Seeking Alpha α

When Markets Crash You Want To Own These 2 High-Yield, Low Risk ETFs

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by: Dividend Sensei

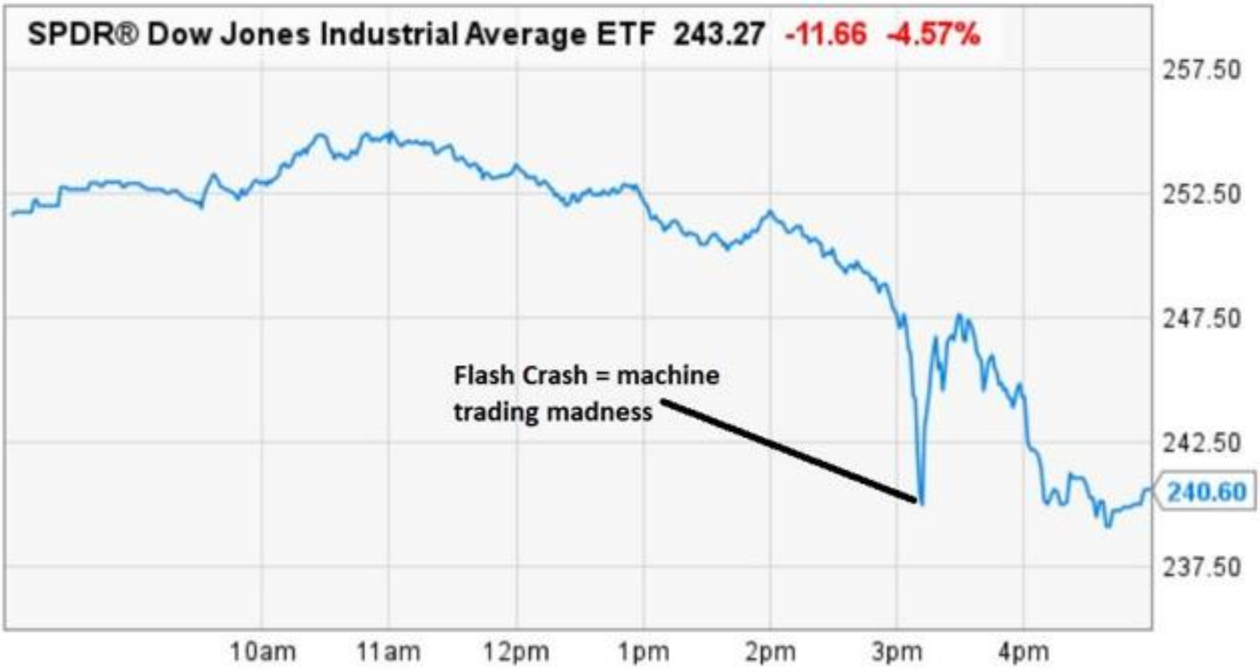
Summary

- Last week the market suffered its worst weekly loss in two years, and this week it finally entered a correction.
- When markets are panicking is the perfect time for investors to take a step back, take a breath, and consider the great opportunities that suddenly appear before them.
- VNQ and SPHD are two high-quality ETFs that offer long-term investors high-yield, low volatility, and steady dividend growth.
- All of these are proven alpha producing factors that, combined with today's low prices, should mean superior risk-adjusted total returns in the future.
- But, of course, there is no free lunch and there are a few things you need to understand about any ETF before investing your hard earned money.

Source: imgflip

This is it people! The long awaited market correction that value dividend investors such as myself have been praying for is finally here! In other words, precisely the time to be "greedy when others are fearful" so that we can turbocharge our portfolio income and total returns.

During times like these, when it appears that investors lose all sense and panic selling (including machine algo trading that leads to flash crashes) rule the day, knowing what to buy is even more important than knowing it's time to buy.



Source: Ycharts

Personally I prefer to own individual securities because it allows me to achieve very fine control over my income stream. However, I realize that, as someone who analyzes dividend stocks professionally (and puts in 70 to 80 hour weeks doing so), I have an advantage in: expertise, industry knowledge, and time that many don't have.

For the average investor, exchange traded funds or ETFs are often the best default alternative. This is because they offer instant diversification, low costs (relative to active funds), and allow you to target your money by either sector, investment strategy, or both.

For example, over the past 50+ years, reams of financial data crunching and market studies have determined that buy and hold investing is the best chance that regular investors have of compounding their wealth. But there are five alpha (outperformance) producing strategies that beat the market over time:

- smaller size
- equal-weighting (vs. market cap weighting like most indexes do)
- dividend growth
- low volatility
- value stocks

This is why I have built my own high-yield retirement portfolio around these strategies.

This is in an effort to stack these alpha factors on top of each other to generate the best possible returns while meeting my broader overall goal (maximum safe yield with the fastest long-term dividend growth).

So let's take a look at two ETFs which I consider to be excellent long-term choices at any time, but particularly now. These are the PowerShares S&P 500 High Dividend Low Volatility Portfolio (SPHD), and the Vanguard REIT Index Fund ETF (VNQ).

