The Opportunity for Reasonable Growth

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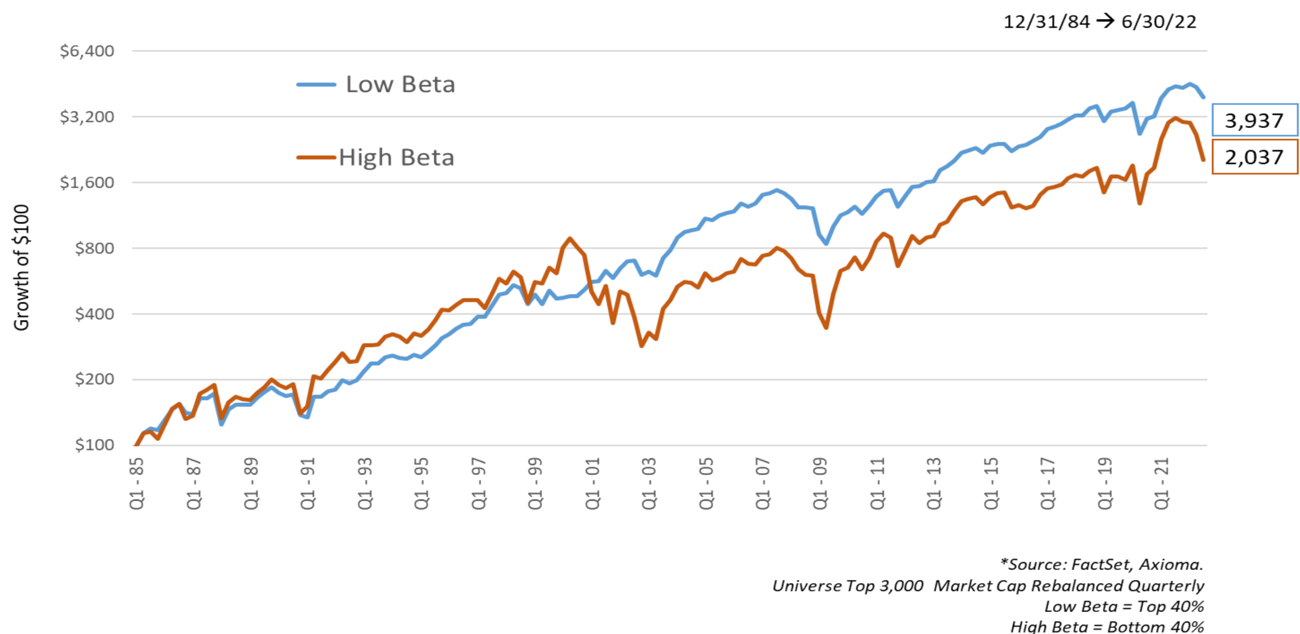
As Yogi Berra is credited as famously positing, "In theory there is no difference between theory and practice, in practice there is." Investment professionals are trained on the textbook theory of investing but eventually learn the market's harsh reality that textbook training can fail to explain the market and stock movements in short to intermediate time periods. Stock markets are directed by humans, or programmed strategies implemented and created by humans through fundamental or quantitative approaches and have been and always will be affected by human behavior and the errors and biases that cloud investor judgment. The inefficiencies caused by investor behavior lead to periods of crowding and overreactions in both bull and bear markets. Multiple instances in market history demonstrate this pattern. While much of investment textbook theory works over the longer-term, the path to the understanding the fundamentals producing the return patterns can be fraught with seemingly illogical turns.

Textbook investment theory would suggest that higher returns are a function of taking more risk, and higher risk stocks should outperform in up markets to compensate for the extra risk assumed by investors. Accordingly, lower risk stocks should offer lower returns given the lower risk taken on by investors. However, one of the most striking longer-term anomalies that seems to confound the textbook theory underpinning long-term bull markets is the notion that lower risk stocks have outperformed higher risk stocks. The textbook investment premise supports that in a longer-term bull market, higher risk stocks should have outperformed on an absolute basis and lower risk stocks should have underperformed. This textbook theory seems to make sense from a risk/reward framework, but what is missed in this equation is the path markets take to the longer-term average and the effects it can have on investing outcomes.

Real world results suggest that theory may have things backwards. Longer-term studies demonstrate the highest risk stocks have underperformed the markets on average while lower risk stocks have outperformed. Beta is a measure of a stock's sensitivity to market movements. A stock with a beta greater than one generally goes up and down more than the market while a stock with a beta less than one generally goes up and down less than the market. The higher or lower a stock's beta, the greater or lesser sensitivity it will generally have to market ebbs and flows. While higher beta and higher risk stocks can provide spectacular outperformance in short periods of time and garner much fanfare and fascination from the investing public, their inability

to hold onto those gains in tougher market periods is the performance cycle component that is often overlooked in the longer story when investors are studying actual earned returns. The path to the longer-term returns is a critically important determinant of realized returns, not just the performance in short-term bursts to the upside.

The following chart demonstrates how beta has performed over a 30+ year period of bull market returns. The blue line represents the cumulative returns of the bottom 40% of stocks based on their market sensitivity while the orange line represents the top 40% of market sensitivity. What is surprising in this result is not only the long-term outperformance of the lower beta stocks but the path taken to this result. The lower beta stocks' underperformance during strong market return periods is hardly noticeable and is swamped by the positive protection of capital during drawdowns in challenging periods after the tech bubble burst and the aftermath of the 2008 financial crisis. Time and time again the lower beta stocks performed well enough in the upswings but the key to their success and long-term compounding was protecting gains the during the drawdowns.



**Source: FactSet, Axioma.*
Universe Top 3,000 Market Cap Rebalanced Quarterly
Low Beta = Top 40%
High Beta = Bottom 40%

The behavioral side of this anomaly makes sense as investors, like moths drawn to the flame, inevitably gravitate to risker stocks during long bull markets. However, what sometimes can seem to be investment savvy decisions can instead easily be a function of being lucky to have a higher concentration of riskier stocks in a period that rewards this approach. The more dramatic the short-term market returns, the more likely an investor's 3-5-year returns can be above other less risky managers. This outperformance will likely attract investor attention and result in positive flows. However, as the old saying goes about seasons changing, failure to lower the risk of this portfolio will cause the longer-term returns to suffer during drawdown periods.

Given the greater asymmetrical effect of negative returns on the geometric linking used in the calculation of performance, higher participation in market losses can cause more damage to

longer-term returns than not catching as much of the upside but protecting better on the downside. In the current environment, examples abound to demonstrate this pattern of funds gaining assets due to high short-term returns then being overwhelmed by the downside when the risk pendulum swings the other way. Not only do longer term investors of these funds see much of their gains evaporate but newer investors that bought the hot performance suffer the full brunt of the downside with less of the previous upside outperformance to mitigate the damage.

After 13 years of arguably the most accommodative central bank policy ever, the Fed has shifted 180 degrees to address the highest inflation in 40 years. Markets appear to be entering a period when the excesses built up in the previous 3-5-year speculative run are set to unwind and risk may be more of a consideration for investors than it has been in some time. While the Fed will shift its hawkish policy at some point, it's unlikely that it can or will return to the unprecedented levels of accommodation seen in the last 13 years. A lower risk, more consistent approach to investing could also serve as a potential driver of returns during the next bull market as new market leadership will likely be different than that which lead the previous bull market. Investment approaches that focus on risk management across all periods of the market cycle as a critical part component of their investment philosophy and strategy should be especially well prepared to handle the more challenging conditions and thrive as markets become more difficult. The real secret is that a risk conscious approach is not just a means of conservatism but is a strategy for long term outperformance.