Low volatility investing is not a fad…

With the end of 2013 comes reflection on the year that was. As we reflect on the year, we'd like to recognize the passing of the man known as the "Father of low volatility investing" Robert (Bob) A. Haugen. Mr. Haugen had tenaciously challenged the long held paradigm, that greater risk is expected to produce greater reward. Mr. Haugen began his work on low volatility investing in 1972 in a paper he co-authored with A. James Heins titled "On the Evidence Supporting the Existence of Risk Premiums in the Capital Market" and has been defending and updating his work ever since. In a 2012 working paper published before his death "Low Risk Stocks Outperform within All Observable Markets of the World", by Nardin L. Baker and Robert A. Haugen discuss their, and others' empirical evidence that "contradicts the very core of finance: that risk bearing can be expected to produce a reward".

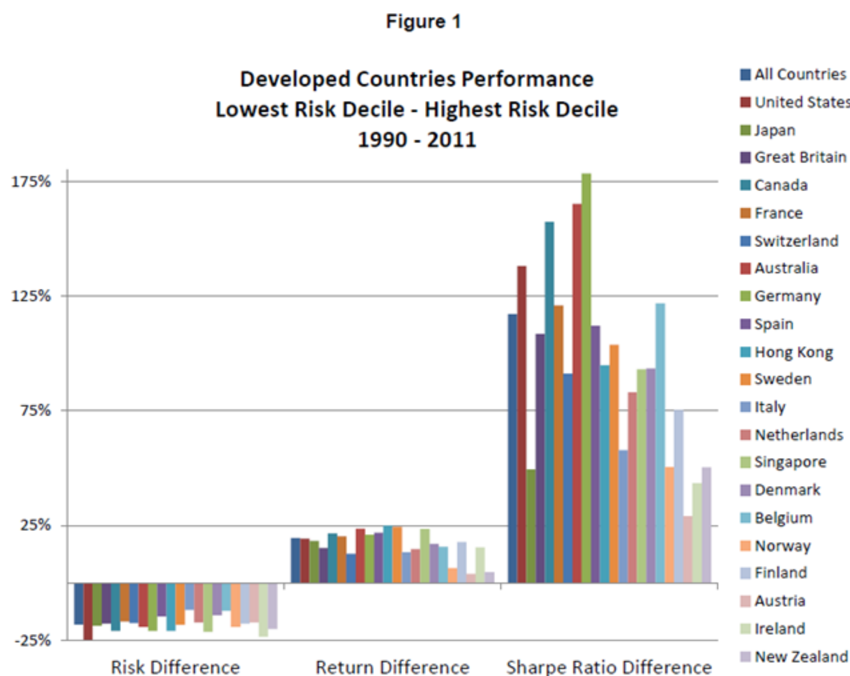
As a result of the rise of Modern Finance in the 60's, significant amounts of capital have been invested into capitalization-weighted indexes (passive index funds and more recently, ETF's), as a result of the belief that the market portfolio (think S&P 500, or TSX) was the "optimal" risk-adjusted portfolio and that markets fully reflected all relevant information. But this passive investment strategy assumes investors are willing to accept the 'default' level of risk inherent in the index, something we at SEAMARK have come to seriously question in recent years. As highlighted in our last publication, in the article "Smart Beta…, or Smarter Beta", the premise for our Low Vol investing strategy is to deliver to investors a lower level of volatility than the Canadian 'default', the S&P/TSX Composite. Haugen and company take this one step further, illustrating that *low volatility stocks exhibited a higher return, despite their lower observed risk, over many decades, and in many different markets worldwide.*

With that as a preamble, let's take a look at some of the compelling conclusions that are backed by empirical evidence. In a recent study that spans the period 1990-2011, the authors observed the following from historical data:

Despite a clear difference in risk, the lowest risk stocks in the group versus the highest risk stocks generated higher absolute returns and higher risk adjusted returns in all developed markets from 1990-2011. Not illustrated here, but equally telling, the same anomaly is observed in emerging markets.

So, we have the effect. What could be the cause? The authors offer an explanation grounded by the theory of 'agency' and provide empirical evidence to support their theory. They *contend the anomaly can be explained by the nature of manager compensation issues and agency issues* (i.e. conflict of interests) between professional investment managers within an organization, and between these professionals and their clients. A couple of their key conclusions:

1. If managers receive bonus-like compensation that is tied to performance being sufficiently high, they are likely to construct a higher volatility portfolio to hit the bonus hurdle rate.
2. Analysts desiring to make a compelling investment case to the Chief Investment Officer are incented to recommend noteworthy stocks that receive high flows of information, because they "can confidently make a compelling case".
3. Stocks that have high analyst coverage, large institutional ownership, and receive more news coverage… also create demand for more volatile stocks.



Collectively, the authors conclude *"agency issues are responsible for creating higher demand for volatile stocks, which results in their overpricing and their production of inferior returns in the future."* At this point, you may be wondering what our views to these conclusions are, and what SEAMARK does to avoid these conflicts of interest to ensure we always put clients' interests ahead of our own. *We wholeheartedly agree with the conclusions!*

One of the inherent advantages we have had at SEAMARK is being away from the loudest 'noise' that is entrenched in our financial centers; we're away from the madding crowd so to speak. For most of our existence, we have shunned the industry compensation practices that reward short term thinking and risk taking in client portfolios. For a period of time after going public, we lost our 'simple' approach to compensation, which had started to look more like standard industry practices. We have since gone back to our compensation roots, and delivered strong returns, in absolute and risk adjusted terms for our clients. Today, we are in the process of offering each investment team member a share of equity in the firm, thus incentivizing a long-term view. A rising equity value is a function of a growing firm, composed of loyal clients whose objectives are always at front-of- mind.

We have also been strong advocates of balanced fund management, and constructing portfolios from our total equity platform. For us, as portfolio managers, this makes the best sense for clients. We search the world to deliver efficiently constructed portfolios to our clients. We have long argued that this format allows us to effectively manage risk, in fact, *reduce risk for clients.* Conversely, the entire industry has gravitated toward specialty management, picking the best manager for Canadian, U.S. and International mandates. We contend that within these individual silos, risk management responsibility is removed from the manager. Even worse, when combined with the ill-advised compensation practices, risk is embraced by portfolio managers. And this risk becomes additive as each silo combines to create a portfolio. The consultant industry, by contrast, openly endorses the silo approach. We have had an uphill battle with most consultants, trying to sell balanced management, or even total equity management. We recognize that the diminution of risk management responsibility by portfolio managers is integral to the consultants' business models…but has it worked? Even SEAMARK fell into this trap for a time, organizing research and portfolio managers along 'specialty' lines, which met with little success for clients. It was one of the most significant changes we undertook upon returning to the company in 2012….going back to the total equity platform which is our proven niche in the industry.

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1. *Low Rise Stocks Outperform within All Observable Markets of the World*, by Nardin L. Baker & Robert A. Haugen, April 2012.

2. Note: SEAMARK employs a fundamental approach to stock selection and does not utilize the same quantitative measures used in this study and therefore uses this data for illustrative purposes only. For further details of the approach of the study go to: http://www.lowvolatilitystocks.com/wp-content/uploads/Low_Risk_Stocks_Outperform.pdf