Finding quality investments in an overcrowded market

– Michael Mack, Portfolio Manager

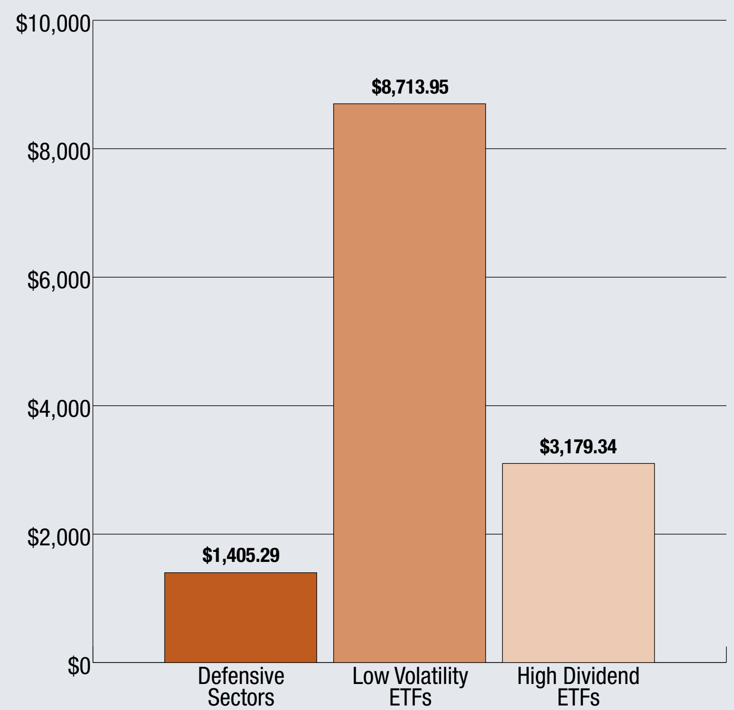
Given the recent market volatility, investors are searching for stability in their portfolios. Weak economic growth, a hawkish Fed and declining earnings are creating more urgency for this stability. The Fed's concern in raising interest rates to normal levels is slowly trickling through the economy. Earnings have been declining since they peaked at the end of 2014. The strong dollar and low commodity prices are hurting corporate earnings and are partly to blame for this decline.

Investors have responded by turning to US quality stocks in the form of US companies in low volatility stocks, dividend payers, and stocks in defensive sectors all of which have historically declined less in market downturns. Over the past couple of years, there has been significant money flowing into these three areas.

Significant Inflows Into 3 Quality Areas

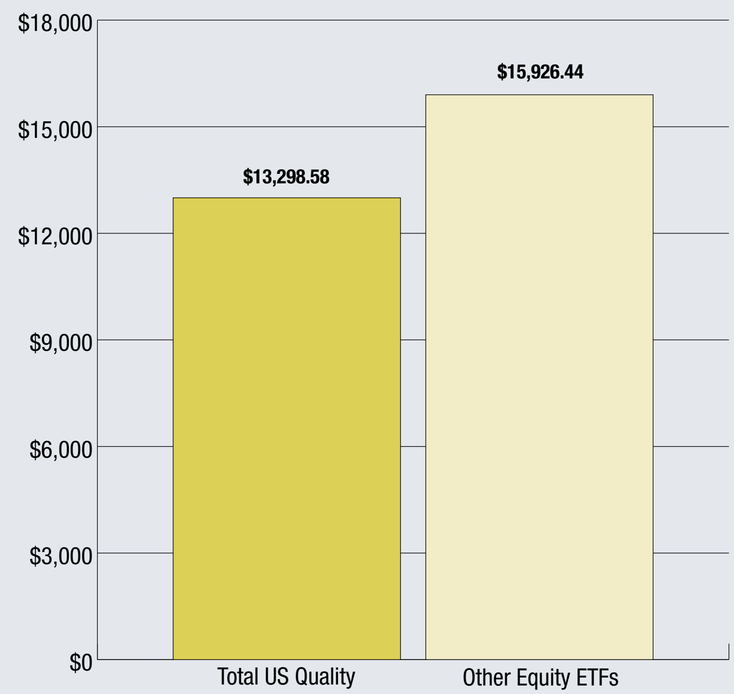
Year to date, the top 3 low volatility ETFs have attracted nearly $9 billion in assets. The top 3 dividend ETFs have seen $3.1 billion in inflows and defensive sectors of Utilities and Consumer Staples accrued inflows of $1.4 billion. These three categories of quality equities received inflows of more than $13 billion this year, only $3 billion less than all other equity ETFs combined.

