Seeking Alpha α

I Like This Low-Vol High-Yield ETF... But I Wish It Was Better

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Summary

- SPHD is a high dividend and low volatility ETF.
- I focus on the methodology of how these factors interact.
- While I applaud their efforts, I would prefer slightly less yield for more exposure to the volatility factor.

With so many dividend ETFs to choose from – how do you separate one from the other? Some people focus on expense ratios. I also believe that you should pay attention to these figures – but only when they are extreme or when two funds are incredibly similar. Otherwise, focus on how the funds are actually designed.

For instance, ALPS Sector Dividend Dogs (SDOG) and AAM S&P 500 High Dividend Value (SPDV) are almost identical ETFs. The one exception is that SPDV adds in the awesome factor of free cash flow yield (read about it here). But their construction methodology is very similar including such aspects as sector balancing, S&P 500 index, position weighting scheme, number of stocks and focus on high yield factor. Yet the slightly inferior SDOG ETF has the audacity to demand a higher expense ratio. In this instance, yes – expense ratios matter (but actually the FCF yield matters a whole lot more). In general, I prefer to focus on more important issues - what drives the fund and how that might affect future returns.

But I digress. Is the PowerShares S&P 500 High Dividend Low Volatility Portfolio (SPHD) one worth adding to your existing lineup? This is my viewpoint based on how it is constructed and not how much it costs.

Focusing Too Much On Expense Ratios Is Like....Oh look...a nickel!

SPHD Overview

The PowerShares S&P 500 High Dividend Low Volatility Portfolio does pretty much what the name of the ETF says: it selects 75 high-yielding stocks in the S&P 500 universe and then keeps the 50 with the lowest volatility.

- There is some sector balancing rules.
- The positions are weighted according to dividend yield.
- The dividend yield is over 4%.

Nuff said.

What I Like About SPHD

I am a strong believer in both dividend yield and low volatility.

A strong dividend yield creates a strong link between the shareholder and the company. Such a firm cannot easily blow their cash on foolish or overpriced growth opportunities. Doing so will quickly create a cashflow problem which will make it difficult for the firm to steadily increase dividends without borrowing or issuing more stock. A strong yield creates accountability and reduces reckless wastefulness. A very high yield, however, might signal higher risk. So caution is warranted when you approach higher yielding stocks.

I like low volatility because I believe it exploits an unchanging behavioral trait. Investors prefer stocks which have large upside potential. They like them so much that they are willing to bid the price up slightly beyond its fair value. Boring stocks with lower growth prospects and mediocre upside win the long-term performance race because of this. You can find these ho-hum stocks by filtering based on volatility.

So when you combine the two, boring high-yield stocks, you position yourself for a lower risk subset (volatility) of a higher risk (high dividend yield) category.

Now, this is not to say that this will always result in the highest return. Because low volatility doesn’t always beat the market. But it should result in one of the best *risk-adjusted* returns. It is not only about the end result but in how you got there.

My Own High Yield Low Volatility Testing

Below is a chart which ranks all the stocks in the S&P 500 from 1999 until today based on volatility and dividend yield. Rank 10 stocks are the highest ranked meaning the highest relative combined score of big dividend yield and low volatility. Rank 1 stocks have the lowest dividend yield and the highest volatility. Each portfolio has 50 stocks and is re-sorted every 4 weeks.

High Yield Low Volatility	Annual Return%	Max DD%	Sharpe
Rank 10	9.33	-39	0.68
Rank 9	8.79	-51	0.59
Rank 8	8.61	-55	0.52
Rank 7	9.88	-56	0.58
Rank 6	10.04	-63	0.56
Rank 5	11.56	-60	0.60
Rank 4	11.38	-61	0.58
Rank 3	10.43	-68	0.50
Rank 2	9.34	-63	0.41
Rank 1	3.86	-87	0.22
(SPY)	6.26	-55.4	0.35

If you are wondering why the SPY is so low compared to the average portfolio, that is due to cap-weighting as opposed to the equal-weighting of the other portfolios.

The difference between the highest and lowest ranked 50 stocks is the most notable. The high yield / low volatility portfolio has a low max daily draw-down of 39% compared to a gut-wrenching 87% drop in the highly volatile and low yielding portfolio.

The high yield and low volatility portfolio gets you to your destination with less hair-pin turns.

What I Don't Like About SPHD

While I like the combination of dividend yield and low volatility, I feel that they were too restrictive on the volatility side. Put another way, this portfolio selects the 75 highest yielding stocks and throws away the 25 tickers which have the highest volatility. But I wouldn't exactly class the remaining ones as low volatility.

According to my volatility calculations less than half the portfolio falls into the lowest quartile of volatility in the S&P 500. I would have preferred the reigns to be a little looser on yield and tighter on volatility. For example, why not take the 125 highest yielding stocks and select the 50 with the lowest volatility. Or forget the rules - create a two factor ranking system so the best combined score of yield and volatility are kept.

