Are low volatility equities expensive? A second look

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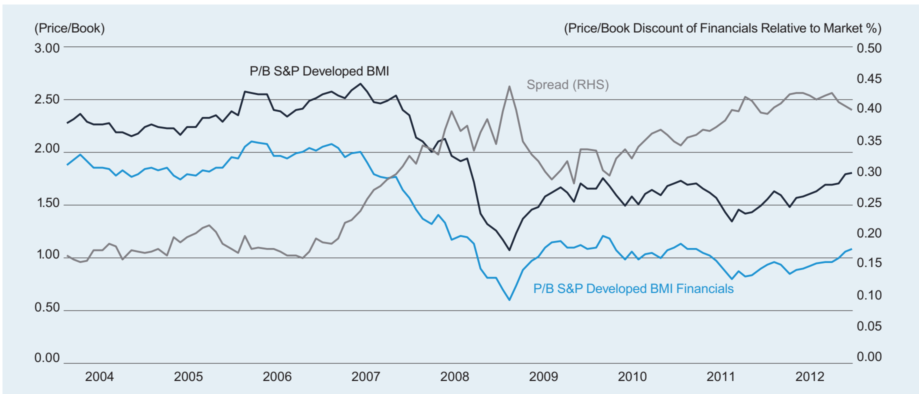
Investing in low volatility equities is not about market timing, rather it is a long term strategic decision to improve an overall risk profile. That being said, we understand concern from potential investors when they hear that low volatility stocks are overvalued. We have been keen to allay these valuation fears through our research efforts as we believe potential investors are forfeiting an opportunity to achieve equity-like returns with much less risk. We remain confident that the valuation concerns have been greatly exaggerated and the broader market for low volatility equities is not unreasonably priced.

We first conducted research in late 2011 to investigate concerns that low volatility equities were expensive compared with the market and historical valuations. We found then that low volatility stocks and the general equity market were both selling at multiples that were below their long-term 20-year averages. While the general market was selling at a more significant discount to its average, this was largely attributable to the valuation discount present in financial stocks (see Figure 1). Western financials do distort the wider values in the market because, as the chart below shows, they were dramatically sold off as a result of the crisis. The grey line shows the dramatic widening in the discount (as measured by price to book) throughout 2007 and 2008, and then again in 2010-2011. Even following this sell-off, few would argue that western financials are now trading at a major discount to their intrinsic value.

With the increasing global interest in low volatility strategies, the valuations of these stocks continue to be cited by some researchers, consultants and sponsors alike as a reason to delay an investment. There have been several studies which disagree with our earlier conclusions and suggest that low volatility stocks are unduly expensive. By extension they also point out that high volatility/beta companies represent particularly good value. These studies argue that it is not a good time to invest in low volatility stocks and to defer investment until the relative valuations correct themselves. One such paper goes as far as suggesting shorting low volatility and going long high volatility stocks.

The number of contrasting views in the market has led us to re-investigate the matter based on more recent data. Is it

Figure 1: Financials versus broader market



As of 31 December 2012. All data in US dollars
Source: Lazard Asset Management/S&P

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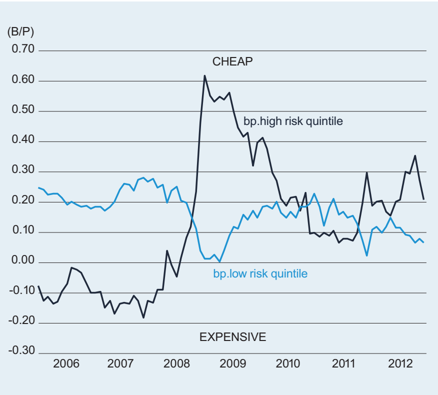
Figure 2: Book to price



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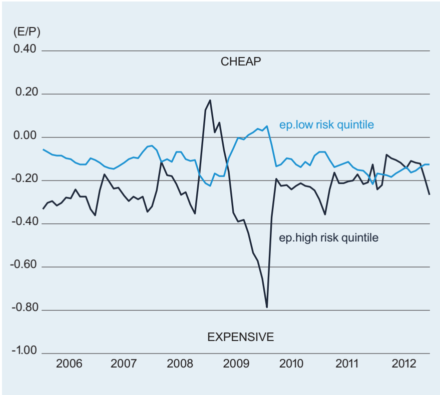
possible that we missed something? Or have the market characteristics changed significantly from year end?

Financial services stocks were actually one of the better performing sectors in 2012, so intuitively low volatility stocks should have got cheaper when compared with the broad market as there are few low volatility financial stocks.