Specifically, find out what makes these two ETFs strong core holdings for your diversified high-yield portfolio, especially at times of peak market fear like we have currently.

Source: CNN

SPHD: Your Safe Port In The Storm

Beta factors: value, dividend growth, low volatility, smaller size ($43 billion market cap vs $97 billion S&P 500)

Morningstar Rating: 5 stars

SPHD takes the stocks in the S&P 500 and then selects the 75 with the highest yields. From these the 50 least volatile (relative to the S&P 500) are then chosen. These stocks are weighted by dividend yield, up to a max of 3% in any individual stock.

SPHD is what's called a "smart beta" fund. This means that rather than passively track a well known index (and weight by market cap), it instead sets out to beat its relative benchmark (Russell 1000 value index) through alpha stacking of proven long-term strategies.

In this case high-yield stocks are used to reduce volatility, and give the ETF strong focus on defensive, and low volatility blue chip names.

Top 25 Holdings	% Portfolio Weight	Shares Owned
HCP Inc	3.03	3,651,590
Iron Mountain Inc	2.95	2,517,642
Welltower Inc	2.84	1,404,244
AT&T Inc	2.78	2,121,368
Ventas Inc	2.73	1,446,853
PPL Corp	2.69	2,485,236
FirstEnergy Corp	2.66	2,355,694
Southern Co	2.64	1,690,256
General Electric Co	2.43	4,561,456
The AES Corp	2.34	6,186,863
Entergy Corp	2.32	873,422
Realty Income Corp	2.30	1,283,345
Verizon Communications Inc	2.28	1,260,717
Ford Motor Co	2.27	6,210,457
Duke Energy Corp	2.27	836,868

Simon Property Group Inc	2.16	390,476
Occidental Petroleum Corp	2.11	834,402
Dominion Energy Inc	2.06	771,944
Host Hotels & Resorts Inc	2.04	2,949,001
Public Storage	2.02	305,920
CenterPoint Energy Inc	2.01	2,088,695
Philip Morris International Inc	1.98	562,608
International Business Machines Corp	1.97	362,276
The Western Union Co	1.95	2,795,503
People's United Financial Inc	1.95	2,872,283

Sector Weightings SPHD

	% Stocks	Benchmark	Category Avg
Cyclical			
Basic Materials	1.63	3.05	3.29
Consumer Cyclical	5.83	6.50	8.27
Financial Services	6.98	26.93	23.10
Real Estate	16.99	4.45	2.45
Sensitive			
Communication Services	5.09	3.25	4.16
Energy	8.74	11.05	9.85
Industrials	9.84	8.08	9.98
Technology	5.32	8.50	11.71
Defensive			
Consumer Defensive	15.34	8.44	8.94
Healthcare	3.61	14.29	13.49
Utilities	20.63	5.45	4.76

As of 02/04/2018

Source: Morningstar

That means heavy exposure to utilities, REITs, and consumer defensive stocks.

As with any ETF, especially smart beta ones, some of the holdings may be suboptimal, or even downright iffy. For example, the reason I personally avoid investing in ETFs such as SPHD is that I don't want to have any money invested in General Electric (GE). That's because I consider GE's dividend to be unsustainable and thus potentially facing another cut or outright suspension in the future.

However, in general the strategies that SPHD is pursuing are sound, and the results so far have been impressive. For example, over the last five years SPHD has managed to beat SPDR S&P 500 (SPY), the most popular ETF in the world, and what many use as a proxy for the broader market.

In fact it's managed to beat it by 4.03% a year, at a time when the market was firmly "risk on" and focused on red hot growth stocks.

MPT Statistics SPHD

3-Year | **5-Year** | 10-Year | 15-Year

5-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio
vs. Standard Index					
SPHD	S&P 500 TR USD	47.94	0.65	4.03	21.94
Category: LV	S&P 500 TR USD	84.34	0.97	-2.03	13.26

01/31/2018

Volatility Measures SPHD

3-Year | **5-Year** | 10-Year | 15-Year

5-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio
SPHD	8.99	14.65	1.54	3.40
S&P 500 TR USD	9.54	15.91	1.57	3.13
Category: LV	10.09	13.00	1.25	2.34

Source: Morningstar

As importantly for low risk investors, SPHD has managed to outperform the market while generating superior risk adjusted returns. This can be seen in its five year Sortino ratio, which measures excess returns (alpha) divided by only downside volatility.

$$\text{Sortino Ratio} = \frac{< R > - R_f}{\sigma_d}$$

Where,

$< R > =$ **Expected Return**

R_f = The Risk Free Rate of Return

σ_d = Standard Deviation of Negative Asset Returns

Source: Investopedia

This is superior to other risk-adjusted metrics like the Sharpe ratio, because that measures excess returns divided by all volatility; even to the upside. I don't know about you but high volatility in an upwards direction is something I strive for.