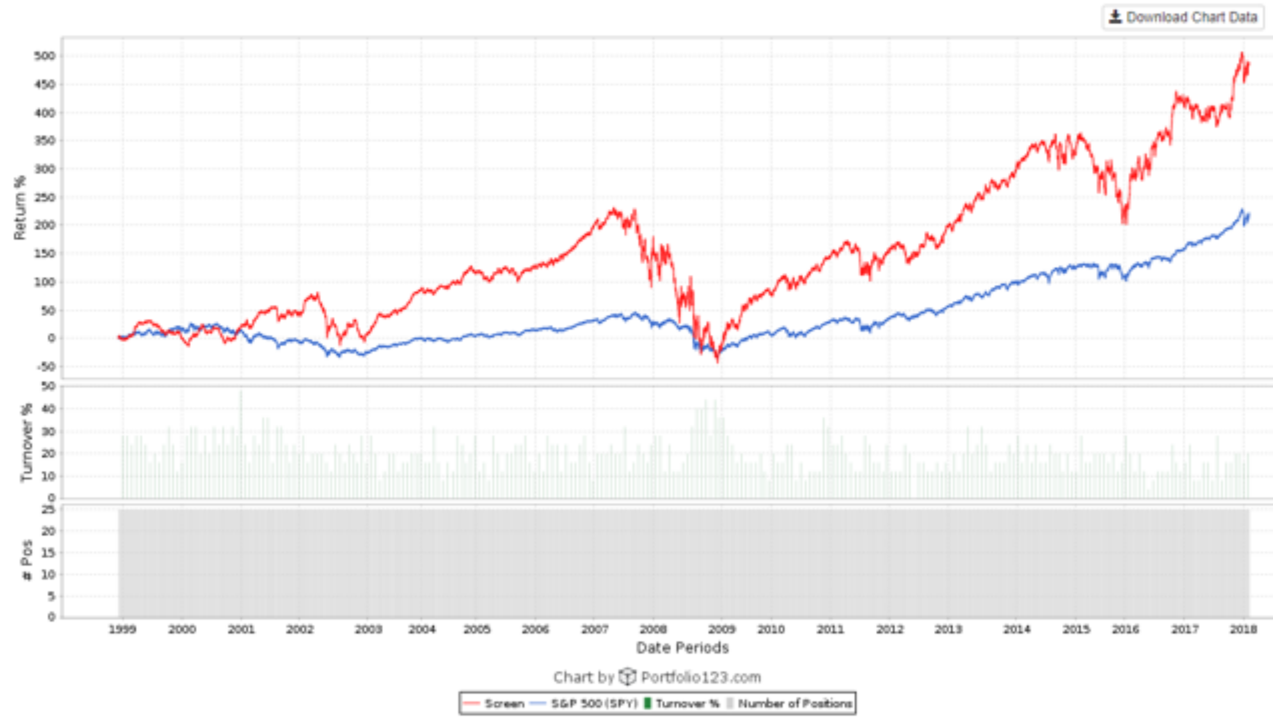
What difference does this make in historical simulations? Mostly around bear markets. More exposure to low volatility could lessen the portfolio exposure to one crashing sector (think financials in 2007-2009). While this fund does have some sector weighting controls – it can still go awry. Right now, it has 40% weighting towards Utilities and Real Estate.

With rising interest rates, the heavy weighting towards these sectors could pull down ETF performance and the volatility controls are not broad enough to counter this. Especially since the positions are yield weighted, which might place even more emphasis on the riskier names.

I believe there is too much emphasis on yield - both in the screening rules and in the weighting scheme, and not enough on volatility.

For curiosity sake, I screened for the 75 highest yielding stocks in the S&P 500 and kept the 25 most volatile names in an equal-weight portfolio. While the annualized return is about the same – the gyrations are unsettling. So you won't see me complaining about throwing out these tickers - I just don't think they went far enough.

	Total Return	Annualized Return	Max Drawdown	Risk Statistics (MONTHLY Period) Sharpe	Sortino	StdDev	CorrelBench	R-Squared	Beta	Alpha
Screen	486.94%	9.66%	-82.95%	0.42	0.58	26.47%	0.74	0.55	1.32	4.29%
S&P 500 (SPY)	220.60%	6.26%	-55.42%	0.35	0.46	14.78%	-	-	-	-



Summary

My final verdict is that SPHD is fine if you have a need for a higher dividend yield while investing in large-cap stocks with a pinch of risk reduction thrown in. It does try to weed out the stocks with higher volatility, but I don’t think the measures go quite far enough. If you could potentially sacrifice even 0.5% portfolio yield to include slightly lower yielding stocks, I believe you could have a much smoother running portfolio that wouldn’t have such extreme sector imbalances and tilts toward risk. I believe this fund should be called High Yield and Somewhat Reduced Volatility – but 'low volatility' is a bit of a stretch for me.

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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