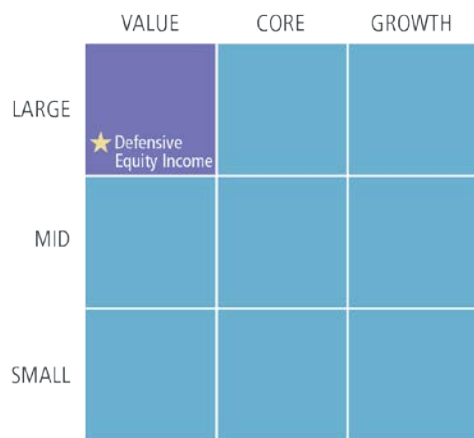


Diversifying Traditional Value: Thinking Outside the Box with Defensive Equity Income

The Style Box, which was developed by Morningstar in 1992, provides an intuitive framework for equity investing, splitting the entirety of the opportunity set along the size (large, mid, small) and value/growth segments. Since its inception, investors have embraced the Style Box as a means of balancing risk exposure and gaining diversification within their equity portfolios. However, investor experience has not always been as smooth as advertised, especially during periods of market turmoil when seemingly diversified portfolios fail to live up to expectations. In an ever more challenging environment to generate long term alpha net of fees, investors are considering new tools to shore up traditional methods and looking into outcome based



Source: Morningstar

portfolio construction approaches. This need has led to the rapid rise in popularity of smart beta strategies over the past decade. However, some investors have shied away from these approaches, unsure about how to deploy them. We believe that smart beta can be utilized within the traditional style box construct to help investors achieve their desired portfolio outcomes. Investors can use smart beta approaches designed to capture stocks with certain fundamental characteristics that are not captured in the style box (such as low volatility, dividend yield, quality and momentum, among others). By adding other dimensions to the style box, smart beta can work to further diversify and enhance traditional investing styles. In this piece we will focus on how Defensive Equity Income can do this within the value sleeve.

The Challenges of Value Style Investing

The value premia has proven to exist over time, providing investors with the ability to earn alpha as stocks that are mispriced by the market appreciate. However, value investing comes with emotional challenges. In order to successfully harvest the value premia, investors must be willing to stomach some discomfort:

- **Cyclicality:** Value investing can be in and out of favor for prolonged periods of time; as such, investors must have a long-term view to realize the benefits. Trying to tactically time when the factor is in or out of style can be challenging to realizing long-term growth.
- **Drawdowns:** Market ebbs and flows can create value opportunities; however, at times, markets can get overly pessimistic or overly optimistic on certain sectors or segments of the market, leading to sharp drawdowns in value stocks.
- **Stability:** Value stocks may exhibit more volatility than the market as investors often disagree about their future potential for these “out of favor” stocks.

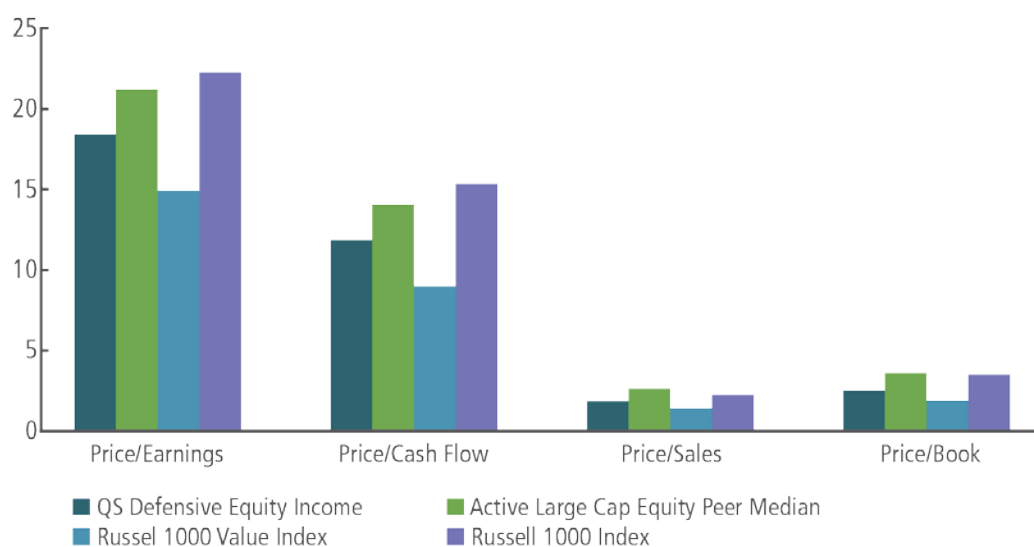
A Defensive Equity Income strategy invests in dividend-paying stocks with strong earnings and profitability, while aiming to avoid the more risky ones by penalizing companies with higher price and/or earnings volatility.