The bottom line is that SPHD is an excellent smart beta fund to consider for any investors interested in low risk, high-yield, and steady dividend growth over the long-term.

VNQ: Real Estate Is Always Good To Own, And Now Is The BEST Time In Over Six Years To Buy

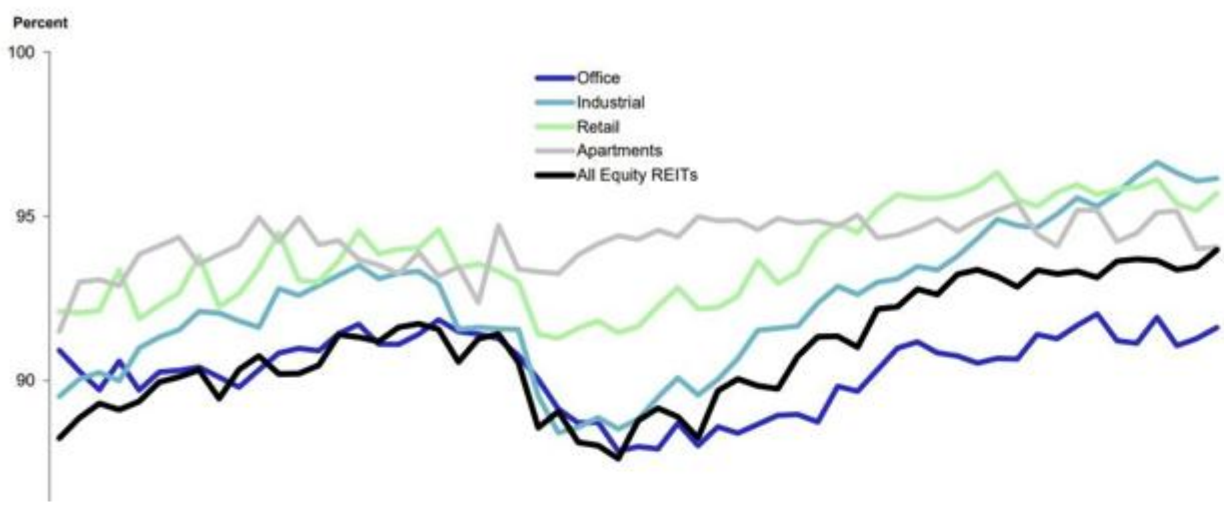
Beta factors: value, dividend growth, low volatility, smaller size ($10 billion market cap vs $97 billion S&P 500)

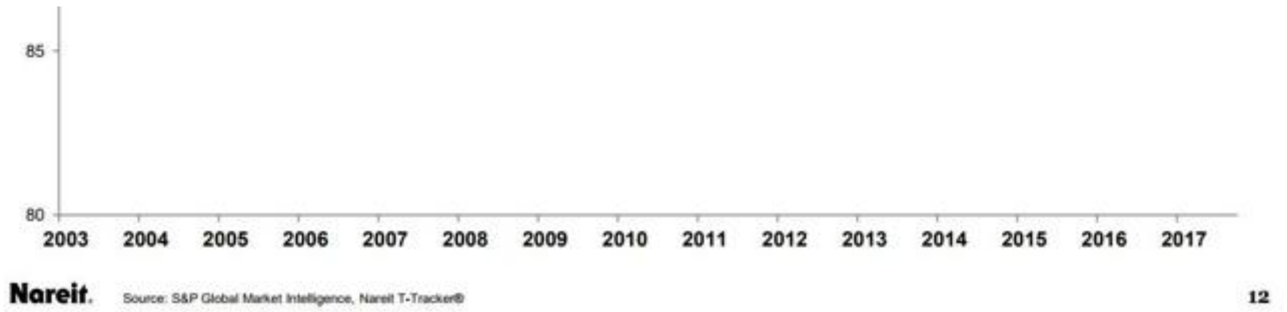
Morningstar Rating: 3 stars

In my most recent portfolio update, I explained why today is the best time in over six years to buy REITs. Specifically, I explained why the common theme of "interest rates up, REITs down" is incorrect, and why over the long-term, rising interest rates have absolutely no negative effect on REIT total returns.

