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## Thoughts on WSJ article “Beat the Market – with Less Risk”: Looking Back and Thinking Forward

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### The Low Beta Anomaly: Less Risk = More Return?

There has been a lot of buzz in the financial press and industry conferences about low-beta and high-quality strategies. A recent Wall Street Journal article, [“Beat the Market with Less Risk”](#), by Ben Levisohn pointed out that low-volatility equities have not only held up relatively well this year but have also provided higher returns with lower risk over longer periods of time. This low risk/higher return anomaly has been observed and studied since the 1970s but has only captured investor interest in the recent (more volatile) years. A recent study by Baker, Bradley, and Wurgler found that stocks with lower betas/volatility outperformed the market with less risk from 1968 – 2010.<sup>i</sup>

### Explanation of the Low Beta Anomaly

One possible explanation for the anomaly is right out of behavioral finance. Investors tend to chase home runs by betting on higher risk stocks. This demand for riskier stocks leads to overvaluation as investors view these stocks as lottery tickets to outperformance. Odds of actually getting that home run may be very low but it doesn't stop investors from placing the bet. While low risk, “boring” stocks may not provide home runs, they do, on average, win with less risk.

Given the persistence of this anomaly over the decades, it would be reasonable to expect that more sophisticated investors would have arbitrated away any advantage. Some academics speculate that the anomaly persists because, by definition, it deviates significantly from the historical traditional benchmarks. Investors, in particular institutional investors, are focused on benchmark risk and asset managers which are often judged versus the market capitalization benchmarks. These low-risk strategies have high tracking errors making them difficult to place within a portfolio. They have thus not been widely adopted by institutional investors. This benchmark ‘hugging’ behavior is one explanation why this anomaly has not been arbitrated away and is likely to persist in at least the near future unless and until institutional investors adopt some of the newer low-beta indices *en masse*.

### Long Term Behavior of Low Beta Stocks

In response to wealth advisors seeking exposure to these strategies for their clients, we started running our own rules-based low beta/high quality strategy in 2010. Our back test on the strategy shed some light on its behavior in different market conditions. Our simulation of the factor quality strategy shows outperformance with lower risk from

1988-2011. The strategy keeps up with the market over the 1988-1998 bull market, underperforms in 1999, and then outperforms during the recent volatile decade. These strategies provide investors with lower risk (standard deviation) but a high tracking error compared to the traditional market capitalization weighted benchmarks. Investors should be comfortable with years of under-performance in order to achieve this lower risk portfolio. As Levisohn quotes in his article: "You need to have an honest conversation with yourself. You have to be able to live with the results." While lower risk has resulted in above-average returns over the most recent past, the sophisticated investor knows that this is no guarantee of future performance.

- By Ran Leshem, Head of Portfolio Management and Operations

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i Baker, Bradley, and Wurgler. 2011. "Benchmarks as Limits to Arbitrage: Understanding the Low Volatility Anomaly", Financial Analysts Journal Volume 67 Number 1.

## Disclosure

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With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described. Past performance is not indicative of future results. Every investment program has the potential for loss as well as gain. Risk models shown reflect no explicit assumptions for future returns.

Performance results from back tests of particular strategies exclude any trading or management fees that would reduce the return. Furthermore, future returns for any such strategies could be worse than the results shown or the identified benchmark. Back-testing involves simulation of a quantitative investment model by applying all rules, thresholds and strategies to a hypothetical portfolio during a specific market period and measuring the changes in value of the hypothetical portfolio based on the actual market prices of portfolio securities. Investors should be aware of the following: 1) Back-tested performance does not represent actual trading in an account and should not be interpreted as such, 2) back-tested performance does not reflect the impact that material economic and market factors might have had on the manager's decision-making process if the manager were actually managing client's assets, 3) the investment strategy that the back-tested results are based on can be changed at any time in order to reflect better back-tested results, and the strategy can continue to be tested and adjusted until the desired results are achieved, and 4) there is no indication that the back-tested performance would have been achieved by the manager had the program been activated during the periods presented above.