Can Certain ETFs Cut Client Risk?

Inflows into these low-volatility funds have soared. Here's what advisers should know about them.

BY BRYAN BORZYKOWSKI

MANY CLIENTS WANT INVESTMENTS THAT CAN STAY cool under pressure. So it's no surprise that low-volatility ETFs — funds that hold defensive, dividend-paying stocks to help mitigate market ups and downs — have seen strong inflows.

In the first five months of 2017, managed volatility ETFs have seen more than $1.68 billion in net inflows, according to Lipper Research. Almost half (46%) of advisers surveyed by FTSE Russell in its 2016 smart beta survey say they're employing low-volatility strategies, up from 39% in 2015.

Many advisers are putting too much emphasis on these ETFs, argues 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."

Low-volatility funds do reduce risk, but they don't outperform in the same way that owning a number of factor investments might, says Dave Haviland, a partner with Beaumont Financial Partners in Needham, Massachusetts.

Between November 2011 and March 2017, the S&P 500's standard deviation was 10.06, per Morningstar. Over that same time, the main low-volatility ETFs, iShares Edge MSCI Min Vol USA ETF (USMV) and PowerShares S&P 500 Low Volatility Portfolio (SPLV), had standard deviations 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%.

Flows into managed volatility ETFs

Flows from 2012 to 2017

Flows in ($)	Managed Volatility ETFs
2012	5,035,650,000
2013	6,551,540,000
2014	4,897,020,000
2015	11,782,060,000
2016	14,855,380,000
2017, as of May	1,684,970,000

Source: Lipper

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

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 danger of these ETFs is using them to stave off short-term market declines. These should be seen more as long-term investments, Haviland says.

The main reason an adviser should want to use low-volatility ETFs is to offer clients better risk-adjusted returns, Bryan says.

It is possible to employ low-volatility strategies without buying a fund, says Ahmed, who 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, due to worry that larger inflows and outflows would impact their own volatility.

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

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