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Emerging markets

EM equity ETFs targeting low volatility

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As Jason Draho described in his blog post earlier this week, there were notable changes to our tactical asset allocation recommendations. One is that we are now underweight emerging market equities.

There are two min/low volatility ETFs focusing on EM equities: the iShares Edge MSCI Min Vol Emerging Markets ETF (EEMV) and the Invesco S&P Emerging Markets Low Volatility ETF (EELV).

EEMV tracks an index that seeks to construct the lowest volatility portfolio by investing in a subset of the securities included in the MSCI EM Index. There are constraints that limit how EEMV's index can deviate from the MSCI EM Index with respect to countries, sectors, and individual stock weightings. For sectors and for the larger emerging market countries, that limit is +/-5%.

EELV's index follows a less complex methodology that simply includes the 200 least volatile EM stocks and weights them based on the inverse of the volatility so that the least volatile stocks get the highest weights. The process is largely unconstrained as the sector cap is 40%, which leads to higher exposure to the low volatility factor than EEMV, but also larger country and sector tilts. Historically, EELV's index has been overweight financials (currently 39% vs. 25% for MSCI EM) and underweight information technology (7% vs. 14% for MSCI EM). On the country front, it's been overweight Taiwan (currently 27% vs. 11% for MSCI EM) and underweight China (10% vs. 32% for MSCI EM). These tilts are not static and can change relatively quickly.

Thus far, performance has favored EEMV. Over the longest common period, which dates back to January 2012, EEMV has captured 77% of the upside of the MSCI EM Index versus 70% of the downside. So it's participating more on the upside than on the downside. Its maximum drawdown over this period has been 23% vs. 30% for the MSCI EM Index. While EELV has captured 76% of the downside of the MSCI EM Index, it's captured less of the upside at 74%. Its max drawdown of 29% is very close to that of the MSCI EM Index.

We generally suggest maintaining diversified exposure to factors, as timing whether to be 100% in or out of a factor is challenging. Employing factor tilts can help to adjust the risk-return positioning of a portfolio. Investors looking to enhance returns may consider overweighting factors such as momentum, value, and size while those looking to manage risks may overweight low volatility and/or quality. We encourage investors to understand an ETF's methodology and portfolio tilts prior to investing as ETFs with seemingly very similar objectives can be very different in their construction/exposure.

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For more, see Intellectual Capital Blog: EM equity ETFs targeting low volatility, 29 August 2019.

Appendix

Exchange Traded Funds (ETFs) Disclosure

For purposes of this report, ETFs include index-linked funds regulated under the Investment Company Act of 1940 that trade on US securities exchanges under exemptive relief from the Securities and Exchange Commission. The shares of all of the ETF issuers discussed in this Report are listed on U.S. securities exchanges. The ETFs are either open-end, registered investment companies (including UITs) operating under an exemptive order from the SEC, or collective investment vehicles, formed as grantor trusts, limited partnerships or similar structures that offer pass-through tax treatment to investors. The different structures provide different rights for investors. For example, ETFs registered under the Investment Company Act of 1940 must stand ready at all times to redeem shares (albeit only in creation unit size) whereas those ETFs that are not subject to registration under the Investment Company Act of 1940 may suspend redemptions at any time. We refer to ETFs registered with the SEC under the Investment Company Act of 1940 as "'40 Act ETFs" and to non-registered ETFs as "33 Act ETFs." All of the ETFs discussed in this Report track an index of financial instruments or provide exposure to a single commodity type.

US-registered, open-ended index-linked funds are redeemable only in Creation Unit size aggregations through an Authorized Participant, and may not be individually redeemed. Many ETFs are redeemable only on an "in-kind" basis. The public trading price of a redeemable lot of ETFs may be different from their net asset value, and ETFs could trade at a premium or discount to the net asset value. UBS AG or its affiliates act as authorized participants for many of the ETFs discussed in this report. In addition, UBS is a regular issuer of traded financial instruments and privately issued financial products that may be linked to the ETFs mentioned in this Report. UBS regularly trades in ETFs. Through these and other activities, UBS may engage in transactions involving ETFs that are inconsistent with the strategies in this report.

ETFs are subject to the same risks as the underlying securities and commissions may be charged on every trade, if applicable. This definition does not imply that ETFs are endorsed by the Securities and Exchange Commission. ETFs are sold by prospectus, which contains details about ETFs, including investment objectives, risks, charges and expenses. Clients should read the prospectus and consider this information carefully before investing. Clients may obtain more information about ETFs, including copies of prospectuses or summary, from their UBS FS financial advisor.

Risk Information