The Style-ish Factor Solution: Defensive Equity Income

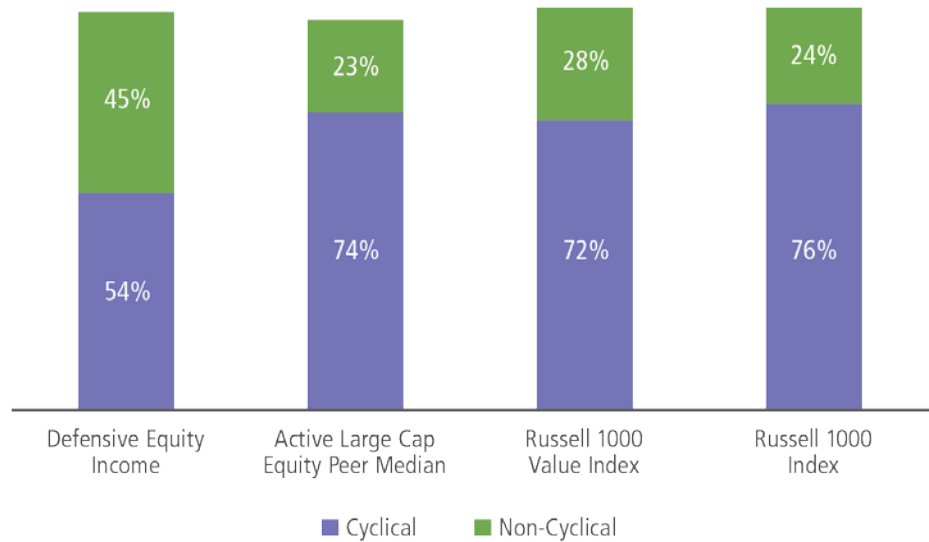
Blending traditional value strategies with a Defensive Equity Income strategy, can allow investors to weather the short-term emotional challenges associated with value, thus allowing them to fully harvest the value premia. A Defensive Equity Income strategy invests in dividend-paying stocks with strong earnings and profitability, while aiming to avoid the more risky ones by penalizing companies with higher price and/or earnings volatility.

The first Figure below compares QS' Defensive Equity Income strategy to active value peers and the Large Cap Value Index across four commonly used valuation metrics. Defensive Equity Income focuses on high earnings yield (E/P) companies, which can result in a low overall price-to-earnings (P/E) ratio, this may differ from traditional active and passive value funds which tend to focus on low price-to-book (P/B) stocks. The companies that a Defensive Equity Income strategy tilts toward tend to be in favor at very different times than securities targeted by value and growth funds, thus resulting in different overall sector style exposures as illustrated in the cyclical versus non-cyclical break down in the chart to the right. This can lead to enhanced diversification, an increase in the consistency of returns within the value sleeve, and overall portfolio, as well as a reduction in risk.

VALUATION BASED ON FOUR KEY METRICS



SECTOR EXPOSURE



Source: Bloomberg, Russell and Solactive Indices. Active Large Cap Equity Peer Median sourced from eVestment. Data as of December 31, 2019. Large Cap Value Index represented by the Russell 1000 Value Index. Large Cap Index represented by the Russell 1000 Index. Defensive Equity Income represented by the QS Low Volatility High Dividend Index. Sector Exposure based on GICS Sector Classification using the following assumption: Non-Cyclical Sectors (Consumer Staples, Health Care, Utilities, Telecommunications) and Cyclical Sectors (Consumer Discretionary, Energy, Financials, Real Estate, Technology, Industrials and Materials). The QS Low Volatility High Dividend Index was launched in December 2015. Data prior to the launch date is back-tested data (i.e., calculations of how the index might have performed over that time period had the index existed). There are frequently material differences between back-tested performance and actual results. Past performance -- whether actual or back-tested -- is no indication or guarantee of future performance. The Index was calculated jointly by Solactive and QS Investors. Solactive is paid by QS Investors.

What makes a Defensive Equity Income Strategy complementary to traditional value?

