

Volatility Level as a Criterion for Stock Selection
August 2012

The table below presents a comparison of the performance since inception of various Russell high volatility and low volatility exchange-traded funds (ETFs). These ETFs have an inception date of May 25, 2011. Incidentally, similar low volatility ETF offerings from iShares and PowerShares have inception dates not very far from that of the Russell funds; hence, there appears to be competition between these firms for low volatility ETF business.

Performance of Russell Low and High Volatility ETFs:
(5/25/2011 (inception) to 5/31/2012)

Russell 1000 Low Beta (LBTA)	5.00%
Russell 1000 Low Volatility (LVOL)	2.30%
Russell 2000 Low Beta (SLBT)	(0.08)%
Russell 2000 Low Volatility (SLVY)	(0.01)%
Russell Developed ex-U.S. Low Beta (XLBT)	(2.69)%
Russell Developed ex-U.S. Low Volatility (XLVO)	(1.43)%
Russell 1000 High Beta (HBTA)	(7.74)%
Russell 1000 High Volatility (HVOL)	(7.98)%
Russell 2000 High Beta (SHBT)	(17.81)%
Russell 2000 High Volatility (SHVY)	(22.78)%

Source: *Russell Investments*

From the almost one-year period of May 25, 2011 to May 31, 2012, the Russell 1000 Low Beta ETF (LBTA) had a 5.00% return. At the moment, we are only looking at returns. During the same period, the Russell 1000 Low Volatility ETF earned 2.30%. The Russell 2000 Low Beta (SLBT) earned negative eight basis points, and the Russell 2000 Low Volatility (SHVY) earned negative one basis point. The Russell Developed ex-U.S. Low Beta (XLBT) had a -2.69% return, and the Russell Developed ex-U.S. Low Volatility (XLVO) returned -1.43%.

Russell offers only two high volatility ETFs and two high beta ETFs. For the same period, May 25, 2011 to May 31, 2011, the return on the Russell 1000 High Beta (HBTA) was -7.74%, the Russell 1000 High Volatility (HVOL) was -7.98%, the Russell 2000 High Beta (SHBT) was -17.81%, and the Russell 2000 High Volatility (SHVY) was -22.78%.

Clearly, a distinction is being drawn between those securities being classified as high volatility and those being classified as low volatility. We are dealing with a very large number of securities. Those securities in the Russell 2000 that are classified as low volatility earned a return of negative one basis point for the period in question, and those classified as high volatility earned—if that’s the correct word—a rate of return of -22.78%. How is this situation possible for such a large agglomeration of companies for which the fundamentals are so vastly different? That is the question before us.

The basic data pertaining to the Russell 1000 Low Volatility ETF in the table below are derived from Russell’s own database. The 13.74x forward P/E is based on consensus estimates (which might not be accurate), and an 8.55% consensus forecast for EPS growth.

<u>Russell 1000 Low Volatility ETF (LVOL)</u>	
P/E (trailing)	16.26x
P/E (forward)	13.74x
Price-to-Book Ratio	2.55x
Price-to-Sales Ratio	1.34x
Price-to-Cash Flow Ratio	10.23x
Dividend Yield	2.75%
Return-on-Equity (ROE)	20.27%
Debt-to-Equity Ratio	1.35x
Dividend Payout Ratio	43.11%
EPS historical growth (per annum)	6.18%
EPS growth consensus forecast (per annum)	8.55%

Source: Russell Investments, as of June 15, 2012

How is it conceivable that companies can invest nearly 57% of their earnings (1 minus the 43.11% payout ratio) back into their businesses at a 20% ROE and only have an EPS growth forecast of 8.55%? It seems to result from an implied forecast of declining ROE.

To compare and contrast, here are the corresponding numbers for the Russell 1000 High Volatility ETF:

<u>Russell 1000 High Volatility ETF (HVOL)</u>	
P/E (trailing)	14.86x
P/E (forward)	12.34x
Price-to-Book Ratio	1.97x
Price-to-Sales Ratio	1.28x
Price-to-Cash Flow Ratio	10.00x
Dividend Yield	1.38%
Return-on-Equity	15.72%
Debt-to-Equity Ratio	1.03x
Dividend Payout Ratio	16.58%
EPS Historical Growth Per Annum	10.76%
EPS Growth Forecasted Per Annum	14.49%

Source: Russell Investments

The Russell 1000 Low Volatility trailing P/E ratio is 16.26x and for the Russell 1000 High Volatility that number is 14.86x. The Russell 1000 Low Volatility forward P/E is 13.74x, and the High Volatility forward P/E is 12.34x. The price-to-book value ratio on the Russell 1000 Low Volatility is 2.55x; for the High Volatility it is 1.97x. The price-to-sales ratio on the Russell 1000 Low Volatility is 1.34x and for the High Volatility it is 1.28x.

Over the last year, by Russell’s own calculations, the high volatility stocks have become statistically less expensive than the low volatility stocks. One has to wonder why they are more volatile.

Historically, high volatility stocks were those that generally projected higher growth with higher levels of uncertainty and attendant higher valuations. The only way volatility can be measured is on historical numbers, but statistics in valuation are measured at a point in time; consequently, it makes no sense for the higher volatility stocks to become statistically cheaper, unless they cease being high volatility stocks and become low volatility stocks. Low volatility stocks may become high volatility stocks, although everyone’s already invested in what they believe to be low volatility stocks. However, those may actually become the high volatility stocks. Therein lies a very serious problem.

Now let us compare the PowerShares S&P 500 Low Volatility ETF (SPLV) with the PowerShares S&P 500 High Beta Portfolio (SPBH).

	PowerShares S&P 500 Low Volatility (SPLV)	PowerShares S&P 500 High Beta Portfolio (SPBH)
	Low Volatility (SPLV)	High Beta (SPBH)
Performance Since Inception (5/5/2011 to 5/30/2012)	11.67%	(8.46)%
P/E Ratio	14.92x	14.17x
P/B Ratio	2.47x	1.23x
ROE	22.67%	11.11%

Source: Invesco PowerShares as of 5/30/2012

The performance from the inception date of May 5, 2011 through May 31, 2012 for the PowerShares S&P 500 Low Volatility is 11.67% and for the S&P 500 high Beta portfolio it is -8.46%. The P/E ratio of the low volatility stocks in the S&P is 14.92x, according to PowerShares’s calculations, and the stocks of the high beta variety in the S&P have P/E ratios of 14.17x. On a price-to-book value basis, the low volatility shares trade at 2.47x book, and the high beta shares trade at 1.23x book. Thus, the low volatility shares are priced twice as much on a price-to-book value basis as the high beta shares. As calculated by PowerShares, among the low volatility names, the ROE is presumed to be 22.67%, while the high beta names achieve a mere 11.11%. That may indeed be the ROE, but it’s adequately discounted by the proportionately lower book value multiple.

An interesting point about the PowerShares Low Volatility ETF is that 29.49% of the index is composed of companies in the utilities sector, but no utility has an ROE even remotely approaching 22.67%. One might reasonably inquire how these low volatility shares are going to sustain an ROE of 22.67% when nearly a third of the companies in question are invested in utilities, most of which are only allowed by their regulatory commissions to have ROEs of less than 10%.

DISCLAIMER

Past performance is not indicative of future returns. This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer to sell or a solicitation to invest.

This information is intended solely to report on investment strategies as reported by Horizon Kinetics LLC. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable.

No part of this material may be: a) copied, photocopied, or duplicated in any form, by any means; or b) redistributed without Horizon Kinetics' prior written consent.