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ISSUE #40
08 | 2021

WHAT OPPORTUNITIES DOES THE **LOW-RISK ANOMALY** OFFER?

Less risky stocks often achieve higher risk-adjusted returns – a phenomenon called the low-risk anomaly. But is this theory still valid today and what role does it play in the current market environment?

Before answering this question, we need to look more closely at the current market environment. The data from Robert Shiller on the left side of Figure 1 shows that the real equity risk premium is around 3% – a value well below the long-term average of around 4.7%. In addition to this low value, real interest rates are negative. Inflation expectations are currently around 2%, only slightly below the historical value. Due to the low equity risk premium and low real interest rates, we are in an environment of low expected returns, which at approx. 4.5% are only half the historical average.

We will question five frequently made arguments for the low-risk anomaly and analyse whether they are still relevant in the current environment of low expected returns.

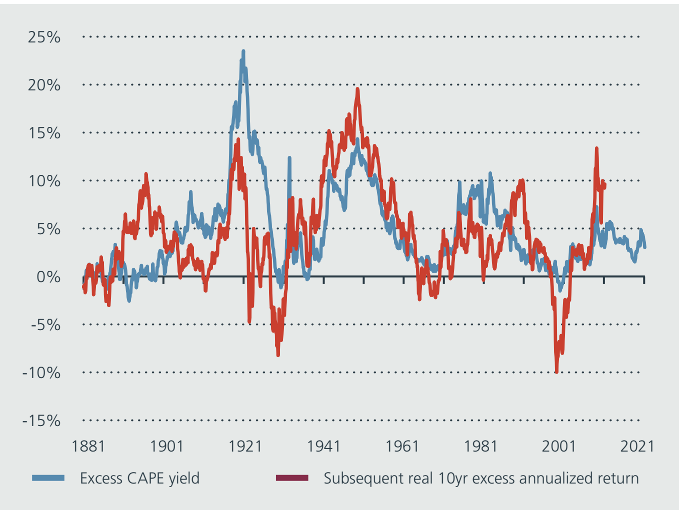
ARGUMENT 1: Leverage constraints

Most investors cannot leverage their portfolio, and so pursue a long-only strategy. However, if an investor has a fixed target return of 7%, for example, that they want to achieve with an equity investment, they can only realise it in a low-expected-return environment by betting on a risky portfolio with a beta of 1.8. Low-risk stocks are not represented in these portfolios – even if they are undervalued. Therefore, leverage constraints support the continued existence of the low-risk anomaly in the current environment.

ARGUMENT 2: Compounding effect

The compounding effect becomes more significant the lower the expected return, as it has a stronger relative impact on the total return. If two stocks have the same average expected return and are held for several periods, the stock with the lower volatility will have the higher accumulated return. This effect is also known as volatility drag. For the same arithmetic return, in the low-expected-return environment, the geometric return of a stock with 9.5% volatility is about 20% higher than the return of a stock with 15% volatility. This argument also continues to speak in favour of the low-risk style.

Low expected returns due to below-average equity risk premium and low interest rates



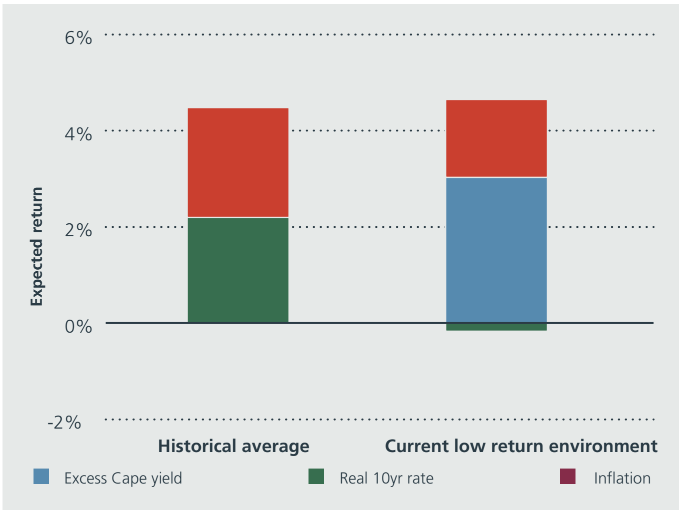


Fig. 1: Source: Robert Shiller Online Data (yale.edu). The excess CAPE yield is defined as the cyclically adjusted earnings yield minus the ten-year real interest rate.

ARGUMENT 3: Information inefficiency

Figure 2 presents three factors for measuring the attention that low-volatility stocks receive compared to high-volatility stocks. All factors are negative on average and thus less pronounced than for high-volatility stocks. This is a sign that this market segment attracts little attention. Thus, it is also very likely that information is not processed as quickly as with high-risk stocks, and inefficiencies are accordingly more exploitable.

