HIGH RETURNS FROM LOW RISK

THE INCONVENIENT TRUTH OF A REMARKABLE STOCK MARKET PARADOX

For generations investors have believed that risk and return are inseparable. Empirical-evidence proves them wrong. The good news: investors can profit from this paradox.

Pim van Vliet

'THE DIFFICULTY LIES NOT SO MUCH IN DEVELOPING NEW IDEAS AS IN ESCAPING FROM OLD ONES', IS A WELL-KNOWN QUOTE OF JOHN MAYNARD KEYNES. Although widely-regarded as a great economist who liked to challenge existing economic believes, he is less-known as being a contrarian investor. Opposite to economics, he never shared his thoughts on this subject in books on investing. As such it is unknown whether Keynes held a contrarian view on the relation between risk and return in equity investing as well.

Generations of investors have been raised with the idea that there should be a positive, linear relation between risk and return. Common investment wisdom says that if one wants to obtain a higher return in the equity market, one should take upon more risk. Should this conventional wisdom – in the spirit of Keynes – be challenged?

As an undergraduate student I stumbled upon the work of economist Robert Haugen who dared to challenge the prevailing status quo of 'higher risk equals higher return'. In an academic article he proved the opposite: higher risk equaled a lower return. Ever since the day I read his article, I have been fascinated by this remarkable stock market paradox and devoted half my life researching this phenomenon and managing low-risk equity portfolios for investors around the world.

Professor Haugen was not the only academic who proved the old idea of risk and return being inseparable to be wrong. In 1972, Nobel Prize winner Fischer Black, well-known for his contribution to the development of the Black and Scholes option pricing formula, had already discovered that low-risk stocks exhibit higher returns than one could expect given the – still prevailing – classic investment theories.

The well-known advocate of passive investing, John Bogle, showed in the 1960s that defensive mutual funds earned higher returns than the market and high-risk equivalents. What's more: a few years ago academics documented that in the 19th century those stocks that exhibited low risk characteristics offered higher returns than high-risk stocks. And they kept on doing so through the 20th century and up to today.

In my new book, I demonstrate what would happen if you had the possibility to invest $100 in either a low-risk or a high-risk equity portfolio back in 1929. Two portfolios are created each consisting of the 100 stocks with the highest/lowest volatility out of the largest 1,000 US stocks. The portfolios are rebalanced on quarterly basis each of these portfolios is rebalanced until 2015.

If you – just like generations of investors – have learnt at university or read from finance text books that high-risk investing should yield high returns, than the result might surprise you. The 'winning' portfolio is the low-volatility portfolio with $395,000, while the high-volatility portfolio's final value is only $21,000. That's right: low-risk beats high-risk in US equity markets by a factor 18.

This remarkable investment paradox is not only visible when one looks at the returns of US stocks. Also in European, global, and even emerging market, low-risk stocks do offer higher risk adjusted returns.

If numerous of academic studies and an abundance of empirical evidence points out that a common investment wisdom and a widely-applied investment theory does not hold up in real life, why are investors still hanging on to these old ideas? And perhaps more important: why are they not applying these new ideas into their portfolios? I believe there are three main explanations for it.

First of all, as an investor you have to be aware of the existence of this investment paradox. Although awareness of this low-risk effect is on the rise, mainstream academics and investors still refer to this

effect by the French word 'anomaly' to indicate that this effect is just a kind of weird observed deviation from the classic theory instead of an outright indication that current risk-return theories might be flawed.

It seems Keynes was right: it is apparently difficult for some to escape from an old idea and embrace a new one. As a result textbooks and investment courses at universities still teach students to apply theoretic models that don't seem to fit the reality of Wall Street.

Second, even though some investors are aware of the paradox, it might be difficult to put the theory to practice in portfolios. A lot of professional fund managers need to finish ahead of the market every quarter in order to keep their clients and bosses happy.

For these managers it is understandable that they focus on finding exciting, but risky, stocks that have the appeal of outperforming a benchmark on a short notice. A boring low-risk stock does not offer that appeal.

The good news: if you are aware of the investment paradox and you don't have to outperform a benchmark every single year, then you might be in a better position to profit from these investments then most professional investors.

Might this be because there is a third reason why low-risk investing isn't embraced by every investor? These stocks have the tendency to lag the market during steep bull market rallies. In other words: when investors and markets go crazy with annual returns of at least 15 per cent per year, even a carefully selected portfolio of the best low-risk stocks will probably cause you to lag the market during those moments.

Most investors do not have the stamina to hold on to these unexciting low-risk stocks in such a cheerful stock market environment and decide to sell out. As a fund manager of several low-risk equity funds I have witnessed this investor behavior over the past ten years.

Keynes is often quoted saying 'When the facts change, I change my mind. What do you do, sir?'. Given the long term results of low-risk versus high-risk investing, it might be time to escape from an old investment idea and start developing a new idea.

Pim van Vliet is the founder and fund manager of the multi-billion dollar Conservative Equity funds at Robeco. These low-risk funds are based on academic research and provide investors with a stable source of income from the stock market. He is a guest lecturer at several universities, the author of numerous financial publications and travels the world advocating low-volatility investing. His latest book High Returns from Low Risk: A Remarkable Stock Market Paradox, combines the latest research with stock market data going back to 1929 to prove that investing in low-risk stocks gives surprisingly high returns, significantly better than those generated by high-risk stocks.