Go against the flow
Why low volatility ETF investors should consider switching to Sustainable Equity

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Summary

- Investing in lower volatility stocks can help preserve wealth in falling markets; we believe it can be an important allocation to have, and particularly relevant for investors with one eye on the end of the bull market cycle.
- Some popular low volatility indices and ETFs have become expensive because they don’t consider valuations or the fundamental reason as to why a stock should exhibit lower risk features; this may hamper future performance.
- Rosenberg Equities’ Sustainable Equity strategy aims to avoid the pitfalls present in simple low volatility indices by taking an active approach which avoids the most expensive names as well as anchoring to strong earnings fundamentals.
- Rosenberg Equities’ flagship fund – AWF Global Factors - Sustainable Equity – has outperformed the market (MSCI World Index) by 7% over the last 12 months while remaining reasonably valued. The fund has successfully delivered on its long-term objective of lowering volatility while generating excess returns.

Equity volatility is on the rise

After a tumultuous end to 2018, global equities (led by the US) rose some 16.7% in the first four months of 2019, as measured by the MSCI World index in dollar terms. Returning trade war concerns brought the rally to an abrupt halt in May, however, with increased volatility and day-to-day moves seemingly at the mercy of Donald Trump’s tweets. With the 2020 Presidential election around the corner, his Twitter account is not likely to be going quiet any time soon.

Exhibit 1: The power of a president’s tweet

A popular solution for many investors concerned about rising volatility has been to invest in Exchange Traded Funds (ETFs) that track ‘Low Beta’ or ‘Minimum Volatility’ indices. ETFs can offer investors quick access to specific markets or investment styles, and low volatility ETFs have attracted significant assets recently; the iShares Edge MSCI Min Vol USA ETF (USMV) is the 5th best-selling ETF year-to-date with net flows of around $5bn, according to ETF.com.

**Exhibit 2: US minimum volatility ETF net flows, YTD**

*Data for the iShares Edge MSCI Min Vol USA ETF as of 31 May 2019.

**Exhibit 3: World minimum volatility P/E versus the market**

Source: AXA IM Rosenberg Equities. P/E calculated using proprietary recurring earnings data. ‘World Cap Weighted’ is the MSCI World Index; ‘World Min Vol’ is the MSCI World Minimum Volatility Index. Data as of 31 May 2019.

Some low volatility ETFs are becoming expensive

We are firm believers that investing in lower volatility stocks can help preserve wealth in falling markets and is a structurally important allocation for any investor concerned about equity market downside risks. However, the wall of passive money flowing into low volatility strategies has resulted in some of these stocks, and in turn the ETFs that track them, becoming expensive.

Why is this? We believe that one of the main reasons for this is that many popular low volatility indices ignore valuations and focus solely on price information. In fact, our analysis of a popular global minimum volatility index shows that its price/earnings (P/E) multiple is now at a 23% premium to the market – its highest level in the last five years (Exhibit 3, above).

While minimum volatility indices have performed well over the last year, a large portion of that outperformance can be ascribed to a P/E re-rating. Investors may tolerate rich valuations when markets are in a ‘risk off’ mood and they are happy to pay a premium for safety, but overexposure to expensive stocks, in our view, hampers the ability to generate excess returns in rising markets (it’s worth noting that the MSCI World Minimum Volatility Index lagged the MSCI World Index by almost 5% in the first four months of 2019).

So what could an investor in an overvalued low volatility ETF, or one who wishes to make a lower risk equity allocation, do?

Our solution: Rosenberg Equities’ Sustainable Equity strategy

Our Sustainable Equity strategy has two key features that we believe can provide a better way to invest in low risk equities:

1. We actively avoid exposure to the most expensive low beta/low risk names. By analysing a sufficiently broad investment universe we still find plenty of opportunity to pick low volatility stocks that are reasonably priced.
2. We look beyond stock prices and also consider the stability of each individual company’s earnings (both historical and predicted). This anchors the strategy to companies with the potential to deliver earnings in difficult market conditions, while also proving to be a more robust investment strategy in rising markets by providing a direct link to corporate earnings growth – a feature missing from simple low volatility indices.
As shown in Exhibits 4 and 5 below, the combination of these two features over the last 12 months has delivered strong relative performance without the inflated valuation measures seen in some low volatility ETFs.