"Quality Equities"
YTD ETF Fund Flows ($ millions) – as of 7/29/16



Source: Bloomberg

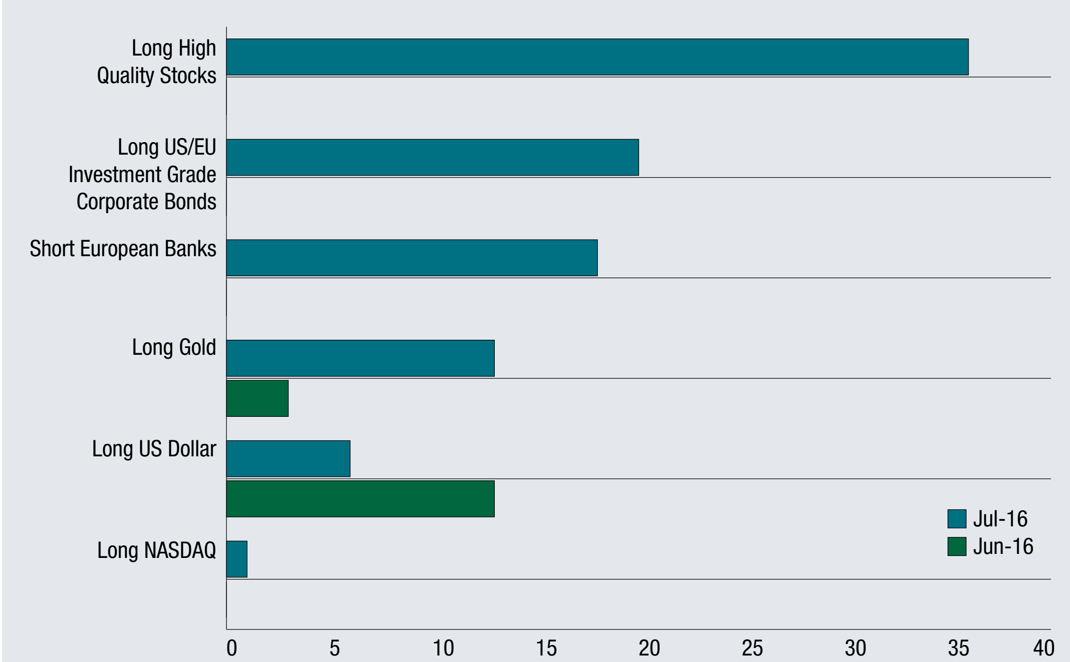
Quality vs. Other Equities
YTD ETF Fund Flows ($ millions) – as of 7/29/16



Source: Bloomberg

What do you think is currently the most crowded trade?

As many investors seek "shelter" in these quality equities, the trade is becoming alarmingly overcrowded. A recent survey conducted by Merrill Lynch found that investors believe US High Quality Stocks have become the most popular trade for investors. When interest in these equities grows too high, they begin trading at a premium and could be more expensive to buy than what they are worth. So, are these quality areas truly congested? One way to answer this is to look at the valuations of these areas of the market.



