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# A Decade of Low Volatility with High Dividends

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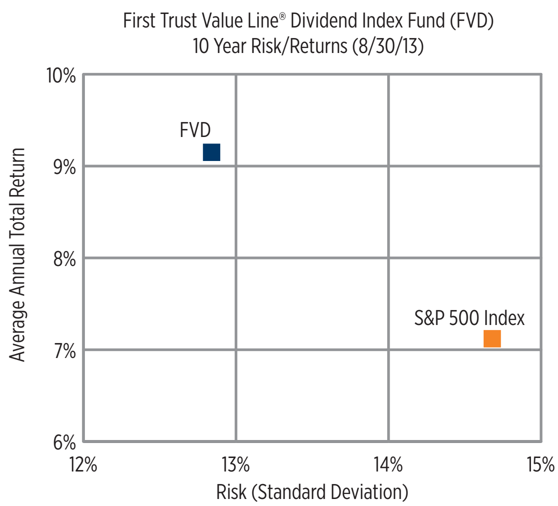
Over the past few years, both "low volatility" and "dividend" strategies have resonated with ETF investors, many of whom were seeking more conservative approaches by which to increase exposure to stocks. Adding further demand for these strategies is a growing body of evidence that suggests an association between both factors and improved risk-adjusted returns.

Unfortunately, while there are compelling theoretical justifications for investing in ETFs that track dividend and low-volatility strategies, and many have produced admirable short-term track records, the vast majority of ETFs in both categories lack long-term, real-world track records for investors to inspect. One notable exception, which recently reached its tenth anniversary, is an ETF that seeks less volatile stocks that pay above average dividends: the First Trust Value Line Dividend Index Fund (FVD).

In this newsletter, we will briefly consider the theoretical rationale for investing in low volatility and dividend-seeking strategies, we will explore how the Value Line Dividend Index selects stocks exhibiting these characteristics, and we will evaluate the results of this strategy over the past decade.

Chart 1




## The case for low volatility

While traditional assumptions of the efficient market hypothesis suggest a direct link between a stock portfolio's returns and level of risk taken to achieve those returns (in other words, higher returns can only be achieved by taking more risk), a growing body of research suggests that less volatile stocks may actually deliver similar returns to the broad market, but with less risk, thereby resulting in better-than-expected risk-adjusted returns.[1] A number of theoretical explanations have been proposed to explain this suspected anomaly, most of which involve behavioral misjudgments made by investors that result in a tendency to overinvest in riskier (or more volatile) stocks, while underinvesting in less risky (or less volatile) stocks. This pattern may open the door for less volatile stocks to outperform in the future, while more volatile stocks underperform.

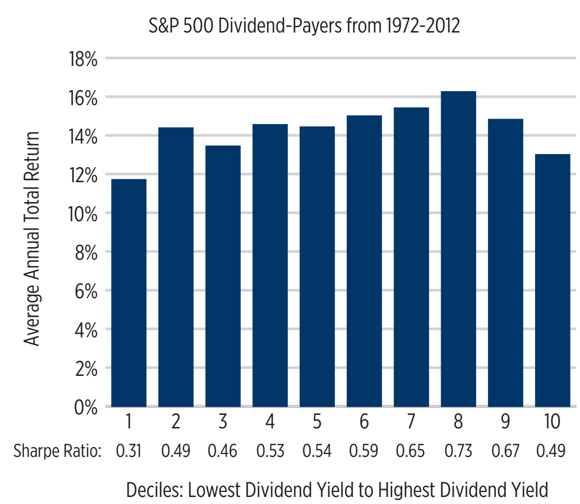
One critique against utilizing historical "low volatility" as a stand-alone factor in constructing an investment portfolio, is that, not only is this data necessarily backward-looking, but it also ignores how potential changes in macroeconomic conditions, company fundamentals, and valuations may cause certain stocks to exhibit substantial changes in volatility from previous periods.

## The case for dividends

Over the past several decades, dividend paying stocks have posted higher returns than non-payers, and have often done so with significantly less risk. According to a study from Ned Davis research, from 1972-2012, dividend paying stocks from the S&P 500 Index returned 8.8% per year with a standard deviation of 17.0%, compared to non-payers, which returned 1.6% per year with a standard deviation of 25.6%.[2] Among the dividend payers, the best performance with the least amount of risk was achieved by stocks that increased or initiated dividends, which returned 9.5% per year with a standard deviation of 16.2%. The worst performance came from companies that cut or eliminated dividends, which returned -0.3% with a standard deviation of 25.6%.

In light of the relationship between dividend paying stocks and better risk-adjusted returns versus non-dividend paying stocks, it's not too difficult to understand why some investors have wrongly inferred that high dividend yields should correspond with high returns. However, this has not generally been the case. From 1972-2012, the highest yielding decile of dividend paying stocks in the US produced the second lowest average annual returns among dividend payers, and the fourth worst Sharpe Ratio (see Chart 2 below).[3] This is largely due to the impact of so-called "dividend traps", stocks whose high yields are due primarily to stock price declines rather than dividend growth. When combined with worsening fundamentals, these companies are often forced to reduce or eliminate future dividend payments.