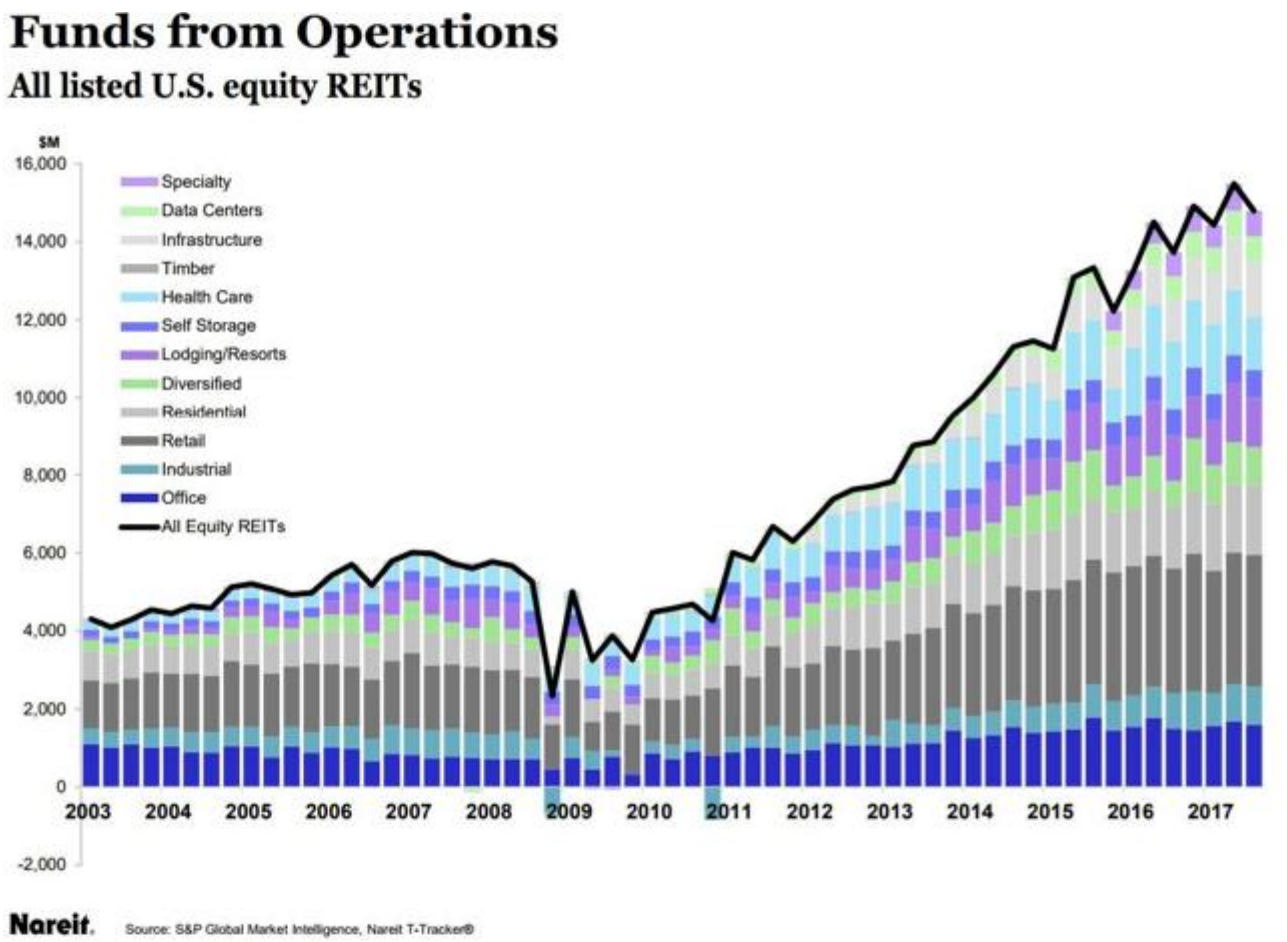
Ultimately this is because what ultimately drives REIT share prices is pure fundamentals, specifically cash flows which convert into safe and growing dividends. And fortunately, the very thing causing this correction (fear of spiking interest rates) is a result of stronger than expected economic and wage growth.

