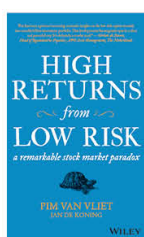




There is a general saying that there is no such thing as a free lunch, but High Returns from Low Risk sets out to prove that low volatility stocks can outperform high risk ones over time. **Jonathan Boyd** has reviewed the 'paradox'

Is a free lunch on the menu for the low risk investor?



High Returns from Low Risk: A Remarkable Stock Market Paradox
Pim van Vliet and Jan de Koning
168 pages
£16.99 in UK
Wiley
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Pim van Vliet is a fund manager who oversees conservative equity strategies at Robeco and Jan de Koning is an investment specialist in quantitative equity strategies at the same firm. Together they have written a book that sets out to argue the case for investing in low volatility stocks, as a way to access better returns over time.

Given how this argument upends many adages of investing – such as that investors ought to be paid a bigger premium for taking on greater volatility, as defined by standard deviations from the benchmark index – then it also makes sense to start reading this book more from the back rather than the front.

The authors refer to a 'paradox' of investing in low volatility stocks to achieve better outcomes; their chapter 16 lays their view out in stark terms:

"Low-risk stocks beat high-risk stocks: an inconvenient truth.

"Inconvenient, as these results prove that the standard models are wrong. Despite these results, it is still commonly accepted wisdom – and assumed in basically all financial models and textbooks – that more risk should lead to higher returns."

Since the chapter is headed 'The paradox is everywhere', it is clear that they are firm in their belief that the data is available to support their thesis.

PHILOSOPHY

The authors start by identifying the common philosophy that underpins much logic of decision making, such as the law of diminishing returns or the idea of the golden mean written about as far back as Aristotle's time as a Greek philosopher.

They then move on to cover facets such as optimism bias, and the actions of investors that follow suit.

The book highlights how research was conducted in 2015, in which the historical monthly volatility of the 1,000 largest companies in the US between January 1926 and December 1928 was measured to separate those exhibiting respectively the highest and lowest risk characteristics. From this, two portfolios were created, both starting on 1 January 1929 and running through to 1 January 2015. The results suggest the portfolio constituting lower volatility stocks outperformed,

significantly, turning \$100 invested into \$395,000 versus \$21,000 for the higher risk portfolio.

This works out to an annual return of 10.2% for the low-risk stocks, against 6.4% for the high-risk stocks.

"But, what should we do with the counterintuitive finding that high risk gives low returns and low risk gives high returns?"

"Should we change the theory so it fits the data, or should we change the data to confirm the theory? Well, as we cannot rewrite history or historical price movements, it's probably best to change the theory. However, changing the perceived relationship between risk and return for every investor in the world is quite challenging, as we will need to convince a lot of people."

Indeed, which is why the authors spend the subsequent chapters discussing what support there is to the evidence put forward in the example portfolios, and how investors ought, perhaps, to react in a thoughtful way – rather than just immediately cash in their existing portfolios to buy into lower risk ones.

EVIDENCE

Among the key factors to consider in reacting to such evidence is the need to understand the effects of compound interest over time – which helps explain how a small difference in annualised return percentages can lead to such different outcomes in cash

terms for the different portfolios – but also for investors generally to understand that many people working in the asset management industry are themselves looking to relative rather than absolute risk when considering strategies.

Generally, this is a clearly defined set of arguments and evidence that does not rely on understanding mathematical equations to get the best out of the book, and therefore does pose an interesting challenge for those who remain intent on chasing higher premiums in return for taking on more volatility risk. ■

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