

Stock Market Perspective: Lower Volatility “Index” and Fund

The first widely available index fund dates back to 1976 when Vanguard began its Index 500 fund that closely tracks the S&P 500 Index. At the time it was considered to be a radical departure from the ways mutual funds operated. Rather than trying to select the most promising stocks according to the management’s investment approach, the index fund would simply buy all 500 of the stocks in the index in the same proportion—according to market capitalization—as in the index. One important consequence was that the fund’s expense ratio was far less than that of traditional funds. Over the years the benefits and advantages of this type of fund have become evident, and index funds are now quite popular.

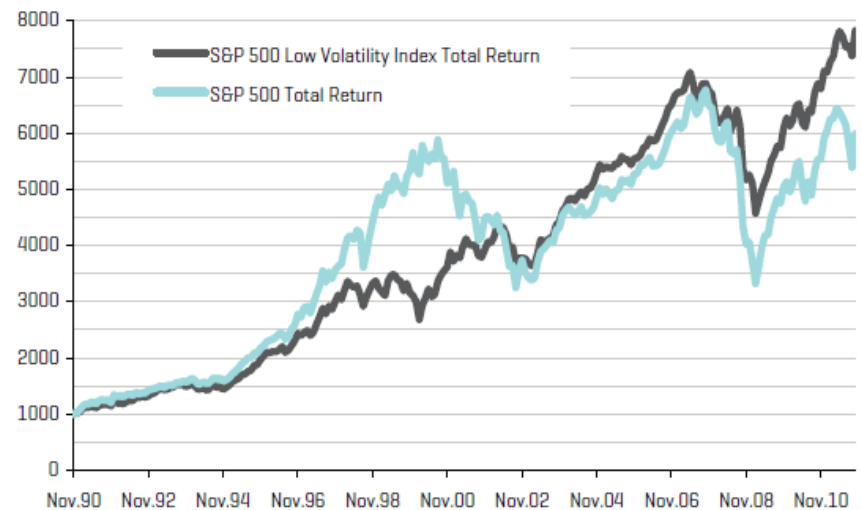
While the S&P 500 is considered to be a good measure of the overall U.S. stock market because its constituents comprise about 75% of total market capitalization, there are alternative indices that measure different market segments. Since the 1990s, several of these have been tracked by mutual funds or exchange traded funds (ETFs). Two indices that have become widely used by these funds are the Nasdaq 100, which emphasizes high technology firms, and the Russell 2000, which holds smaller capitalization issues.

The next important development in the index fund universe was the introduction of leveraged and inverse funds. The former are designed to have daily percentage moves that are a multiple, 1.5, 2, or 3 times, of the move in the associated index. Inverse funds will move in the opposite direction of the index, with leverage in some cases.

All of these types of funds are based on a well defined underlying index and do not attempt to “improve” on the index. In the past decade, there have been several new funds that claim to

do that based on historical research. The idea is to start with a well known index and then decide to own all or only a subset of the constituent issues with weightings other than market capitalization. The simplest of these

Historical Performance



owns all of the S&P 500 stocks with equal weights, so each stock is 0.2% of the portfolio.¹

Others select S&P 500 stocks based on factors such as dividend revenue, or book value. Although the managers of such funds often claim they are index funds, that is not really the case. They are index-linked or index-related and are managed using passive techniques determined by formulas. Unlike true index funds, which change their holdings only when the index changes, these funds typically trade each quarter to rebalance or change the stocks they own according to formulas or other methods. The rebalancing likely helps to improve performance.

In May, a new ETF (ticker symbol SPLV) was introduced for the S&P 500 Low Volatility Index. The index consists of the 100 stocks in the S&P 500 that have been the least volatile

¹ Rydex offers an ETF (ticker RSP) for this, and I sometimes trade its shares according to my market timing models in TAA managed accounts.

over the past year.² Weightings are in decreasing order of volatility so the least volatile issues are a higher percentage of the holdings. The index and the ETF are rebalanced quarterly.

One characteristic of this index is that it has a higher dividend yield than the S&P 500 because stocks with higher yields tend to be less volatile than the broad market. On the other hand, it is less diversified than the S&P 500. Its recent sector allocations were 31.7% in utilities, 29.5% in consumer staples, and no other sector more than 12%. The top ten holdings were six utility companies—the largest with 1.6% of the portfolio—and three consumer staples firms (Proctor and Gamble, Kellogg, and Kraft Foods, each about 1.4%) plus McDonalds, which the tenth at 1.25%.

Standard and Poors' web site has reports about some of their research and historical back testing of the low volatility index. The above graph shows how its performance compares with that of the S&P 500 over the past twenty plus years.³ The darker line shows the total return of the low volatility index, and the lighter one is for the total of the S&P 500 index.

The graph is typical of the relative performance of risk reduction methods. The broad index greatly outperformed during the roaring bull market in the late 1990s. After the top in 2000, the S&P 500 fell sharply while the SPLV continued to gain, and the two had shown about the same long-term gains by late 2002. The two had similar performance until the highs in

² The measure of volatility is the standard deviation of the percent changes over the preceding 252 market days.

³ The graph is taken from an S&P document. The vertical scale is linear. It would be better if it were logarithmic. The linear scale distorts the relative moves up and down so that the same percentage moves at higher prices appear larger than those at lower prices. The logarithmic scale avoids that distortion.

2007. After that, the broad index dropped a lot more, so the low volatility one moved ahead. For the 20 years through this past October, SPLV had a hypothetical annualized total return of 10.0% while the S&P 500 has returned 8.1%.

Moreover, the risk measures of low volatility index, not surprisingly, are better. In particular, its maximum drawdown was 35% in comparison to 51% for the broad index. While large, combined with an appropriate allocation to stocks, that might be an acceptable level.

Since we have been in a secular bear market since 2000 that is quite likely to last for at least another five years and possibly longer, the low volatility fund can be an attractive alternative to the S&P 500. That is particularly so for portfolios that buy and hold index funds.

As I think you realize, that is not how I manage accounts. So a relevant question is how SPLV will perform when my models have us in stocks. The S&P web site had hypothetical daily historical data for the low volatility index available from the start of 2006. Using comparable data for the equal weighted and regular S&P 500 indices, I compared the results of trades following the transaction dates from the model I use to trade broad based index funds. The comparisons are consistent with the overall performance of the low volatility index. That index gains less than the others during the best performing signals, but it loses less or gains a little more from the trades that either make small profits or lose money. Overall, it is pretty much of a wash. I will consider using SPLV for future model buy signals because the dividends were not included in the hypothetical data I had available, and those likely would have made the comparisons more favorable for the low volatility fund.

To wrap up, SPLV looks like it will prove to be an attractive holding for those who want

*A recently started exchange traded
“index” fund holds lower volatility
stocks. It may be a worthy choice.*

exposure to stocks with less risk and higher dividend yields than the S&P 500. As of September 30, the low volatility index had a yield of 3.43% according to an S&P report while the 500 index yielded 2.18%. Over the longer period in the report starting November 30, 1990, the yield gap was even greater, 4.3%

to 2.4%. It is worth pointing out that there are other ETFs, which have longer track records, that likely will have similar characteristics to SPLV. One such is the SPDR S&P Dividend ETF (ticker SDY) that owns stocks that have raised their dividends every year for quite a few years. It began trading over six years ago.