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## Two Changes to Raise Long-Term Returns

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With markets gyrating all over the map, investors these days crave steadiness, and some of that can be found in two types of investments: high-dividend stock funds and low-volatility stock funds. I've been studying these for several months and am ready to recommend that we all move a portion of our stock allocation to these two areas.

First, much has been written recently about the virtues of dividends. I should say right away that dividend-paying stocks are not a panacea and they're a poor substitute for cash or short-term bonds and bond funds. On the equity side, though, such stocks do well over the long term, according to the data presented in a newly published book, [The Strategic Dividend Investor](#), by Daniel Peris. He shows that high-yielders routinely outperform low- and no-yield stocks by a significant margin. In addition, 3 economists from the London Business School compiled an exhaustive database of stock market returns going back to 1900. They found that dividends accounted for more than 50% of stock market returns in every country they studied.

The fund I've settled on for dividends is called the SPDR S&P Dividend ETF (exchange-traded fund). This is an investment with good liquidity and a tight bid/ask spread, good features for an ETF (which trade on exchanges throughout the day). It's an index with very low expenses of 0.35%. It tracks the S&P Dividend Aristocrats Index, which consists of the highest 60 payers, all of which have consistently increased their dividends over the past 25 years. The fund weights those stocks by their dividend yield. The yield is currently 3.5%. By this strategy, the fund hopes to choose firms with conservative management that have delivered consistent growth. In the last 5 years (through 10/31/11), this index has provided an annualized return of 4.20%, compared to 0.27% for the S&P 500. Note that financial companies make up only 10% of this index, versus 16.1% for the S&P index.

Moving on to the 2nd prong of the strategy, research has found that low-volatility stocks have outperformed high-volatility stocks, as measured by beta (a measure of a stock's market-related movement and risk). There's a recent analysis by 3 economists, Baker, Bradley and Wurgler, in the Financial

Analysts Journal of February 2011, that says "contrary to basic finance principles, high-beta and high-volatility stocks have long underperformed low-beta and low-volatility stocks." They go on to speculate that this anomaly exists because of "the combination of irrational investor demand for high volatility stocks and delegated investment management with fixed benchmarks." Specifically, a lot of institutional investors try to beat certain benchmarks for their clients, and as a result, they have a bias for choosing high-volatility stocks, as opposed to boring, low-volatility stocks such as Kellogg and the utility holding company Southern.

Whatever the reason, there appears to be solid evidence for the superiority of low-volatility stocks; granted, if everyone were to adopt this strategy, the advantage would eventually disappear, but my guess is that enough investment managers will continue to invest as described above, so that the opportunity will persist. In fact, there was a short piece about this strategy in this week's Barron's newspaper. By the way, if any of you would like to see the scholarly piece or the Barron's article, just let me know.

The vehicle I've chosen for a low-volatility fund is called the PowerShares S&P 500 Low Volatility ETF. This fund's expenses are a low 0.25%. It's a new fund, so it doesn't have a long record, but it tracks the S&P 500 Low Volatility Index, and it fell less than 0.1% from late July through last Tuesday, compared to an 8.0% drop for the S&P 500 Index. So it's working as advertised. I'm attaching a Morningstar report on both ETFs.

My approach will be to take 50% of your large-cap U.S. stock exposure, and replace it with these two ETFs, weighted equally. I'll be doing this over the next few weeks. So be sure and let me know if you do not want me to do this on your portfolio, or if you want to discuss it further first.

By the way, both the high dividend and the low volatility strategy works with foreign stocks as well, so I'll be identifying in the upcoming few months appropriate foreign funds to further implement this strategy. Note that you already hold Matthews Asia Dividend.