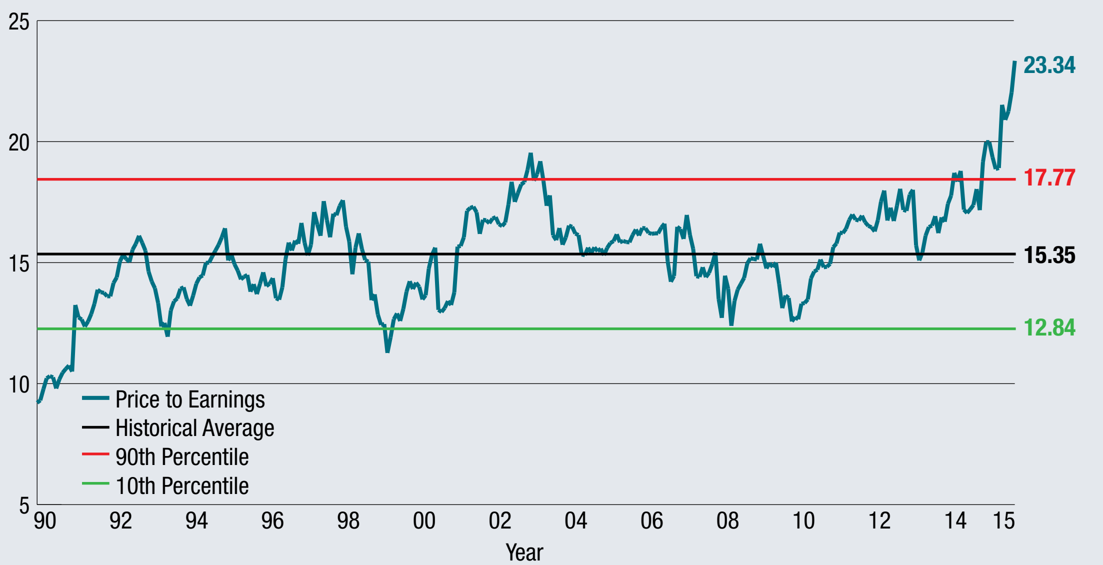
Source: BofA Merrill Lynch Global Fund Manager Study

Low Volatility Stocks Are Trading at a Premium

Top 100 Companies in Russell 1000 with Lowest 12-Month Annualized Volatility – as of 7/29/16

Looking at the low volatility space, we reviewed 100 companies in the Russell 1000 with the lowest 12-month annualized volatility. As of 7/29/16, these 100 stocks are trading at their highest valuations in the past 25 years. Because of high demand for these investments, investors are paying a premium for the reduced volatility.

The 90th percentile P/E means that 90% of time the P/E of these companies was below this number.



We chose to evaluate 100 companies because it was a solid sample size and could be used to remain consistent throughout the assessment in this piece.

Russell 1000 is an index of approximately 1,000 of the largest companies in the U.S. equity markets. The Russell 1000 comprises over 90% of the total market capitalization of all listed U.S. stocks.

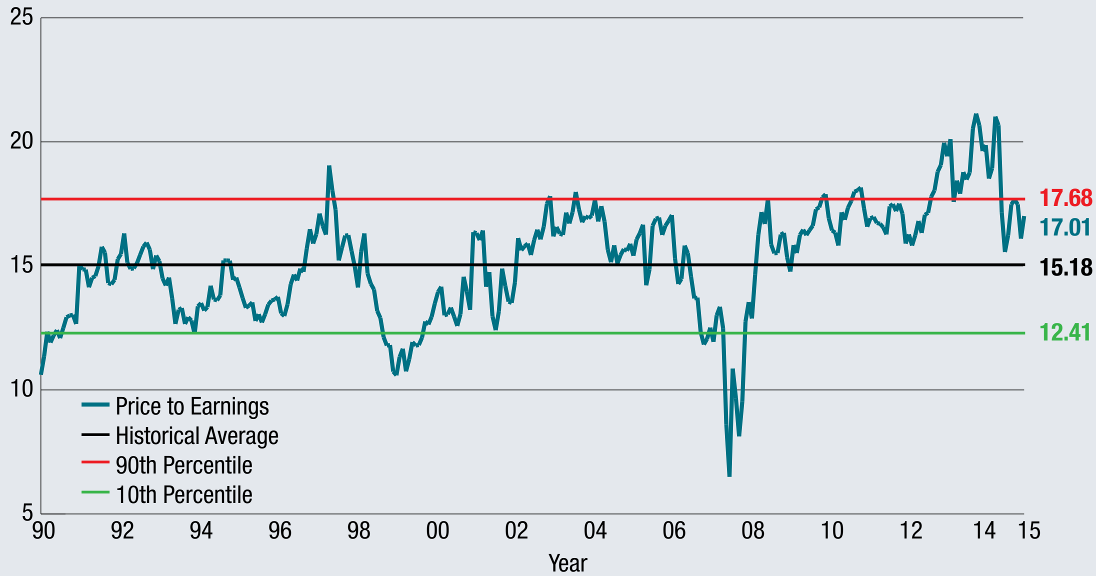
Price-to-earnings ratio (P/E ratio) is a fundamental measure commonly used to determine if an investment is valued appropriately. Each holding's P/E is the latest closing price divided by the latest fiscal year's earnings per share. Negative P/E ratios are excluded from this calculation.