**Exhibit 4: Strong outperformance over last 12 months...**

![Graph showing strong outperformance over last 12 months.]

**Exhibit 5:...while keeping a stable valuation (P/E) profile**

![Graph showing stable valuation (P/E) profile.]

Source: AXA IM Rosenberg Equities, MSCI. ‘Rosenberg Sustainable Equity’ refers to the I USD share class of the AWF Global Factors – Sustainable Equity fund (net performance based on official NAV); ‘World Cap Weighted Index’ refers to MSCI World Index in USD. Returns are rebased to 100. Data as of 31 May 2019.

**Longer-term performance and ESG**

While performance has been excellent over the last 12 months, the strategy has also delivered on its objective of generating long-term excess returns while mitigating market downside risk:

<table>
<thead>
<tr>
<th>Performance</th>
<th>YTD</th>
<th>1 Yr</th>
<th>3 Yr</th>
<th>5 Yr</th>
<th>S.I.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AWF Global Factors – Sustainable Equity Fund (%)</td>
<td>12.58</td>
<td>7.50</td>
<td>10.13</td>
<td>7.67</td>
<td>8.76</td>
</tr>
<tr>
<td>MSCI World Index (%)</td>
<td>10.72</td>
<td>0.59</td>
<td>9.34</td>
<td>5.81</td>
<td>7.48</td>
</tr>
<tr>
<td>Excess return (%)</td>
<td>1.86</td>
<td>6.91</td>
<td>0.79</td>
<td>1.86</td>
<td>1.28</td>
</tr>
</tbody>
</table>

Source: State Street. Data for I USD share class as of 31 May 2019, net of fees. Performance based on official NAV with dividends reinvested.

<table>
<thead>
<tr>
<th>Risk Statistics</th>
<th>1 Yr</th>
<th>3 Yr</th>
<th>5 Yr</th>
<th>S.I.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Volatility (%)</td>
<td>13.32</td>
<td>9.34</td>
<td>9.75</td>
<td>9.72</td>
</tr>
<tr>
<td>Index Volatility (%)</td>
<td>15.54</td>
<td>10.72</td>
<td>11.31</td>
<td>11.12</td>
</tr>
<tr>
<td>Up-Market Capture Ratio (%)</td>
<td>109</td>
<td>90</td>
<td>91</td>
<td>91</td>
</tr>
<tr>
<td>Down-Market Capture Ratio (%)</td>
<td>76</td>
<td>79</td>
<td>80</td>
<td>83</td>
</tr>
</tbody>
</table>

Source: Northern Trust. Data shown is for AWF Global Factors – Sustainable Equity fund as of 31 May 2019 (gross of fees, USD).

We further enhance the fundamental focus of our Sustainable Equity strategy by considering environmental, social and governance (ESG) information. In our view, this provides vital fundamental information about companies’ long-term strategic choices and when used in concert with traditional financial accounting data, should help mitigate risks and generate returns.

<table>
<thead>
<tr>
<th>ESG Profile</th>
<th>Sustainable Equity</th>
<th>Relative to Index</th>
<th>MSCI World</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG score</td>
<td>6.8</td>
<td>↑ 15%</td>
<td>5.9</td>
</tr>
<tr>
<td>Carbon intensity (CO2e tons/$m revenue)</td>
<td>145.1</td>
<td>↓ 43%</td>
<td>255.8</td>
</tr>
<tr>
<td>Water intensity (m3/$m revenue)</td>
<td>17,565</td>
<td>↓ 22%</td>
<td>22,448</td>
</tr>
</tbody>
</table>

Source: AXA IM Rosenberg Equities. Data shown is for AWF Global Factors – Sustainable Equity fund and MSCI World Index as of 31 May 2019.
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