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One of the Most Famous Rules of Investing Might Be Totally Wrong

By Allison Schrager December 03, 2014

There is supposed to be one fundamental truth in investing: If you take on more risk, you can expect a bigger reward. With new research suggesting that things may not be so simple, investors may want to adjust their strategies—or at least their expectations—accordingly.

Boston-based asset manager GMO recently looked at risk and return data for U.S. stocks from 1970 to 2011, and what the researchers found is surprising: The riskiest 25 percent of stocks—those most vulnerable to swings of the broad market—logged an average annual return of just over 7 percent per year. The least-risky 25 percent of stocks returned 10.6 percent per year. On a $10,000 investment over those four decades, the lower-risk stocks would have yielded more than $450,000.

Investors who took on more risk in search of higher returns should be ticked about this new information. Owning a stock whose price moves with the rest of the market makes your whole portfolio more volatile, and it's reasonable to expect a bigger return in exchange for taking on that risk. But the 40 years of data suggests otherwise—and it's not a passing trend.

One explanation could be that investing has changed. In 1980, individuals owned 48 percent of stocks. By 2007, that proportion had dropped to 22 percent. The vast majority of stock is now owned by large asset managers: hedge funds and mutual funds that employ professionals to pick stocks. A paper from Paul Woolley and Dmitri Vayanos, both of LSE, and Boston University's Andrea Buffa argues that the way fund managers are judged and paid has altered how markets function.

A fund manager's performance is judged according to how well a fund does in comparison to a benchmark, often an index such as the Standard & Poor's 500-stock index. Because underperformance means losing assets, and beating the market is extremely difficult, most managers respond by hewing pretty close to their benchmark. For example, managers might believe that a stock is overvalued but feel compelled to buy more of it—which would further drive up prices, making the stock more volatile.

This effect is true for index funds—those designed to follow the market, rather than beat it—as well as actively managed funds. Index fund managers typically save on costs by buying enough shares to mimic the returns, while not buying everything in the index. If enough index-fund managers follow the same strategy, though, the relationship between the stock and the rest of the market changes because stocks are no longer chosen on their investment fundamentals.

Duke University finance professor Campbell Harvey agrees that the risk-return relationship, as investors have traditionally considered it, may have changed. He also argues that that volatility may have taken on outsized importance, especially compared to other measures of risk. His research measures the relationship between returns and what's called tail risk—the chance of an unlikely but major event such as a 50 percent drop in price. The recent financial crisis is considered an example of tail risk. (While tail risk can also manifest to the upside—as in winning the lottery—most people are more freaked-out by the remote chance of losing everything than they are motivated by the small odds of winning big.)

When Harvey performed an estimate similar to GMO's, he included tail risk and other factors (such as momentum). He found that stocks with more tail risk do, in fact, have higher returns. If he's right, investors get compensated for taking on extra risk. It's just a different kind of risk than they thought—and one that's far harder to see.

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