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COROMANDEL WEALTH MANAGEMENT

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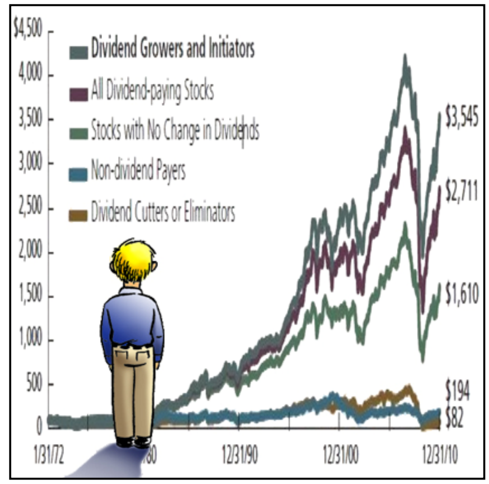
Want Better Returns with Less Risk? Read On…

Navigating the Retirement Maze



In his classic 1973 work, "A Random Walk Down Wall Street", Burton Malkiel made a persuasive case for the efficiency of the stock market, and how it is a fool's errand to try to beat it. Generally speaking, the mutual fund industry has proven Malkiel's premise time and time again, as very few of the over 11,000 funds have outperformed the market consistently. A study conducted by Morningstar showed that 85% of actively managed mutual funds – or about 6 out of 7 – underperformed their benchmarks over any 3-year period. Given those slim odds of picking winning funds, many investors have turned to low-fee index funds.

However, a number of studies have actually uncovered flaws in this "efficient market" theory. They point to two easy ways to implement fund selection strategies that have the potential to give you better returns with less risk. Better still, you can implement them using low-fee exchange traded funds (ETFs). Intrigued? Read on.

The "Dividend Growth" Strategy

There is a significant body of research proving that companies which regularly increase their dividends typically outperform the overall market. Ned Davis Research looked at stock market returns for the 39-year period from 1972 to 2011, and concluded that dividend growers beat the market by an average of 2.34% a year, and with less price volatility. While 2.34% sounds small, the effect compounded over 39 years means that $1,000 invested in dividend growth stocks in 1972 would have grown to $29,860 over that time period, compared to $12,820 for the S&P 500 index. Stocks that did not pay any dividends yielded only $1,930 over the same period.

Previous columns have described the advantages of ETFs over mutual funds, including lower fees, transparency of holdings, and tax efficiency. Among the more than 1,400 ETFs currently available, there are some that use a "dividend grower" strategy to select the stocks they hold. Among my favorites:

- Vanguard Dividend Appreciation (VIG; 0.13% expense ratio)
- SPDR S&P Dividend ETF (SDY; 0.35% expense ratio)
- iShares Dow Jones Select Dividend (DVY; 0.40% expense ratio)

Dividend grower ETFs currently pay dividends between 2% and 4%. The key to their outperformance is that the companies they hold continually increase their dividends year after year.

The "Low Volatility" Strategy

As most investors know, the stock market can be extremely volatile. Prices can move rapidly up and down in response to news, earnings surprises, and government policies. Excessive negative volatility (i.e., losses) can be particularly stomach-churning for investors dependent upon their investments to get them safely through retirement. Thus, the concept of "better returns with less volatility" can be quite appealing.

A recent research paper out of Harvard Business School identified what the authors called "the greatest anomaly in finance." Looking at 40 years of historical data, they determined that portfolios of low-volatility (LV) and low-beta (LB) stocks outperformed the rest of the market by over 2% per year, in contrast to the conventional wisdom which states that achieving outsized returns require tolerating high volatility. When the sample set was restricted to the 1000 largest stocks, the outperformance jumped to 3.5% per year.

Based on these results, a number of LV/LB ETFs have become available in the past year. While their track records are short, their stock selection methodologies are well supported by research. Fund companies have announced LV and LB ETFs that cover US stocks, international stocks, and emerging markets.

The largest ETF in this space is the PowerShares S&P Low Volatility Portfolio (SPLV; 0.25% exp.), with over $1.7 billion in assets and rated 9.8 out of 10 by XTF.com. Most of the others – examples include LVOL, EELV, IDLV, XLBT, and SLVY – are newer to the market and have between $5 million and $60 million in assets. These are worth investigating, but only consider purchasing ETFs with at least $25 million in assets to ensure adequate market liquidity.

Do Your Homework

In the course on ETFs that I teach, I always tell students that they should "look under the hood" of each fund to make sure that they understand the types of stocks that are held in that ETF. I recommend that you do the same. Before purchasing one, see which specific stocks the ETF holds, and what the prospectus says about their stock selection methodology.

While these ETFs are not intended as "single holding" funds, they could certainly form the core of your equity holdings, and provide you with some lower risk peace of mind.

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