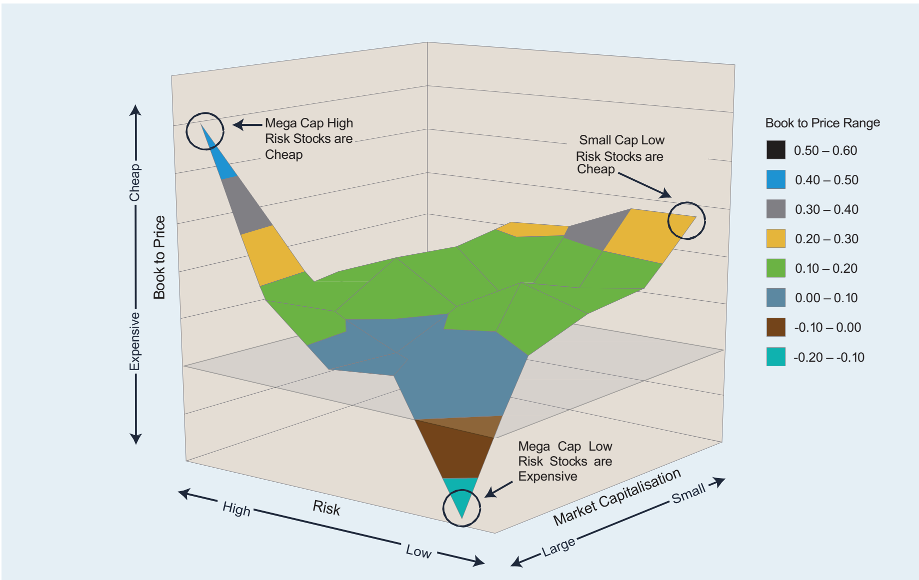
Our research was based on a global developed market universe of 4,500 securities. These are companies with at least one year of price history and financials with a minimum market capitalisation of $400 million and $1 million in daily trading volume. We used the Northfield Risk Model to measure total stock risk and aggregated the universe into equal weighted risk quintiles of approximately 900 stocks. This second round of tests came to the same conclusions as our initial work. That is, there is no discernible premium in the price of low volatility stocks. Whether measured on an earnings (Figure 2) or book value (Figure 3), the prices for low volatility/risk stocks appear to be selling around their averages and close to those of the overall market.

Figure 3: Earnings to price



Despite this reinforcement of our original work we did not feel that we had yet resolved all the conflicting data in the wider market, so we undertook a more forensic research effort. Many of the "expensive" studies were conducted on smaller sample sets and this gave us a reason to look at market data in more depth. We sorted our universe by capitalisation and risk, and then looked at valuations between the highest risk and lowest risk stocks (see Figure 4). This proved to be a fruitful exercise as the expensive nature of low volatility stocks and inexpensive nature of high volatility stocks manifested themselves in the largest capitalisation stocks. The actual spread between high volatility and low volatility stocks was quite pronounced as we broke our universe into capitalisation segments. As we would expect, the high volatility, large cap names were heavily dominated by large financial services companies. As we pointed out in our previous research, these may correct either through a price run-up, or continued write-offs to book value, or a combination of the two.

Figure 4: Valuations by market cap and risk



As of 31 December 2012
Based on a universe of developed market stocks with a market capitalisation of $400 million or greater (approximately 4,500 companies). Total risk was computed using the Northfield Global Risk Model which measures a company's total volatility measured on a 5-year basis. An aggregate risk is computed for each stock in the universe and each company was ranked according to this risk score. Capitalisation and Price to Book was calculated as of 31 December 2012.
Source: Lazard Asset Management/ Northfield Information Services, Inc.

Figure 5: Sample stocks in top decile risk/capitalisation

Name	Country	Cap
Wells Fargo	United States	169,826.30
JP Morgan	United States	153,773.56
Citigroup	United States	95,950.84
Bank of America	United States	95,160.47
Rio Tinto	United Kingdom	57,190.00
Caterpillar	United States	56,207.27
American Express	United States	56,079.58
Suncor Energy	Canada	50,580.70
BNP Paribas	France	49,508.04
Daimler	Germany	48,057.89
UBS	Switzerland	43,871.89
Banco Bilbao Vizcaya Argentaria	Spain	42,326.91
Anglo American	United Kingdom	40,789.13
Barclays	United Kingdom	39,481.49
American International Group	United States	38,241.52