In times of falling markets, the picture weakens. Low-risk equities are then considered a safe haven and receive comparatively more attention from investors. Currently, however, we are in a phase of low attention for low-risk stocks, so the argument for low-risk investments also continues to hold.

average underperformance of about 3.5% per year. In 2020, it showed a return of over 20%, a value that has not been achieved since 1991.

Speculative investors have been driving the markets and lottery stocks in particular during 2020, but based on historical observations, it is very unlikely that this effect will last long. Here, too, we see another argument for choosing a low-risk strategy right now that does not invest in the expensive lottery stocks.

ARGUMENT 5: Interest

We have been experiencing falling interest rates for 35 years. US interest rates last peaked in 1981 and have been falling ever since. Figure 3 shows how low-volatility stocks have performed

Low-volatility stocks continue to be neglected by the market

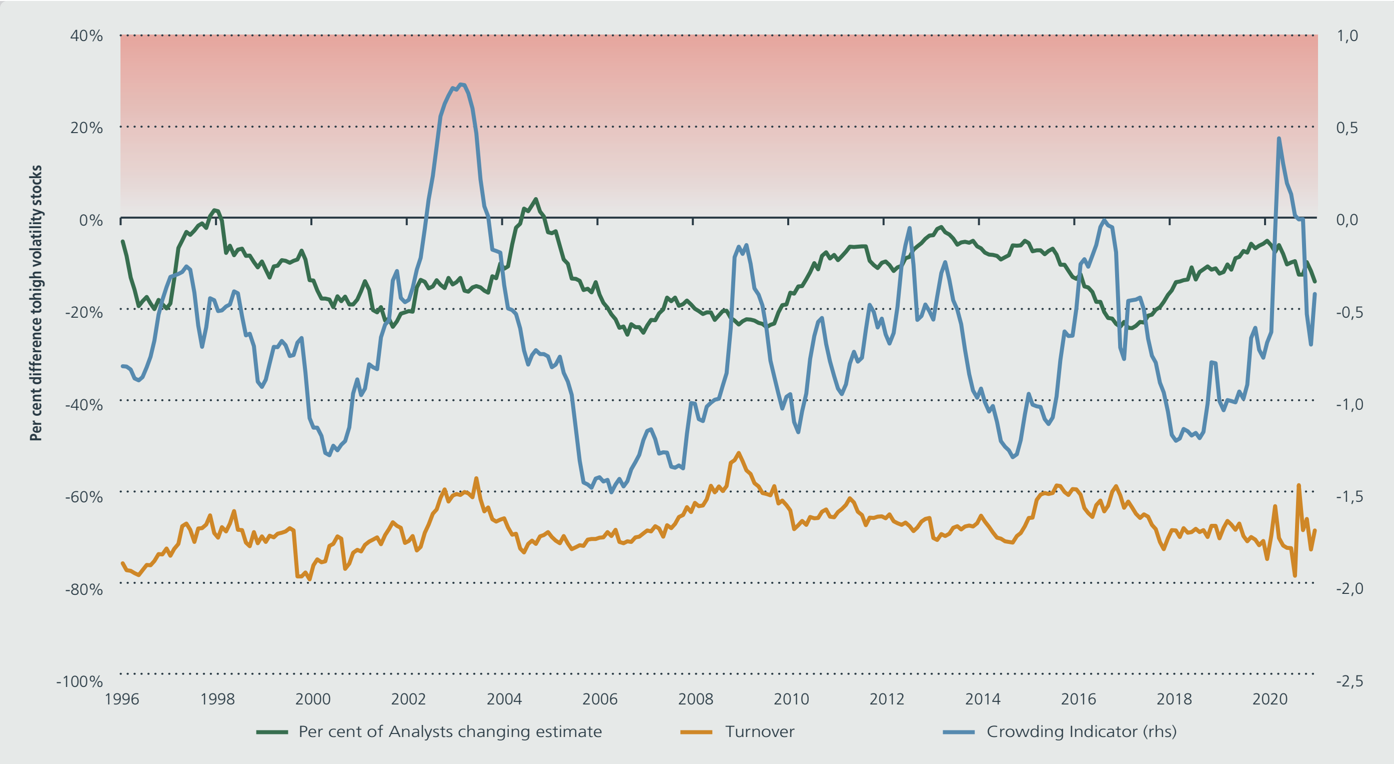


Fig. 2: Source: Datastream, Morningstar, IBES, own calculations. The percentage of analysts changing their forecasts is the 12-month average of the number of monthly forecast changes relative to the number of forecasts. Turnover is calculated as the number of shares traded relative to the free float of shares outstanding. The crowding indicator is a composite measure that uses mutual fund holdings, price and volume data to determine whether a stock is crowded or not. The exposure is shown for the quintile with the lowest volatility. The equity universe includes all stocks from the MSCI standard index in the developed countries of Europe, North America and Japan.

