

Economic Commentary

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Low Risk, High Return?

Increase your risk, increase your potential return. That's how the stock market is supposed to work, with investors willing to take on greater volatility in the expectation of earning higher future returns. At least that's what the research from the 1960's underpinning modern portfolio theory and investing told us. Recently, however, there's a new body of research coming out showing that for the last 20–25 years, the relationship has been turned on its head. That in reality the data shows that increasing your risk actually decreases your return. And that a portfolio of lower volatility stocks or lower beta ones tends to outperform one constructed from higher risk fare.

There were numerous presentations on this topic at a recent Morningstar Ibbotson Asset Allocation conference. Roger Ibbotson kicked off the conference showing how from 1972 to 2013 low beta stocks earned more than 50% more return than high beta stocks while generating only about 60% as much standard deviation, and that similar results can be seen for low monthly volatility stocks versus high monthly volatility ones. Clearly this is not how the efficient frontier is supposed to look. (Incidentally the research for bond markets shows that the expected relationship between risk and return does hold, as it also does for the risk-return dynamic across asset classes — this anomaly appears to only exist in the stock market). Ibbotson also highlighted research that showed if you layered in other factors like low liquidity and smaller cap, you could increase the risk-return dynamic by allocating to this “Low Popularity” portfolio. Ibbotson believes that behavioral biases consistent with greater individual (re: retail) participation in the stock market are the greatest contributor to these anomalies. Other researchers tend to agree pointing to investor preference for fast-moving “story” stocks with the potential for spectacular gains rather than slow and steady stocks.

Then Nardin Baker of Guggenheim presented his take on the subject. Baker refers to the stock market reality (rather than the investment theory) as the Minimum Volatility Effect. In his research, he looks at the time period from 1990–2013 and sorts U.S. stocks into quintiles based on volatility. Over that time, the annualized returns of the two lowest volatility quintiles is near 10% per year while the highest volatility quintile actually loses almost 3% per annum. Simple math helps explain the dynamic — if you invest \$100 in a high volatility stock and it goes up 50% and then down 50% you end up with just \$75 for your efforts. If you invest in a low volatility stock, however, and it goes up 10% and then down 10%, you are left with \$99 for your efforts. And that \$24 gap is difficult to make up over time thanks to compounding. Further that dynamic generally holds for markets across the globe. The main difference between the two presenters was that Ibbotson was less optimistic that retail investors could capture this anomaly in their portfolios due to, among other things, high turnover and trading costs.



And just recently *The Wall Street Journal* published a long article on the subject and even *Barron's* has weighed in. Further, in the most recent *Financial Analyst Journal* a paper on the topic was published. Apparently once I decided to write on the topic everyone wanted in on the action. In fact, the FAJ article decomposes the volatility anomaly into two parts – micro at the individual stocks level and macro at the country or sector level. Most practitioners have focused their research on the micro-level, and for the purposes of this discussion that is what we've focused on as well. Obviously one can't deny the attraction to owning a set of stocks that promise higher returns with lower volatility than offered by the broader market. But the two issues are: one, will this anomaly be arbitrated away if too much money flows into the products following such strategies and two, what happens if this anomaly eventually reverts to the previous market standard of high risk = high return. So let us look at these two issues.

First, will this anomaly be arbitrated away? That means will so much money flow into the space that the anomaly gets phased out. I think that is unlikely. Those looking to invest in this style have only a few options at current. According to Morningstar Inc., there are approximately 50 products available with only about \$16.5 billion in assets. At that asset level these strategies are nowhere near a level that would arbitrage out the anomaly. Index construction differs and that is a key consideration when reviewing this burgeoning investment area. And yes, investment firms will begin to roll out more and more products should this area get more traction but I don't see a massive proliferation in this space because the quantitative, index-like nature of the portfolios may preclude some larger, more active-management oriented shops from entering the space.

The second question is the more compelling one: will this anomaly eventually revert to historic norms and if so what might be the catalyst for the change back to accepted portfolio theory? One concern is that valuations for these low beta stocks have gotten stretched in the recent bull market as investors have piled into them as a way to tip-toe back into the stock market. That is a strong consideration since for most of the sample time period low risk stocks traded at discounts to higher risk fare. Now, however, that dynamic has largely flipped with many low risk stocks trading at a premium to the market. One issue that comes with picking a pure low beta or low volatility portfolio is the introduction of biases. For example, you can end up with a very sector-heavy portfolio of utility and consumer stocks if you are purely picking low beta as your only factor for a low risk portfolio. However, it is also important to note that the constituents of a low volatility portfolio are not static over time. For example, the Russell 1000 Value index has actually exhibited higher volatility than the Russell 1000 Growth index over the more recent four-year period. And while certain biases might exist – like favoring utility stocks and underweighting technology ones – the sector weightings do change much like they do for the S&P 500 or other cap-weighted indexes. Financial and Healthcare stocks in particular show a lot of fluctuation in their weighting.

An issue here, beyond whether or not this is just an anomaly that could disappear at any time is if it is really exploitable. To make this type of strategy a success requires discipline, something many investors lack. After all the real bread & butter period for these strategies is typically, but not always, when markets are either falling or trading sideways, not when markets are booming. If you sell out to pile into higher beta fare during a boom you've got to time the market a few times to make it pay off rather than just sticking with the low volatility anomaly. But if investors can maintain their position and consider their holding part of their U.S. large cap core/value position, then as long as the anomaly persists the potential is there for higher returns with lower risk.

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