As of 31 December 2012
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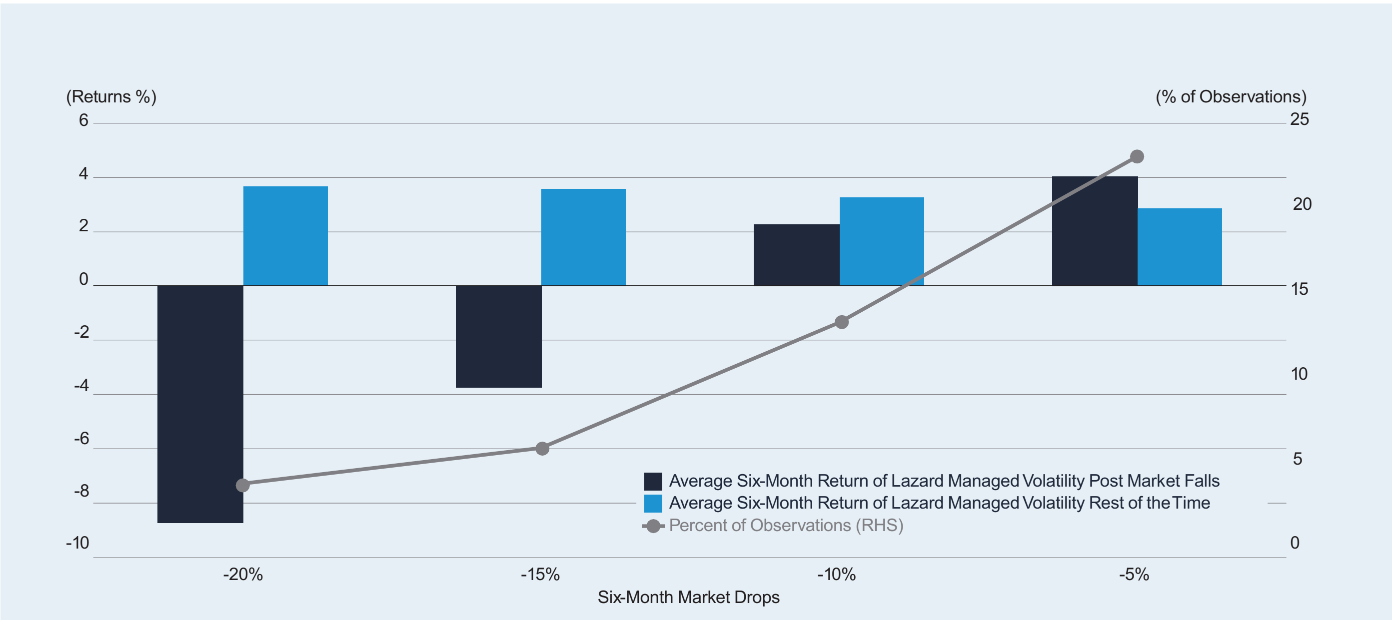
Source: Lazard Asset Management

There are several implications for investors considering a low volatility investment. Firstly, low volatility portfolios that are built on a capitalisation weighting scheme are likely to be buying into this valuation disparity. This includes many of the new low volatility indices which generally weight their exposures according to market capitalisation.

Secondly, low volatility portfolios which size positions according to risk are likely to be less affected by the valuation mismatch as it only is felt in companies with market capitalisation of $10 billion or more. The risk-sized portfolios will generally be dominated with companies in the small- and mid-cap range where the valuation levels are more evenly distributed. It is interesting to note that in the smaller end of our universe the valuation disparity switches to the point where low volatility stocks sell at a discount to higher volatility stocks. Finally, we also strongly suggest that a successful low volatility strategy should incorporate some measure of stock evaluation in the selection process.

We believe that the low volatility anomaly will persist for a variety of reasons, but there will be low risk companies that are either temporarily mispriced, lack a catalyst for growth and/or are burdened by negative sentiment. A successful stock ranking process can minimise exposure to these stocks and improve the risk/return trade-off for investors. A systematic process has the ability to select from a broad global universe of companies and is not restricted to the largest capitalisation names in order to create a defensive, low volatility portfolio.

Figure 6: Low volatility in different market environments



As of 31 December 2012
All data in US dollars. Represents the LQE – Global Managed Volatility Composite. The performance quoted represents past performance. Past performance is not a reliable indicator of future results
Source: Lazard Asset Management

Timing entry to low volatility investing

The question of timing entry/exposure to low volatility stocks is one that we hear repeatedly. Our research would suggest that there are no obvious metrics that indicate partiality to low volatility or market capitalisation based approaches. At a minimum, valuation disparity is an especially poor predictor as an entry point for low volatility approaches. In fact, periods when low volatility strategies look exceptionally expensive relative to market cap indices (1999 and 2007, see Figure 2), are the points where the payoff from low volatility is the greatest. Conversely, periods when low volatility stocks look inexpensive relative to the overall market (2001 and 2009) are periods where they experienced the greatest relative underperformance. While low volatility investors in 1999 would ultimately be proved correct, both that year and 2000 were two of the weakest periods of relative performance in the past two decades. Through our research, the only simple rule that we have found effective is to avoid buying low volatility after the market has declined by 10% or more in a six month period. As the chart below demonstrates, low volatility does underperform directly after sharp drawdowns (15%-20%) as more cyclical stocks recover some of the lost ground. This same effect is not seen in shallower pullbacks, as shown in Figure 6. The benefits of low volatility will become more obvious in the period directly after a significant fall. In the short term at least this may be the investment equivalent of buying insurance after your house has burned down.

We believe that the benefits of low volatility investing have a place in most diversified equity portfolios. In many respects, they offset the risks implicit on a cap-weighted, momentum-driven strategy. The valuation disparity in the very largest capitalisation stocks is another reason that an investor needs to be careful about the approach that they select to realize the benefits of low volatility. Taking the wrong option could result in more serious complications to an investor's portfolio. However, if a low volatility strategy is diversified by sector and market capitalisation a portfolio can be constructed that is not expensive when compared with the broader market.