Chart 2



## The Value Line Dividend Index: Seeking Dividends from Less Volatile Stocks

The process by which less volatile stocks with above average dividends are selected is what makes the Value Line Dividend Index unique. Value Line's coverage universe of approximately 1700 stocks is screened to eliminate any stock that fails to achieve a 1 or 2 rank by Value Line's "Safety" ranking system (on a scale of 1 (highest score) to 5 (lowest score)), or that has a below-average dividend yield compared to the S&P 500 Index. Included in Value Line's proprietary Safety ranking system is an evaluation of a stock's volatility over the previous five years, as well as its "Financial Strength," which is Value Line's measure of a company's financial condition. Financial Strength is determined by a variety of factors including a company's debt to capital ratio, amount of cash on hand, level and consistency of sales and profits, returns on capital, as well as a company's position and performance within an industry.

Inherent in the Value Line Dividend Index methodology is a realization that low volatility is a result of strong and stable company fundamentals. Similarly, stable and growing dividend policies are the result of stable and growing company profits. So, rather than focusing primarily on these characteristics to select stocks, the strategy also considers the fundamental underpinnings of less volatile stock prices and steady dividend growth.

## A decade of evidence

This summer, the First Trust Value Line Dividend Index Fund (FVD) reached its tenth anniversary, enabling us to look back at how this low beta dividend strategy performed during one of the most tumultuous periods in US stock market history. During the 10 year period ending on 8/30/13, FVD achieved a 9.13% average annual total return, outperforming the S&P 500 Index by more than 2 percentage points per year. Interestingly, the fund did not achieve these returns by taking more risk than the market; rather, with a relatively low beta of 0.83, the fund took less risk. Instead, the outperformance of FVD can be largely attributed to the fact that the fund captured only about 80% of the market's downside, while also capturing approximately 90% of the market's upside.

This analysis does not, of course, imply that low volatility or dividend strategies like FVD will outperform in every market environment. In fact, through the end of August, FVD trails the S&P 500 Index for the year. However, as the past decade has demonstrated, this strategy is not designed to "swing for the fences" during periods of strong stock market performance; instead, by focusing on fundamentally strong, potentially less volatile, above average dividend paying stocks, the First Trust Value Line Dividend Index Fund seeks to mitigate some of the downside risk that leads to underperformance over the long-term.

[1]For example, Blitz, David C., and Pim van Vliet (2007). "The Volatility Effect: Lower Risk without Lower Return," Journal of Portfolio Management, Vol. 34, No. 1.

[2]Ned Davis Research, 12/31/2012. Based on equal-weighted geometric average of total return of dividend-paying and non-dividend-paying historical S&P 500 stocks, rebalanced annually. Uses indicated annual dividends to identify dividend-paying stocks and changes on a calendar year basis.

[3]Data acquired from the Kenneth French data library, including firms incorporated in the US and listed on the NYSE, AMEX, or NASDAQ.

Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

| Quarter End Performance (as of 6/28/2013) | | | | NAV Total Returns (%) | | | Market Price Total Returns (%) | | |
|---|---|---|---|---|---|---|---|---|---|
| | Fund Inception | Net Expense Ratio | Gross Expense Ratio^ | 1 Year | 5 Years | Since Inception | 1 Year | 5 Years | Since Inception |
| FVD | 8/19/03 | 0.70% | 0.76% | 19.08 | 9.99 | 8.64 | 19.15 | 9.99 | 8.64 |
| S&P 500 Index | | | | 20.60 | 7.01 | 7.07 | 20.60 | 7.01 | 7.07 |

***Performance data quoted represents past performance. Past performance is not a guarantee of future results and current performance may be higher or lower than performance quoted. Investment returns and principal value will fluctuate and shares when sold or redeemed, may be worth more or less than their original cost. You can obtain performance information which is current through the most recent month-end by visiting ftportfolios.com.***

^Expenses are capped contractually at 0.70% per year, at least until April 30, 2014.

On December 15, 2006, the fund acquired the assets and adopted the performance history of the First Trust Value Line® Dividend Fund, a closed-end fund. The investment goals, strategies and policies of the fund are substantially similar to those of the predecessor fund. Performance information for periods prior to December 15, 2006 is based on the performance history of the predecessor fund and reflects the operating expenses of the predecessor fund.

**NAV** total returns are based on the fund's net asset value (NAV). NAV represents the fund's net assets (assets less liabilities) divided by the fund's common shares outstanding. Fund shares are purchased and sold on an exchange at their share price rather than NAV. **Market Price** returns are based on the midpoint of the bid/ask spread. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative. The fund's performance reflects fee waivers and expense reimbursements, absent which performance would have been lower.

## ETF Characteristics

The fund lists and principally trades its shares on the NYSE Arca, Inc.

The fund's return may not match the return of the Value Line® Dividend Index™. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, unlike mutual funds, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

## Risk Considerations

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund may invest in securities issued by companies concentrated in a particular industry. The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

First Trust Advisors L.P. is the adviser to the fund. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the fund's distributor.

## Definitions

**Standard Deviation** is a measure of price variability (risk). **Beta** is a measure of price variability relative to the market. **Sharpe Ratio** is a measure of excess reward per unit of volatility. The **S&P 500 Index** is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance; indexes are unmanaged and an investor cannot invest directly in an index.

***You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.***