Occupancy Rates



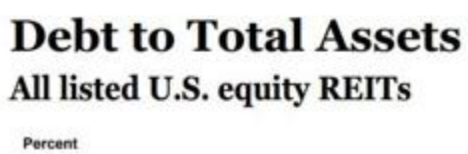


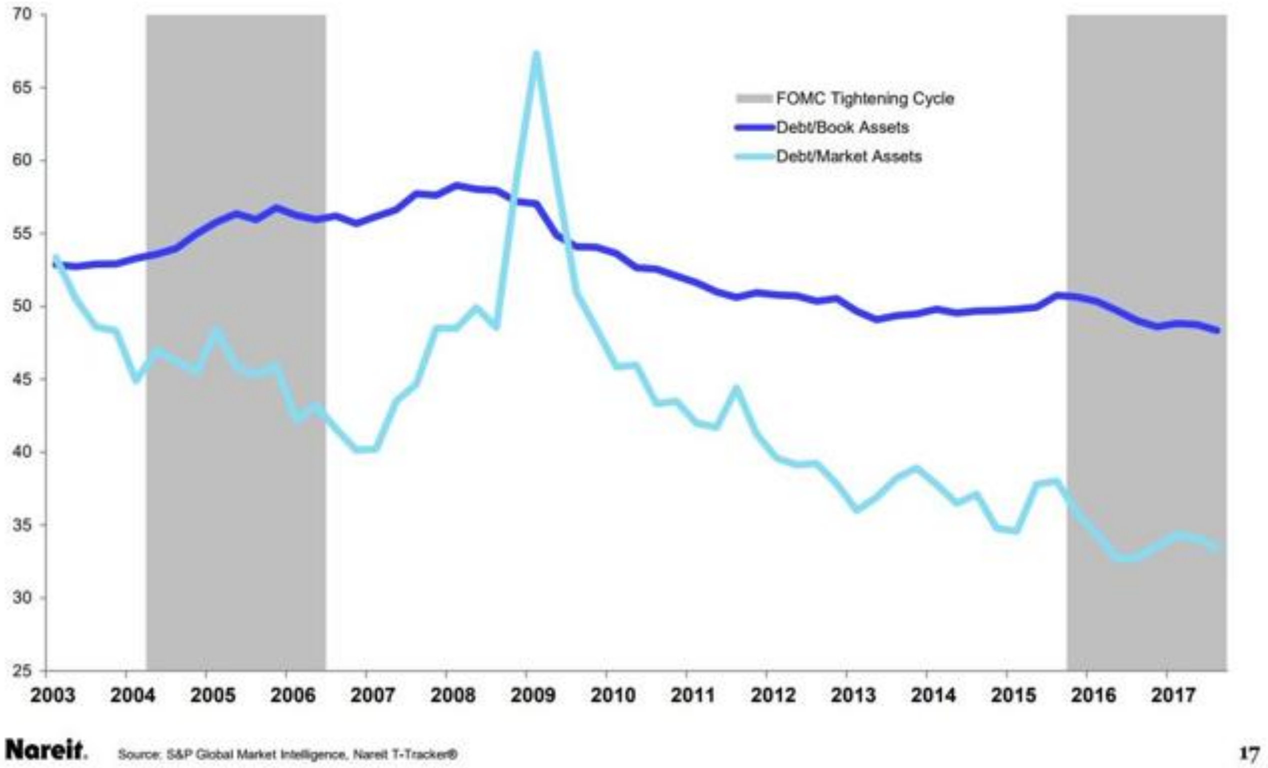
However, if the economy is strong, and wages start growing faster (above 3% a year) then stronger consumer spending is likely to translate into increasing prosperity. This can be seen in REIT occupancy rates, which continue to steadily climb.



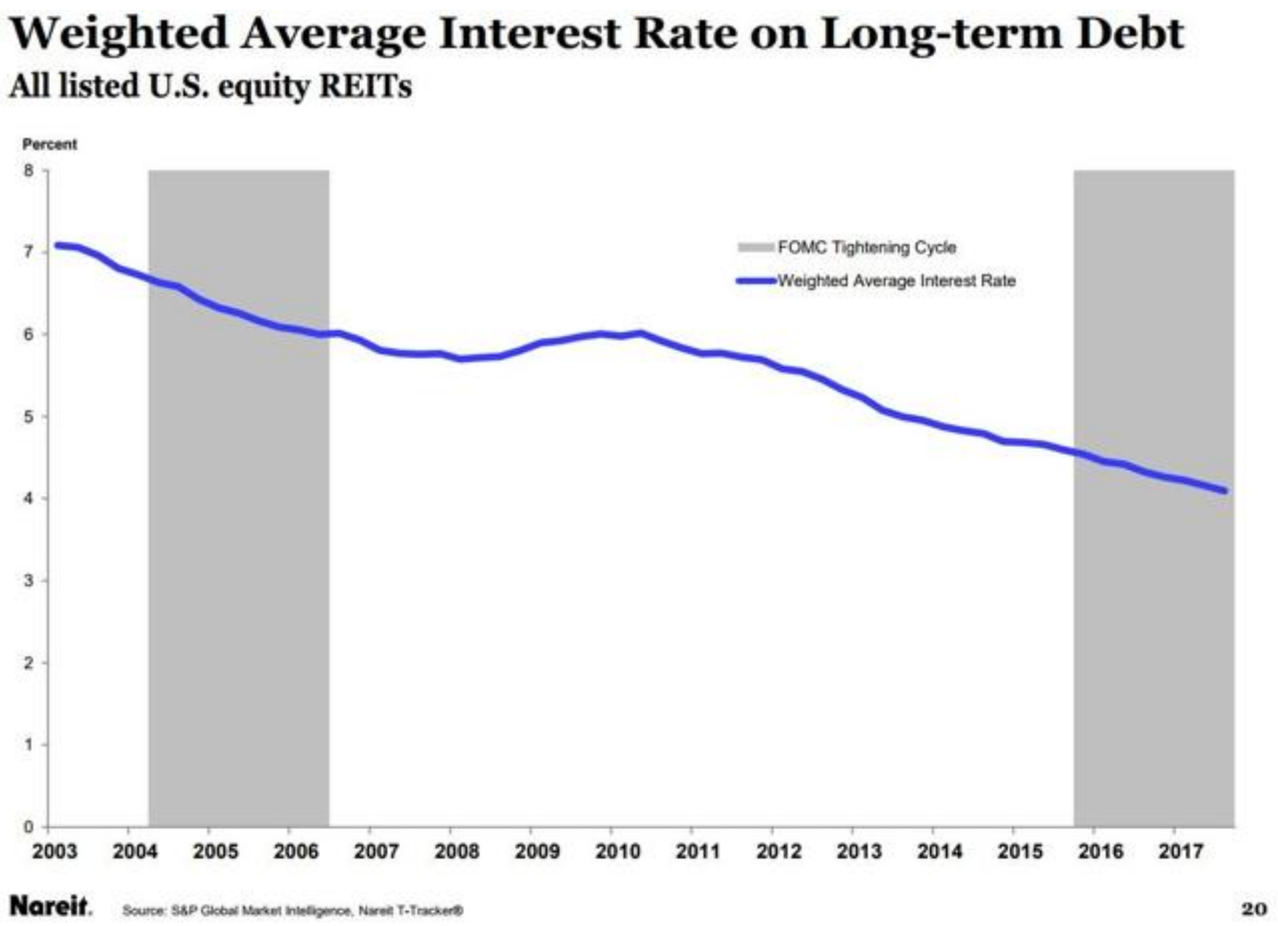
That in turn will translate into rising cash flows (FFO/share) which means that REIT dividends will rise. This will ultimately increase the intrinsic value of shares which are based on the present value of future dividends.

