I'll Take The High Dividend; You Take The Low Volatility - Which ETF Road To Take? Part 1

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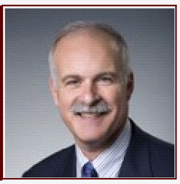
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Disclosure: I am long DVY. **(More...)**

The current ultra-low rate environment that persists after the Financial Crisis continues to force income-seeking investors to find new sources of income-generating assets. One prime asset class that continues to attract strong attention is high dividend-paying equity ETFs. In fact, fund flows into this category at $11 billion through September 17, 2012 already beats the funds flow for all of 2011 (iShares Blog).

The risk with an equity-based income strategy, of course, is the potential market volatility that accompanies the equity markets. For example, the iShares Dow Jones Select Dividend Index Fund (DVY) had a -32.99% return in 2008, dragged down mostly due to its large overweight in the Financials sector. It fully recovered with strong returns in each of the last three calendar years, but large drawdowns are bad news for long-term investors. This is especially tricky for portfolios that are in a "withdrawal state" to fund retirements and other uses since withdrawing during the "trough" period limits long term total return and increases the risk of premature depletion of assets.

One new trend in the ETF market to address this issue is the "Low Vol" ETF. Invesco has been most successful in this new sector with the PowerShares S&P 500 Low Volatility Portfolio (SPLV) it launched in May of 2011. It has attracted lots of attention and lots of new cash flow during that time and is at about $2.5 billion in market value at September 30, 2012. The basic premise of this new ETF is to produce a total return consistent with a passive mix of the 100 stocks within the S&P 500 that have the lowest realized volatility over the past 12 months.

So, how has Low Vol performed thus far and how does it compare to its High Div counterparts? What are the similarities and differences? How does it compare to other, narrower sector funds that have similar risk profiles? And finally, is it really the same product producing similar risk-return profiles with only a different name?

As seen from Table 1, a sample of ETFs that pay high dividends come in all shapes and sizes. They include U.S.-only, international, sector, low beta, average beta, high vol, and low vol. They grow to include the large Vanguard Dividend Appreciation (VIG) and the start-up First Trust Morningstar Dividend Leaders (FDL).

Table 1.
Sample of Large ETFs with High Dividends

Name	Tick	Beta	1-Yr Return	Div Yld	3-yr SD	AUM ($B)
iShares Dow Jones Intl Select Div	IDV	1.06	2.16%	5.15%	22.20	$1.067
iShares S&P 500 Value	IVE	1.04	17.21%	2.19%	16.43	4.316
SPDR S&P 500	SPY	1.00	17.94%	1.91%	15.63	105.931
Vanguard Value	VTV	0.98	16.10%	2.61%	15.42	6.348
SPDR Dow Jones Trust	DIA	0.87	15.76%	2.40%	13.93	11.324
Vanguard High Div Yield	VYM	0.83	20.11%	2.79%	13.28	3.921
Vanguard Dividend Appreciation	VIG	0.82	15.12%	2.05%	13.14	11.658
SPDR S&P Dividend	SDY	0.77	14.04%	3.14%	12.75	9.293

iShares Dow Jones Select Div	DVY	0.71	16.35%	3.41%	12.04	10.966
First Trust Morningstar Div Leaders	FDL	0.53	18.70%	3.20%	11.15	0.652
Consumer Staples Select SPDR	XLP	0.44	18.08%	2.59%	9.78	5.841
iShares High Div Equity	HDV	0.35	21.92%	2.88%	n.a	2.046
Vanguard Utilities	VPU	0.33	11.29%	3.59%	10.05	1.154
Utilities Select SPDR	XLU	0.29	11.60%	3.84%	10.14	6.130
PowerShares S&P 500 Low Vol	SPLV	n.a	17.97%	2.97%	n.a.	$2.353

Since SPLV is fairly new, most of its summary risk statistics are not calculable. Instead, the fund has been back-tested to produce lower risk statistics compared to the S&P 500 with a 3-year vol of 14.25% vs 21.25% and a lower drawdown of 35% compared to 51% (S&P Indices). There is no modeled beta statistic reported for SPLV, but it can be expected to be well below 1.0.

As seen from the table, these statistics by themselves do not distinguish SPLV from its performance-based peers. For example, DVY underperformed the 1-year horizon by 1.62% (17.97%-16.35%) but had a substantially higher dividend payout and lower standard deviation. Vanguard High Dividend Yield (VYM) beat SPLV with a higher total return and lower standard deviation with a comparable dividend yield. The First Trust Morningstar Dividend Leaders (FDL) beats SPLV on all counts.

A broad review of sector exposure for all of the non-sector funds in the table shows consistent overweights to Utilities and Consumer Staples and underweights to Financials, so that is not a distinguishing factor for SPLV. The sector funds shown in the table for Utilities and Consumer Staples look very good over the 1-year horizon compared to SPLV, but the lack of diversification makes these sector bets less of an option for long-term investors.

So what do we do? All of these ETFs produce comparable risk-return profiles based on a passive, buy-and-hold, rule-based investment approach with periodic rebalancing. Some high dividend ETFs compare very favorably on a risk and return basis. From this data it is difficult to distinguish SPLV from any of the other ETFs.

Part II of this series will focus on the investment process employed by managed ETF advisers to apply a truly dynamic rebalancing approach on top of passive ETF investing to improve the risk-return profile.