IS THERE RISK IN LOW RISK?

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Low risk equity strategies such as minimum variance have garnered a lot of attention the past six years. The prolonged outperformance and lofty valuations for 'quality' stocks suggest that alternative indexing is creating a bubble or at the least a very crowded trade. Or is it?

Not surprisingly, during the financial crisis of 2008-2009, minimum variance, low volatility and quality strategies performed very well when compared to market cap weighted benchmarks, further strengthening their appeal to institutional money managers. Since the crisis, tens of billions of dollars and euro have been allocated away from traditional active managers and market cap weighted indices to low risk strategies. These strategies continued to do well in 2010 and 2011 when the credit crisis spread to peripheral Europe, but more remarkably, quality and low risk extended their strong run in 2012 and 2013, when both macro-economic numbers and market indicators suggested a far more benign environment.

A crowded trade?

- Very high valuations and declining earnings momentum: In Europe high quality and low volatility stocks are trading at or very near their 25 year high relative P/E multiple, when compared to the rest of the market, despite significant downgrades to earnings expectations.
- Style investing is becoming more relevant in equity markets : The inflows into minimum variance, low volatility and quality strategies may be large, but compared to the tech bubble and the inflow into quant funds in 2004-2007, they are not very shocking. However, the difference this time is that the number of players in the market with a medium term investment horizon has declined rapidly. Active managers are trading less and high frequency trading is a substantial part of a day's turnover nowadays. When most market participants are either buying the market as a whole or are busy finding short term trading opportunities, a small number of allocators can make a huge difference when it comes to dislocating valuations of preferred investment styles.
- Me too investing: Alternative indexing and specifically low volatility / minimum variance is by far the most popular topic at (quantitative) investment conferences and by far the most requested topic at quant desks within global brokers.

Or not yet a bubble?

- Quality is scarce: In a low growth world with lots of unresolved credit risks, it is no surprise that investors are paying a premium for stable growth companies, oligopolistic market structures and downside protection.
- Quality and low volatility are linked to domestic growth: While BRIC countries and Southern Europe have shown very little sign of improving GDP growth estimates, the US, the UK, Germany and Northern Europe have surprised on the upside for quite a while now and this trend could continue.
- Back to basics: In the nineties, topical investment drivers were Growth At a Reasonable Price (GARP), barriers to entry, value added, competitive advantage and CFROI™, CROCI™, EVA™, NOPLAT™. Emerging markets were considered risky and Euro interest rate conversion was not invented yet. Investors preferred companies with stable high returns, which led them to sectors such as health care, consumer staples, media and luxury goods. These sectors underperformed substantially and consistently from 1998 to 2007. The same companies now show up in high quality and low volatility screens.

Some of the strong performance of quality and low risk has started to reverse in recent months. Investors will have a hard time deciding if a further 'reversion to the mean' is due or if quality and low volatility are a strong foundation for their investment strategy in volatile times ahead.