In the meantime, the REIT industry as a whole has spent the last few years (as rates started rising) deleveraging, and the industry's balance sheet is now the strongest it's been in decades.

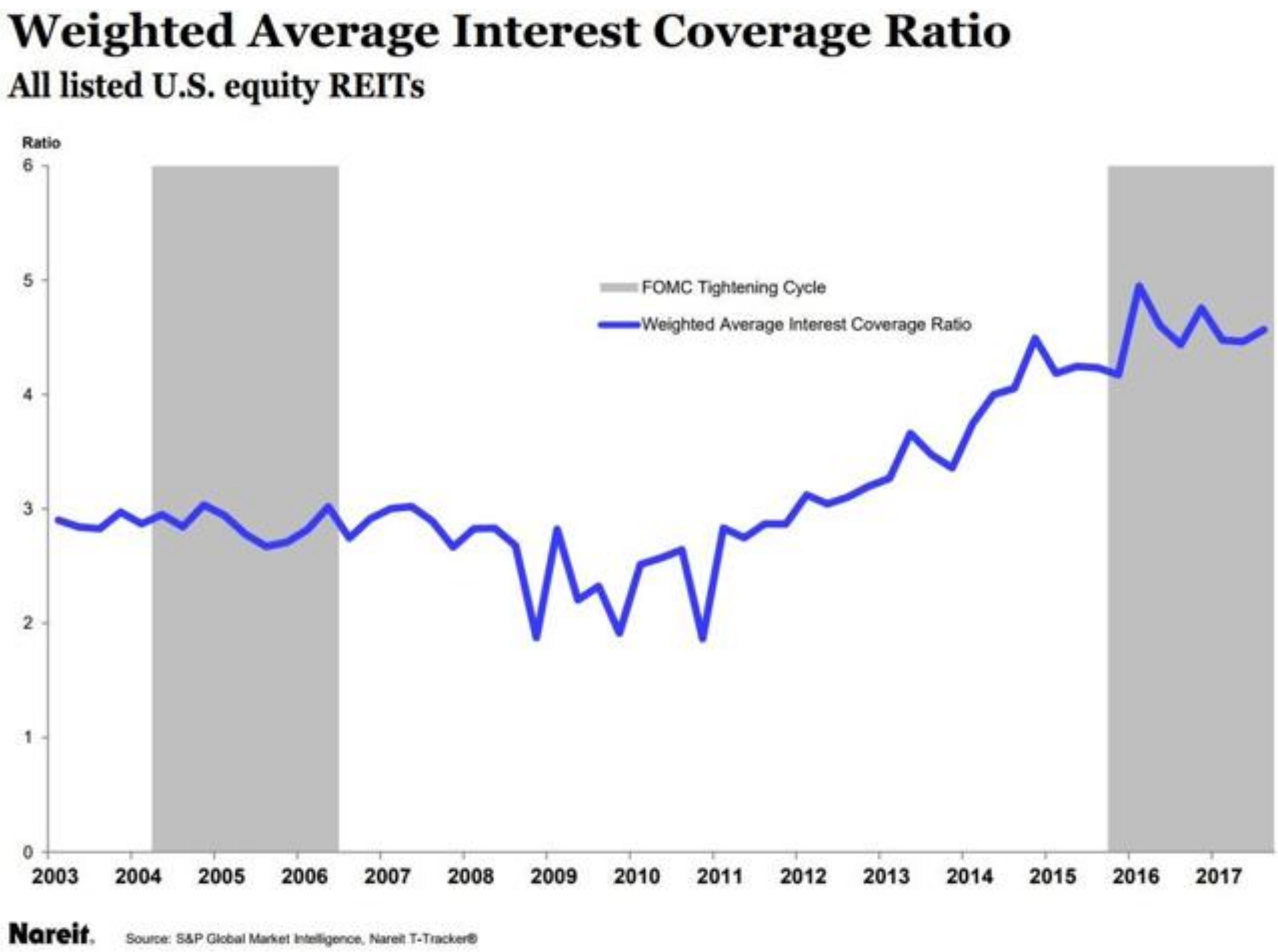




In addition, quality management teams have been refinancing their long-term debt (much of which was taken on before interest rates fell to their lowest levels in history), locking in today's low rates. This is why average REIT interest rates continue to decline.



