

Not All Low Volatility Strategies Are Created Equal

Over the past decade, many investors have migrated to Low Volatility indices or strategies in the hopes that they will provide similar returns to the underlying indices that they're built from, with less risk. In these cases, risk is defined as price volatility. One of the most popular indices used for this investment purpose is the S&P 500 Low Volatility Index.

The universe from which the S&P 500 Low Volatility Index is drawn is the S&P 500. The rebalancing reference dates are after the close of the last business days of January, April, July and October of each year. Using data as of each rebalancing reference date, the 100 least volatile members of the S&P 500 are chosen as constituents for the S&P 500 Low Volatility Index.¹

According to Morningstar, the Invesco S&P 500 Low Volatility exchange-traded fund (ticker: SPLV) now has almost \$9 billion in assets under management. But in the 2020 stock market decline, SPLV has not performed as expected.

Three explanations for what went wrong:

- Large cap stocks (S&P 500 -10.7%) have outperformed small stocks (S&P SmallCap 600 -29.8%) year-to-date, and the S&P 500 Low

Index	MTD 05/15/2020 Return	QTD 05/15/2020 Return	YTD 05/15/2020 Return
S&P 500 Low Volatility	-5.00%	1.40%	-17.80%
S&P 500	-1.50%	11.10%	-10.70%

Volatility Index ignores market capitalization when weighting stocks, whereas the S&P 500 weightings depend primarily on this measure.

- Real estate and utilities, which are historically low volatility sectors and therefore highly weighted in the S&P 500 Low Volatility Index, have underperformed year-to-date, returning -19.4% and -14.5%, respectively.
- As the 1st quarter of 2020 was historic in its volatility, the quarterly rebalance of the S&P 500 Low Volatility Index, using end of April data to rebalance as of May 15th, caused 64% turnover in the index, forcing indexers to sell some relatively illiquid stocks. (Note that because of their Q1'20 price volatility, the real estate and utility sector weights have declined from 45% to 8% of the S&P 500 Low Volatility Index, while the health care and consumer staples weights have increased from 15% to 49% of the index.)

Is low volatility equity a good strategy? Yes, but the definition of the strategy matters, and investors should understand what they are buying.

These were the insights behind the design of **Matarin Low Volatility**. Here are some of the steps that we've taken in seeking to build a better low volatility solution:

- Stocks are drawn from a larger universe of ~1500 stocks, offering many more options to achieve lower risk.
- In addition to volatility characteristics, proprietary long term return forecasts are used to select stocks.
- Market cap is taken into account in the weighting process, to mitigate the effects of large/small size risk on performance, while still delivering a pattern of returns that is similar to a large cap benchmark.
- Exposure to historically interest rate sensitive sectors such as utilities and real estate is limited.
 - This aspect will prove itself particularly important during rising interest rate environments, in which stock markets are often weak, and in which interest rate sensitive stocks are also under pressure, as bonds become an increasingly attractive source of income.
- Portfolio turnover is limited by using an optimization process to build portfolios. This process considers the unique costs to trade each stock in the investible universe, so lowers trading costs, in addition to managing many other risks.

Unfortunately, S&P 500 Low Volatility Index has let down its investors during this unprecedented COVID-19 stock market sell off. Clearly, all low volatility strategies are not created equal, and we believe that it should be possible for investors to find well thought out strategies, such as Matarin's, which offer equity level returns with below market risk, and return patterns that are not highly correlated with bonds.

*Please don't hesitate to reach out to us for a conversation, if you would like to learn more about this work.
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¹April 2011 S&P 500 Low Volatility Index – Index Methodology Data as of 5.15.2020 Sources: FactSet and S&P Dow Jones Indices

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