FACTOR/STYLE INVESTING

The Low-Volatility Anomaly: Market Evidence on Systemic Risk vs. Mispricing

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Researchers have demonstrated a long-term connection between future stock returns and various measures of prior stock price variability, including total return volatility, idiosyncratic volatility and beta. Specifically, in U.S. and international markets, future returns of previously low-return-variability portfolios significantly outperform those of previously high-return-variability portfolios.

These empirical findings are particularly intriguing because, of course, economic theory dictates that higher expected risk is compensated with higher expected return. As such, these findings highlight the need to gain a better understanding of the underpinnings of this curious anomaly.

We explore whether this anomaly associated with low-volatility stocks can be attributed to market mispricing or to compensation for higher systematic risk. Data from a 46-year study period (1966–2011), indicate that the high returns related to low-volatility portfolios cannot be viewed as compensation for systematic factor risk. Instead, they are more likely driven by market mispricing connected with volatility as a stock characteristic.

eliminate the risk of experiencing investment losses.

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