HIGH INCOME

Especially important in slow growth/
low return environments
Dividend screen filters for stocks that
have and are projected to pay high dividends

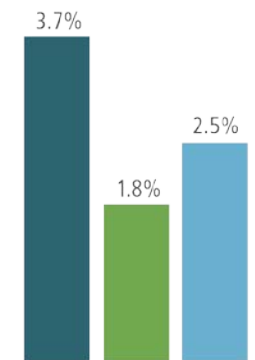
VALUATION CONSIDERATION

Key focus as equity valuations continue to swell
The strategy not only focuses on companies
who pay dividends but also screens for those
with the earnings power and profitability that
can support them

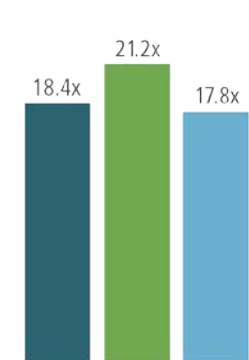
DRAWDOWN MANAGEMENT

Amidst market corrections, losing less means
requiring less to bounce back
The strategy considers profitability as well as
historical and forward looking volatility measures

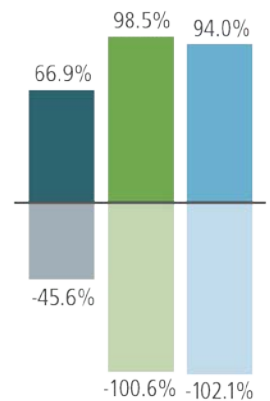
Dividend Yield



P/E Ratio



Upside/Downside Market Capture (vs. Russell 1000 Index)



■ QS Defensive Equity Income ■ Active Large Cap Equity Peer Median ■ Large Cap Value Index

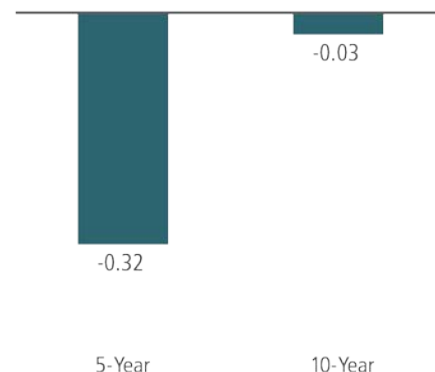
An allocation to defensive equity income can improve diversification between the value and growth sleeves as well as within the value sleeve, reducing cyclical performance.

1) Smoother returns stream: Value investing can be in and out of favor for prolonged periods, so investors must have a long-term view to realize the benefits. An allocation to defensive equity income can improve diversification between the value and growth sleeves as well as within the value sleeve, reducing cyclical performance.

LOWER CORRELATION TO GROWTH
Correlation of Return to Large Cap Growth Index

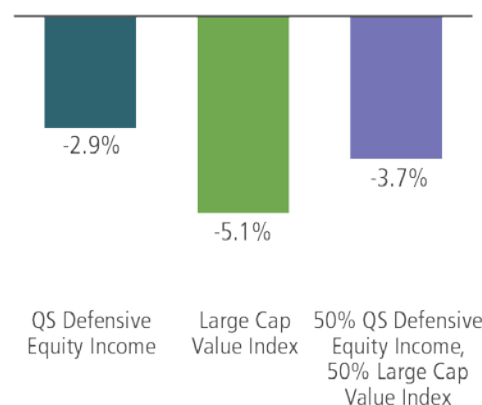


LOWER CORRELATION TO TRADITIONAL
VALUE MANAGERS
QS Defensive Equity Income Strategy
Correlation of Excess Returns to Large Cap Value Index vs 10 Largest Active Value Managers

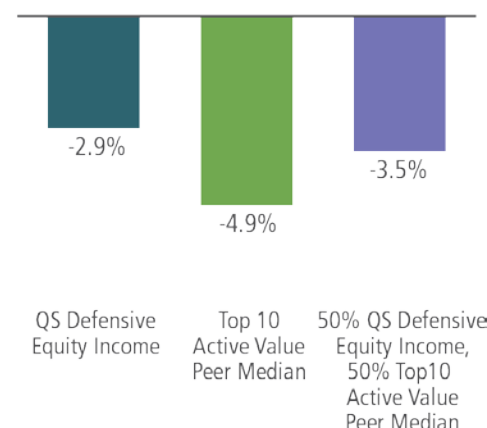


2) Drawdown Protection, More Balanced Portfolio Profile: Markets can become pessimistic, creating value opportunities; however, at times markets can get overly pessimistic leading to sharp drawdowns. A Defensive Equity Income strategy can reduce average drawdowns, providing portfolios with a more balanced profile.

