012, net inflows into low-volatility ETFs has soared by 196%.

While that's still a fraction of the $280 billion in ETF inflows in 2016, demand for these products is increasing, especially after an eight-year bull market.

"Now that we're in the second-longest bull market in history, advisers are looking to stay invested but reduce the risk of volatility in their portfolios," says Dave Haviland, a partner with Beaumont Financial Partners in Needham Heights, Massachusetts.



Indeed, 46% of advisers surveyed by FTSE Russell in its 2016 smart beta survey, say that they're employing low volatility strategies, up from 39% in 2015.

Many advisers, in fact, are putting too much emphasis one these kinds of ETFs, says Kashif Ahmed, founder and president of American Private Wealth in Boston. "A lot of people are saying this is a one-ticket solution to reduce volatility, but that's not the case," he says. "They can be loaded up with utilities, which can be more volatile as interest rates continue to rise."

LOWER RISK, LOWER RETURNS

Low volatility ETFs are part of the smart beta suite of products, which also include value, momentum, fundamental, high quality and other strategies. It's also called factor investing, which is supposed to capture market inefficiencies to help portfolios beat their benchmarks.

On its own, low volatility funds do reduce risk, but they don't outperform in the same way that owning a number of factor investments might, Haviland says.

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Over $14 billion flowed into the low-risk ETF category in the first half of 2016.

Between November 2011 and March 2017, the S&P 500's standard deviation was 10.06, according to Morningstar. Over that same time, the main low volatility ETFs, iShares Edge MSCI Min Vol USE ETF (USMV) and PowerShares S&P 500 Low Volatility Portfolio (SPLV), had a standard deviation of 8.37 and 9.02, respectively. During that period the S&P 500 returned 14.87%, while the ETFs slightly unperformed with USMV returning 14.41% and SPLV returning 13.61%.

Expenses are generally low. USMV, for one, has a 0.15% expense ratio, while SPLV's expense ratio is 0.25%.

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inflows.

It’s not surprising to see these funds underperform, says Alex Bryan, Morningstar’s director of passive strategies research. Usually, any strategy that protects a portfolio from losing money also prevents it from seeing overly strong returns, he says. However, according to MSCI, the low volatility strategy did return 1.75% over the MSCI USA index between 2001 and 2015.

One of the dangers of these ETFs is using them to stave off short-term market declines. It may be tempting for an adviser to jump into a low-volatility ETF when geopolitical issues heat up or when the market takes a dip, but these should be seen as long-term investments, says Haviland. Low volatility, like any asset class, has good and bad years — in 2011, for instance, it returned 10.88% more than the MSCI USA index. In 2012 it underperformed by 4.95%.

And don’t expect it to necessarily hold up during a recession either, though low volatility did fall less than the MSCI USA index in 2008. “The issue we have with any type of factor investing is that they go through ebbs and flows and they’re subject to the same market losses as the S&P as a whole,” says Haviland.

REDUCING UPS AND DOWNS

The main reason why an adviser should want to use low volatility ETFs is to offer clients better risk-adjusted returns, says Bryan. It can be useful for more conservative clients who can’t stomach the ups and downs. “The benefit here comes from the reduction of risk,” he says.

It is possible to employ low volatility strategies without buying a fund, says Ahmed, who says he reduces risk by buying the same kinds of defensive stocks that are in these ETFs. He stopped using low volatility products after everyone else started buying them, because he was worried that larger inflows and outflows would impact their own volatility.

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But for advisers who don't want to spend time designing their own risk reduction strategies, owning a low-volatility fund can make sense. "The ETF takes the work away from the adviser," says Bryan. "It allows them to own always own stocks that have a certain set of defensive characteristics."

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