ARGUMENT 4: Behavioural finance

Research shows that some investor groups prefer stocks with lottery-like behaviour – i.e. stocks that show rare but high profits. If this preference exists for so-called lottery stocks, the prices of these shares are driven upwards, which means a reduction in the expected return.

In our calculation, we looked at the 20% of stocks that had the highest return in the previous month. A strategy that buys these 20% winners of the previous month in each month achieves an

relative to the market for different periods. Low-volatility stocks tended to underperform before 1981 when interest rates were on the rise. This is predominantly due to the post-1976 period when inflation was 10% per annum and interest rates rose by around 8%. By comparison, inflation expectations currently stand at a moderate 2.3%. Concerns about the interest rate argument in connection with low-risk strategies can therefore be neglected at present. Rather, low-risk equities offer an alternative to bonds in the low-interest-rate environment and are risk-adjusted advantageously over high-risk stocks in the long term.

Only with extreme inflation does low volatility tend to underperform

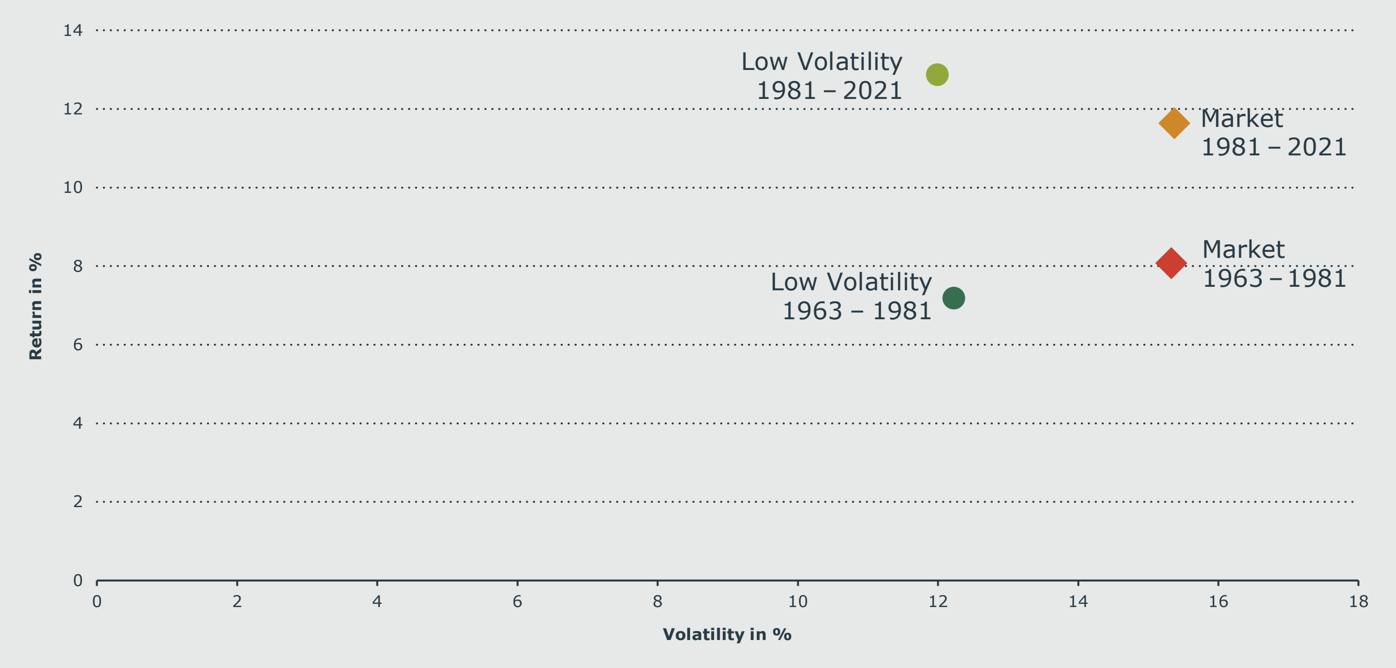


Fig. 3: Source: Datastream, MSCI, Kenneth French Data Library, Robert Shiller Online Data (yale.edu). The equity universe comprises all equities from the MSCI standard index in the industrialised countries of Europe, North America and Japan. The low-volatility portfolio represents the quintile of stocks with the lowest volatility in the 250 days prior to the set-up date.

Conclusion: The arguments are still valid today – low-risk stocks with higher risk-adjusted return in the long term

The theoretical basis of the low-risk anomaly still applies today. We are experiencing high liquidity, leading to asset price inflation in all asset classes. Markets are reaching historic highs. Technology and growth stocks in particular have performed exceptionally well in 2020. Historical data suggests that the extreme growth of the growth style will slow down – the first signs of this are already visible. Nevertheless, equities remain one of the best investment options in the low-interest-rate environment. Low-volatility stocks are particularly suitable if a good risk–return ratio is sought over the long term.

Dr Volker Flögel
Head of Research

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