Falkenstein, Eric G. – The Missing Risk Premium

2012, [Finance] Grade ★★★

A risk premium could be defined as a situation where an investor receives a higher expected return as a compensation for taking higher risk. The overarching thesis of the author is that positive risk premiums are extremely rare. Eric Falkenstein was one of the first to research the low volatility anomaly and he is today a quantitate portfolio manager of, surprise, a low volatility equity portfolio and he has both theoretically and practically shown that the returns from low risk shares historically has been higher than the market in general and substantially higher than high risk shares that have had horrendous returns. This is valid irrespective of whether risk is measured with beta, volatility, profit margins, leverage etc.

In the chapter that makes up the bulk of the book Falkenstein reviews 25 different assets and in all but in a few cases there is either no correlation between higher risk taking and expected returns or the correlation is actually negative. There simply is no such thing as a "linear courage premium". Only in a handful of cases is exposure to a higher level of risk rewarded by higher returns. The positive risk premiums are a) short end yield curve, b) BBB-AAA corporate spread, c) REITs and d) gross equity return. The reason for the "gross" in equity returns is that Falkenstein argues that the actual returns the average equity investor historically has received after taxes, poor market timing, transaction costs and geometric averaging are close to the risk free rate.

The reason that positive risk premiums are so rare is, according to Falkenstein, that humans are more motivated by envy than by greed, that is they are more interested in their relative than in their absolute position. "*In the relative wealth case, risk taking is symmetric – it can be too little or too much relative to the consensus, and due to arbitrage, there is no general risk premium in these cases.*" An example would be a situation when year one the index returns -5% and then year two it returns +25%. Investor X's returns are 0% the first year and +20% the second year. Investor Y's returns are -10% the first year and +30% the second year. In an absolute world the returns of investor Y is highly volatile and risky compared to those of investor X. In a relative world of arithmetic averages the investors are equally risky as they both underperform and outperform by 5 percentage points one year each. "*In relative returns space, the higher absolute volatility is not riskier.*"

Any objections? The subtitle "Why Low Volatility Investing Works" is slightly misleading as there is really only one short chapter that covers low volatility investing. Also it would have been commendable if the author at least shortly had covered the many other explanations there are to the "low volatility anomaly". As Falkenstein is obviously theoretically well-read he is no doubt aware of these.

The author's style of writing is sharply cynical, not the least when he describes academic financial theorists and their reluctance to admit that empirical results contradict core aspects of the prevailing theories. Instead of changing when facts point the other way academics try to patch up the theories that they have made their livelihood. One example of this "mend not end" strategy is the, in my opinion, scientifically dishonorable Fama-French three factor model that simply opens up for that anything that can be shown to have a positive correlation with expected returns are a non-specified "risk". Small caps and value stocks is included in the three factor model accompanying the traditional market beta. Later on momentum has been added in a four factor model. The question is whether low volatility (or beta) should now become a piece of a five factor model at the same time as the high beta factor is also kept?

Investors don't escape Fleckenstein's' scorn either as when he explains the poor high volatility returns with overconfidence and the lottery effect "*the stupid money is much more identifiable – they're into lottery tickets hoping to get rich quick with no effort. The effect is for really high-risk investments to have the most delusional investors, the most opportunistic sellers, and pathetic returns.*" The stupid money, that would be pension funds, mutual funds and other relative return focused investors in contrast to the smart money that is managed by hedge funds.

This is an entertaining book for those who like me enjoy some public spanking of flawed theories, but apart from the insights on relative instead of absolute utility, it doesn't add much to the collective knowledge of low volatility portfolio management.

Mats Larsson, November 24, 2012