PASSIVE VALUE MANAGERS
Average Drawdown Trailing 10-Year

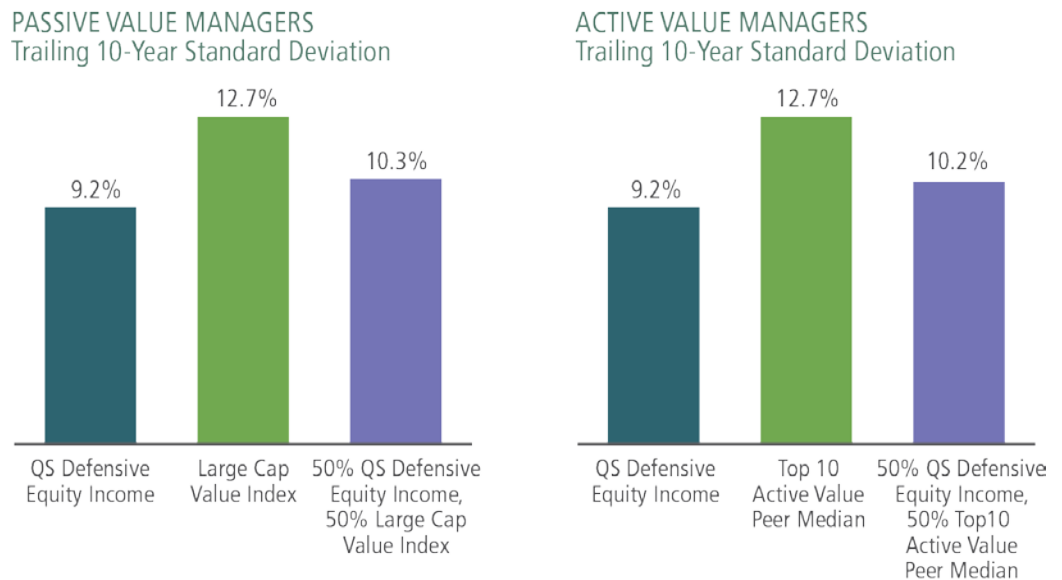


ACTIVE VALUE MANAGERS
Average Drawdown Trailing 10-Year



3) Stability: Value stocks may exhibit more volatility than the market as investors often disagree about their future potential for these “out of favor” stocks. An allocation to Defensive Equity Income can provide a favorable balance between absolute return and relative risk/return characteristics.

In dealing with today's market challenges, investors will have to increasingly think outside of the box to meet their goals.



Source: 10-Year monthly return data as of December 31, 2019 based on the QS Low Volatility High Dividend Index and Russell 1000 Value Index. Large Cap Growth Index represented by the Russell 1000 Growth Index. The QS Low Volatility High Dividend Index was launched in December 2015. Data prior to the launch date is back-tested data (i.e., calculations of how the index might have performed over that time period had the index existed). There are frequently material differences between back-tested performance and actual results. Past performance -- whether actual or back-tested -- is no indication or guarantee of future performance. The Index was calculated jointly by Solactive and QS Investors. Solactive is paid by QS Investors. Top 10 Active Value Managers is a subset of the largest active value managers based on Institutional AUM and required 10-year track record as of December 31, 2019, with performance data gross of fees. This group includes: Aristotle Capital Management Value Equity, LSV Large Cap Value, Eagle Capital Eagle Equity, Harris US Equity, Harris Concentrated Value Equity, Vulcan Value Partners Large Cap, Diamond Hill Large Cap, Brandywine Diversified Large Cap Value, Federated Investors Strategic Value Dividend, and FMI Large Cap Equity. Calculations based on eVestment methodology. Data for 50%/50% portfolios shown above reflects quarterly rebalancing.

Conclusion: Thinking Outside the Box

In dealing with today's market challenges, investors will have to increasingly think outside of the box to meet their goals. With an ever increasing number of tools at their disposal investors will need to seize the opportunity to consider new ways to deploy them. Looking at styles in conjunction with smart beta allows investors to further refine their equity portfolios, allowing them a better chance at achieving their long-term objectives.

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QSCR-18982 (1/2020)