This means that interest coverage ratios are rising. Which gives REITs greater financial flexibility to invest in future growth while still providing generous, and sustainable dividend growth that investors crave and that ultimately drives share prices up.



The bottom line is that REITs are currently experiencing the same strong and improving fundamentals as is the overall US economy. That makes sense since REITs essentially house the US economy and so one would expect their fortunes to be linked. Thus the current REIT selloff is a purely short-term, knee-jerk reaction to a transitory theme (rates up, REITs down), that will ultimately not matter in the long-term.

For those investors who don't have the time, expertise, or interest in picking individual REITs, VNQ is an excellent choice. That's because it offers the best net yield (yield minus expense ratio) of any REIT ETF.

ETF	Yield	Expense Ratio	Net Yield
VNQ	4.42%	0.12%	4.30%
REET	3.83%	0.14%	3.69%
USRT	3.59%	0.08%	3.51%
IYR	3.84%	0.44%	3.40%

FREL	3.36%	0.08%	3.28%
XLRE	3.31%	0.13%	3.18%
RWR	3.18%	0.25%	2.93%
ICF	3.23%	0.34%	2.89%
SCHH	2.31%	0.07%	2.24%

Source: Morningstar

VNQ tracks the MSCI US REIT Index, which includes all domestic REITs from the MSCI US Investable Market 2500 Index. Note that VNQ only invests in equity REITs (not mREITs) and also excludes certain industries such as: telecom (cell towers), prisons, and timber.

Rather VNQ's portfolio is focused on more traditional REIT industries. It's basically 100% composed of American blue chip REITs involved in: self-storage, industrials, retail, office, hotels, and healthcare properties.

Top 25 Holdings	% Portfolio Weight	Shares Owned
Vanguard REIT II Index	9.96	319,564,620
Simon Property Group Inc	5.60	20,927,558
Equinix Inc	3.71	5,247,842
Prologis Inc	3.60	35,808,913
Public Storage	3.43	10,544,914
AvalonBay Communities Inc	2.58	9,296,839
Welltower Inc	2.47	24,836,163
Equity Residential	2.46	24,730,578
Digital Realty Trust Inc	2.45	13,807,565
Ventas Inc	2.24	23,979,953
Boston Properties Inc	2.10	10,390,045
Essex Property Trust Inc	1.67	4,442,931
Realty Income Corp	1.64	18,452,871
Host Hotels & Resorts Inc	1.54	49,830,531
GGP Inc	1.51	41,568,361
Vornado Realty Trust	1.40	11,481,507
HCP Inc	1.28	31,574,247

Alexandria Real Estate Equities Inc	1.28	6,303,683
Mid-America Apartment Communities Inc	1.20	7,649,289
Extra Space Storage Inc	1.16	8,483,341
Regency Centers Corp	1.11	10,307,845
UDR Inc	1.08	18,014,986
Iron Mountain Inc	1.05	17,836,994
SL Green Realty Corp	1.05	6,663,725
Duke Realty Corp	1.02	23,950,398

Source: Morningstar

The largest REIT industries owned by the ETF (by assets) are:

- Retail: 22.4%
- Specialized REITs: 16%
- Office, residential, healthcare: 12%
- Diversified: 7.3%
- Industrial: 6.5%
- Hotels: 6.2%

This REIT is run by legendary Vanguard index veteran Gerard O'Reilly, who has managed the mutual fund version of this ETF since for 21 years. The man is highly skilled at closely tracking enormous indexes, including the $500 billion Vanguard Total Stock market index (VTSMX). Under his steady leadership VNQ has generated the best total returns of any REIT ETF over the past 10 years.

MPT Statistics VNQ

3-Year | 5-Year | 10-Year | **15-Year**

15-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Standard Index						
VNQ	MSCI ACWI NR USD	45.64	1.02	2.31	9.26	USD
Category: SR	MSCI ACWI NR USD	47.33	1.02	1.68	8.70	USD

Source: Morningstar

Meanwhile, over the last 15 years VNQ has also generated significant alpha compared to its REIT ETF peers, by 2.31% a year. All with the same levels of volatility, meaning it has produced superior risk adjusted total returns.

But it's not just other REIT ETFs that VNQ beats. Historically VNQ has managed to greatly outperform the market.

VNQ Total Return Price data by YCharts

In fact, since VNQ started trading in 2004 it has usually beaten the S&P 500, with the notable exception of the most recent time period. This is when the market was melting up, while concerns over rising interest rates have caused REITs to enter their fifth correction since the financial crisis.

