An Alternative to Overvalued Low Volatility Stocks

- **The low-volatility factor has historically been shown to generate long-term investment returns in excess of benchmarks.**
- **But, sticking solely to a low-volatility strategy could lead to underperformance when this factor is out of favor.**
- **The Innovator Lunt Low Volatility/High Beta Tactical ETF (LVHB) offers the opportunity to rotate between low volatility and high beta, readily adapting to changing market conditions.**

The S&P 500 Low Volatility Index underperformed the S&P 500 in 9 of 10 rising rate periods, by an average amount of -8.92%.[2]

Factor-based investing has gained many followers over the past decade, due in large part to the historic success of the "low-vol" factor, which has shown that investing in stocks with historically low volatility levels has generated long-term investment returns in excess of benhmarks. In today's late cycle environment, the WSJ recently reported that investors are turning to low volatility stocks not just to seek long-term outperformance, but as a hedge to their overall portfolios.[1]

Some have raised concerns, however, that low-vol stocks are overvalued. That the demand for such stocks is now driving the price, as opposed to the fundamental factor itself, making valuations high and these securities relatively "expensive." Another consideration for the low-vol factor tilt is concentration bias, as products that employ low volatility strategies often maintain overweight exposure to certain sectors such as Real Estate, Utilities, and certain stocks in the Consumer Staples sector, all of which tend to be vulnerable to higher interest rates compared to the rest of the market.

We believe these concerns are warranted. As one would expect, sticking to only a low volatility strategy may make an investor susceptible to periods of underperformance, when the factor is out of favor. Historically, low volatility stocks have generally underperformed the market on the way up, and outperformed it as markets trend downward (save for severe sustained market declines). To avoid these potential pitfalls, we would propose an alternative strategy using a complementary two-factor approach that invests in low volatility when it is in favor (e.g., highly volatile or declining markets), and the high beta factor for less volatile and rising markets.

In lieu of focusing only on low volatility stocks, the Innovator Lunt Low Volatility/High Beta Tactical ETF (LVHB) follows a rules-based factor rotation methodology, that offers the opportunity for outperformance as the low volatility and high beta factors move in and out of favor. LVHB tracks the Lunt Capital US Large Cap Equity Rotation Index, which is calculated by S&P Dow Jones Indices. The strategy evaluates the underlying low volatility and high beta factors' performance on a monthly basis and then applies risk metrics to evaluate the factors' risk-adjusted relative strength. This formal monthly evaluation is meant to discern and identify any trends in the factors that would lead the fund to rotate from one factor to the other.

Regardless of the factor exposure, the fund remains exposed to all sectors. The component factor indices of low volatility and high beta are rebalanced quarterly, so the stocks included in each factor index represent their respective factor. This dynamic feature of factor rebalancing is not constrained by broader sector targets or ranges. Accordingly, the sector exposure for both the low volatility and high beta factor indices are ever-changing, ebbing and flowing with changing market conditions.

HOW IS LVHB POSITIONED RIGHT NOW?

After being invested in low volatility for over one year, LVHB moved to high beta in December. High beta stocks looked cheaper compared to low volatility stocks and the broader market. Going forward, should interest rates rise, low volatility may face interest rate headwinds.

LVHB is a tactical, rules-based strategy, that is offered in a tax-efficient, ETF structure. LVHB is a 5-star Morningstar rated fund as of 12/31/19, based on risk-adjusted returns out of 1,090 funds in the US Fund Large Value category. It has a three-year track record.

For additional information, visit: www.innovatoretfs.com/LVHB

[1] Weil, Dan. (2019, Nov 3). Low Volatility Funds Are in Demand, Once Again. Wall Street Journal.

[2] Source: S&P Dow Jones Indices as of May 1, 2018.

The S&P 500® Index is an unmanaged index considered representative of the U.S. stock market. Return/Risk is the relationship between the amount of return gained on an investment and the amount of risk undertaken in that investment.

Investing involves risks. Principal loss is possible. The Fund's return may not match the return of the Index. Beta investing entails investing in securities that are more volatile based on historical market index data. The fund may be more volatile since it will, from time to time, seek to have exposure to the most volatile securities. Volatile stocks may be subject to sharp swings in value, and may change unpredictably, affecting the value of such equity securities and, consequently, the value of the Shares.

Also, ETFs face numerous market trading risks, including the potential lack of an active market for Fund shares, losses from trading in secondary markets, periods of high volatility and disruption in the creation/redemption process of the Fund. Unlike mutual funds, ETFs may trade at a premium or discount to their net asset value. ETFs are bought and sold at market price and not individually redeemed from the fund. Brokerage commissions will reduce returns.

The Fund's investment objectives, risks, charges and expenses should be considered before investing. The prospectus contains this and other important information, and it may be obtained at innovatoretfs.com. Read it carefully before investing.

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