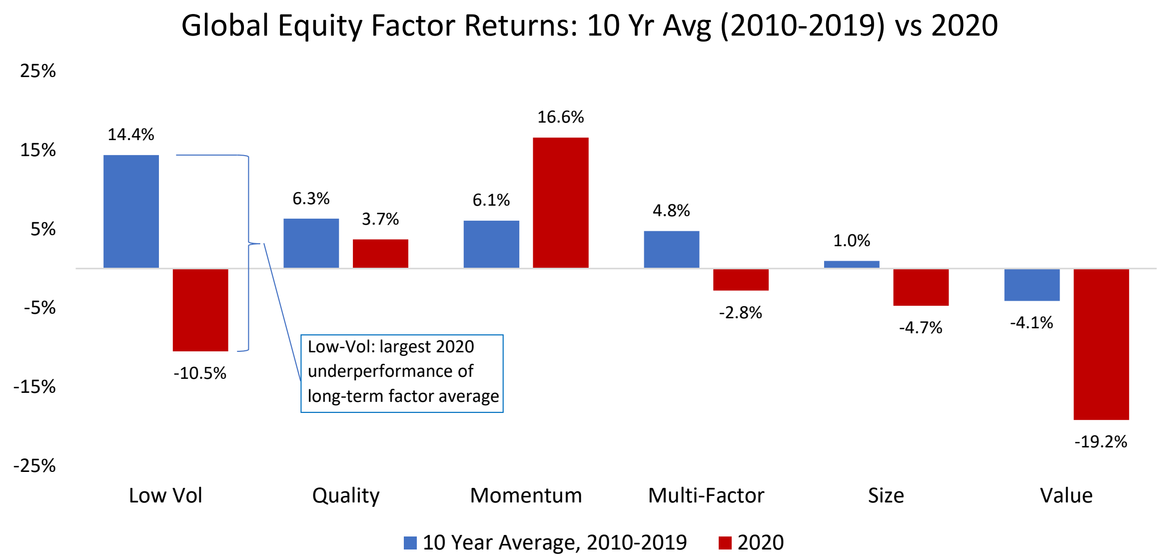
"2020 Lottery" Sets the Stage for Low-Volatility Comeback

Fund in focus: Brompton North American Low Volatility Dividend ETF (BLOV)

Over the past decade, factor investing has branched out from academia and gained broad acceptance in the investment industry as a way to target better equity performance. The term "Factor" refers to the excess return that can be explained systematically by common attributes (or factors) of stocks, in contrast to manager alpha, which is the outperformance of an active portfolio that can't be explained systematically. Major factors and common metrics that have provided statistically significant contributions to equity performance over long periods of time include[1]:

- Size: Buy small cap and sell large cap stocks (market capitalization)
- Value: Buy cheap and sell expensive stocks (this favors lower price-to-book and price-to-earnings ratios)
- Momentum: Buy winners and sell losers (12 month price return)
- Quality: Buy high quality and sell low quality companies (biased towards higher return-on-equity and lower debt-over-equity)
- Low Volatility: Buy less volatile and sell more volatile stocks (12-month trailing standard deviation)

The Low Volatility factor ended a 10-year run of positive returns in 2020, underperforming its long-term average by the most of any major factor. The winning streak ended due to the onset of the COVID-19 pandemic which suddenly and radically changed many things about the way we live and work. Covid-19 disruptions resulted in the reduction of discretionary spending by consumers, travel restrictions, increased unemployment, and the "work-from-home" trend. This disruption and its implications surprised equity investors and had a negative impact on several sectors that have long been Low Volatility stalwarts, most notably retail and office real estate. Following the March stock market drawdown, many investors sold Low Volatility funds and sought out higher-volatility investment opportunities such as Technology equities in an attempt to capture outsized returns as markets recovered, which has been a successful strategy to date.



Returns are for hypothetical long/short portfolios of global equities that isolate the relevant factor.

Source: FactorResearch, "Factor Olympics 2020"[1].

Despite the negative experience in 2020, we have a positive outlook for the Low Volatility factor going into 2021. 2020 was severely impacted by COVID-19, an external event that suddenly turned certain low volatility winners into high volatility losers. Given that the pandemic was an external event, we have no reason to believe that the Low Volatility factor is impaired. To the contrary, we believe current observed investor behaviour provides support for a return to strong relative performance for the Low Volatility factor.

Equity market prices have increased substantially since the beginning of the pandemic, especially for higher-volatility sectors such as Technology. Investor risk appetite seems to be increasing as noted by the recent surge in Bitcoin prices and stories in the investment media, for example.

This type of "risk-on" behaviour is one of the main explanations for the success of the Low Volatility factor, referred to as the "Lottery Effect"[2], whereby investors crowd into higher-volatility investments, seeking outsized returns while ignoring Low Volatility stocks. The Lottery Effect, over time, has historically produced returns that are lower than expected for the higher level of risk assumed, and has provided well-priced entry points for Low-Volatility equities, positioning Low Volatility for higher relative returns. We believe current market activity is a prelude to future Low-Volatility outperformance.

2020 and the structural disruptions that came with it are now in the past. With a gradual return to normalcy on the horizon, we believe that the Low Volatility factor is due to mean-revert to the upside. We recommend investors reposition their portfolios to increase Low Volatility factor exposure to benefit from this mean-reversion. Brompton North American Low Volatility Dividend ETF (BLOV) is designed to produce equity returns with lower volatility through investing in a diversified portfolio of North American large capitalization equities. Our Portfolio Management team employs quantitative analysis with an active fundamentals overlay to construct a portfolio with lower overall volatility than the market. The PM team also overlays an options strategy with the goal of further lowering volatility, while also aiming to increase distributable cash and total returns. Since launching BLOV in April 2020, the net asset value has grown from $20.00 to $21.89, in addition to offering a 3.7% annual distribution rate (as of January 13, 2020).

1) For a more complete description of the methodology in use, please see https://www.factorresearch.com/wp-content/uploads/FactorResearch_User-Guide.pdf

2) The Lottery Effect describes the well-established behaviour of investors buying higher-risk stocks to try to realize outsized returns. This behaviour ironically creates high-return opportunities for lower-risk stocks. For more on the Lottery Effect and Low- Volatility investing generally, please see Brompton's white paper, "The Low- Volatility Effect: Slow and Steady Wins the Race", https://www.bromptongroup.com/wp-content/uploads/2020/05/Brompton-White-Paper-%E2%80%93-Low-Volatility.pdf

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