



FACTOR / STYLE INVESTING

Low-Volatility Cycles: The Influence of Valuation and Momentum on Low-Volatility Portfolios

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In what is often referred to as the “low-volatility” anomaly, researchers have shown that measures of prior stock price variability relate to future performance but not necessarily in the way theory suggests. Theory indicates that investors demand higher returns as compensation for higher expected risk. Researchers, however, have found that, empirically, the lowest-risk stocks tend to outperform the highest-risk stocks.

The finding of a negative risk-return trade-off contradicts the most basic principle of financial economics and has had a dramatic impact on the theory and practice of investment management. In practice, investors have seen an explosion of strategies designed to “take advantage” of the outperformance of low-volatility stocks.

Our analysis of all stocks that traded on NYSE, AMEX and NASDAQ from 1968 through 2012 suggests that so-called low-risk stocks tend to outperform high-risk strategies in the future only when initial valuation levels and positive momentum favors low-risk stocks. In other words, investment success depends importantly on the price paid. The challenge to low-risk investing, common to any successful investment strategy, is therefore to identify “cheapness” and positive momentum ex ante.

We have shown that there have been periods of time over the last 85 years during which high-risk stocks cumulatively outperform low-risk stocks. These periods tend to have coincided to some degree with economic cycles. Although one should be wary of making predictions based on past events, our findings suggest the performance of low-beta stocks depends on a number of important macroeconomic, market and valuation factors.

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