Annualized Volatility is based on monthly returns from the most recent date indicated on the page and expressed as a standard deviation percentage. Standard deviation is a measure of volatility and illustrates the extent of variation (whether higher or lower) that exists from the average given set of results. A low standard deviation indicates that the results tend to be very close to the average result (a low degree of volatility). In contrast, a high standard deviation indicates that the results are spread out over a large range of outcomes (a high degree of volatility).

Dividend Paying Stocks Are Trading at a Premium

P/E's of the Top 100 Highest Dividend Yielding Companies in the Russell 1000 – as of 7/29/16

Analyzing the top 100 dividend payers in the Russell 1000, we see that valuations have been elevated for a long period of time. Low interest rates and the income demands of an aging population have caused high dividend payers to trade at a premium to the market.



Source: Bloomberg

Defensive Sectors Are Trading at a Premium

Finally, comparing the defensive sectors of Consumer Staples and Utilities to the rest of the market, we find that with the exception of Energy, where earnings are depressed from low oil prices, the defensive sectors are at a premium relative to their history while other sectors are trading at a discount. If economic conditions continue to worsen, paying a higher premium for stability could very well be justified. However, if conditions stabilize, then the high valuations of the quality companies could become a drag on performance.

GICS Sector	Current P/E	Historical Median P/E	Premium/Discount
Energy	67.94	14.71	461.86%
Utilities	19.28	15.36	125.50%
Consumer Staples	23.00	19.66	116.99%
Financials	15.84	14.62	108.34%
Materials	19.57	18.40	106.36%
Health Care	21.36	20.31	105.17%
Telecommunication Services	17.05	17.60	96.90%
Consumer Discretionary	19.80	20.56	96.30%
Industrials	17.90	18.84	95.01%
Information Technology	20.91	23.38	89.44%

Where are the quality investments?

While US quality may be expensive, international stocks are more attractive. Excluding the US from the FTSE All World Developed Index (FTSE All World Developed xUS), we see that the valuations are more compelling, but the lower ROE (Return on Equity) and free cash flow yield show that the quality is still lacking.

	Russell 1000	FTSE All-World Developed xUS
Free Cash Flow Yield	3.66	2.95
ROE	16.63	14.43
Price/Earnings	20.41	16.29

Given this information, we believe it may be wise for investors to consider a global mix of quality and value in these uncertain times. **The Pacer Global Cash Cows Dividend ETF (GCOW)** tracks the Pacer Global Cash Cows Dividend Index and uses a global strategy that searches for quality and value by screening the FTSE All World Developed Large Cap Index for companies with high free cash flow yields and dividend yields. The stability of high dividend paying companies combined with high free cash flow yields to support the dividends has the potential to provide exposure to companies that can survive this turbulent economic climate. The Pacer Index offers exposure to companies with higher free cash flow yields, higher ROE, and lower P/Es than its FTSE benchmark index. We believe the underlying characteristics of these companies should provide investors with exposure to both quality and value characteristics.

	Pacer Global Cash Cows Dividend Index	FTSE All-World Developed Large Cap
Free Cash Flow Yield	5.63	3.53
ROE	19.13	16.39
Price/Earnings	16.53	18.32

To learn more about how to incorporate **GCOW** into your client's portfolio, visit **www.paceretfs.com** or call 1-877-337-0500.

Definitions:
Free Cash Flow Yield: Measures a company's total free cash flow relative to its enterprise value. **Free cash flow** is the cash remaining after a company has paid expenses, interest, taxes, and long-term investments. It is the source from which dividends are paid.
Enterprise Value: A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)
FTSE All World Developed Large-Cap Index is a market-capitalization weighted index representing the performance of large-cap stocks in developed markets. Data calculated for the FTSE All World Developed Large-Cap Index screens out all US companies to represent a true international index.

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