However, rather than view this as a sign that the glory day of REITs is past, I would point out that the last time the running total return of VNQ dipped below SPY (financial crisis) was followed by a period of massive and consistent outperformance.

The bottom line is that VNQ is the gold standard of REIT ETFs, at least those focusing on US equity REITs. The skilled leadership of its manager has managed to generate alpha compared to both other REIT ETFs (which is supposed to be impossible), and SPY.

Best of all? As we'll now see, VNQ, (as well as SPHD), also have strong records of relatively strong and consistent dividend growth as well. After all, for investors like me, short-term share price is vanity, but long-term dividend income is sanity.

Dividend Profiles: Superior Risk-Adjusted Total Returns To The Market

ETF	Net Yield	Projected Future Dividend Growth	Total Return Potential	Beta	Risk-Adjusted Total Return Potential
SPHD	2.9%	5.8%	8.7%	0.65	13.4%
VNQ	4.3%	5.3%	9.6%	0.50	19.2%
SPY	1.6%	6.2%	8.6%	1.0	8.6%

Sources: Morningstar, Ycharts, Multpl.com

In the world of high-yield ETF investing the dividend profile is king. This means looking at the yield, volatility, and long-term dividend growth potential.

In the case of both SPHD and VNQ their net yields are far superior to SPY. While true that their dividend growth rates are slower (because they constitute slower growing industries and sectors), note that ultimately both are expected to generate slightly superior total returns over the next few years. And because they both have much lower volatility, this means that on a risk-adjusted return basis, SPHD and VNQ are significantly better than SPY.

In other words these ETFs offer: higher yields, steady income growth, and market beating total returns; both on an absolute and risk-adjusted basis. Thus they have my strong endorsement of both ETFs as core holdings for any passive investor's income portfolio, but especially during a correction.

Things To Keep In Mind

There are two things to keep in mind when investing in any ETF. First, because of the indexed and rules based nature of these securities, you will end up owning some mediocre companies as well as the Grade A blue chips.

That's not ideal (and why I stick to individual stocks myself) but it's the cost of doing business if you want to enjoy the hands off autopilot style ETFs offer.

In addition, keep in mind that because ETFs collect and pass on dividends from dozens, or sometimes hundreds of companies, this means that the payouts can be somewhat variable. This is especially true for SPHD whose portfolio composition strategy results in higher turnover than VNQ (rebalanced every six months), and so the yield can fluctuate somewhat over time as different stocks get removed and replaced with different ones.

Finally, we can't forget about taxes, one of the few certainties in life. Specifically, both

SPHD and VNQ have slightly lower tax efficiency than SPY.

ETF	Total Pre-Tax Annual Total Returns Since Inception	Post Tax-Annual Total Return	Tax Efficiency
SPHD	14.11%	12.63%	89.5%
VNQ	8.48%	7.02%	82.8%
SPY	9.79%	9.14%	93.4%

Source: Morningstar

This is because of two factors. First, SPY has essentially no turnover, since changes to the S&P 500 are relatively rare.

ETF	Holdings	Turnover	Average Industry Turnover
SPHD	50	56%	59%
VNR	152	7%	77%
SPY	505	3%	55%

Source: Morningstar

SPHD has much higher turnover, due to its semi-annual rebalancing, but still basically in line with similar ETFs. VNQ has very low turnover relative to its peers. However, it has lower tax efficiency because the nonqualified nature of REIT dividends naturally mean a higher tax bill (REIT dividends are taxed at top marginal tax rate rather than dividend rate).

In addition, note that both VNQ and SPHD have strong sector concentration relative to the market. This means that while their volatility is less over the long-term, in the short-term it can be greater. That means temporary periods of underperformance.

Of course, I consider these periods to be a feature, not a bug. That's because they are what provides the exact kind of buying opportunities that long-term value investors like me seek.

Bottom Line: Now Is The Time To Be Greedy When Others Are Fearful By Buying These 2 Gold Standard ETFs

Don't get me wrong, I'm not predicting this is the end of the sell-off. No one can predict when market pessimism will peak, and so we might still have another 5% to 10% to drop before this golden buying opportunity ends.

What I do know, however, is that the economy remains strong, is getting stronger, and all the fundamentals that matter (GDP growth, strong labor market, corporate earnings growth) remain firmly in place.

And the faster markets crash, the faster and stronger they tend to recover. In fact, usually the strongest single day gains come within two weeks of the biggest losses. For example, in the last correction, back in 2016, we saw the market drop 12% from its all time highs over five weeks. This correction is potentially on track to hit -12%...in about five days. This means that we may be seeing a "flash correction", which means a hard, and fast, but short-lived pullback. Sadly this might mean that we get just a brief window of opportunity to lock in mouthwatering prices and dividend yields.

So my recommendation is, rather than panic sell, or try to time the bottom (which studies prove is impossible), you should just focus on investing in time tested, long-term market beating strategies when uncertainty is at its peak.

That would be right now, and so I strongly recommend you consider adding SPHD and VNQ at this time, before the market realizes just how overblown this panic selling has become.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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