It Is Easy To Beat Markets With Low-Risk Stocks

When market volatility is on the rise, it is the low volatility stocks that come into high demand. But the question that investors need an answer to is whether the low volatility stocks outperform in the long run on a consistent basis. Shreya Chaware throws some light on the subject that matters most to long-term investors i.e. consistency in low volatility stocks

Beating the markets consistently is a professional game. There are many instances of investors beating the market in the short term; however, there are very few success stories of beating the markets consistently in the long term. And those investors that are able to do so are often given a celebrity status, both globally as well as in India. Interestingly, ace investors Warren Buffet or Rakesh Jhunjhunwala seem to be trending on the internet these days than film actors! 'Consistency' in beating the markets is the key word here. How do you beat the markets consistently and which stocks should you hold in your portfolio to beat the markets consistently?

Which is the best strategy to adopt – growth investing, value investing, high dividend yield stocks investing or penny stocks investing? There are different approaches to beating the markets in the long term. The normal perception amongst investors is that one can expect higher returns for every unit of higher risks adopted. This would suggest that those investors who want higher returns should ideally invest in high-risk stocks. It also literally indicates that those investors who consistently invest in high-risk stocks can expect to get high returns and beat the market indices. Here is where the stock market practicalities and empirical evidence questions this assumption and actually completely contradicts the notion of high risk equating to higher returns in the equity markets.

It is found that it is the low volatility stocks that tend to beat the

Special Report

Satish Ramanathan

Managing Director and Chief Investment Officer (Equity), **JM Financial Asset Management Ltd.**

"Current market rally has been on the back of earnings' growth and PER expansion"

What is your outlook on the markets? When do you see the markets peaking?
The markets may move up a little bit more but broadly we believe that the euphoria is overdone. Over the past five months Indian markets have outperformed other emerging markets handsomely. As per a study by Morgan Stanley, the Indian markets have outperformed MSCI EM Index by 31 per cent. This degree of outperformance is unusual and usually markets revert over time. We believe India still remains exposed to the energy risk as a surge in demand across all countries and power outages could spike crude oil prices. That could impact the market sentiments. So, we are watchful while mindful of India's emerging strength in the global manufacturing and service chain.

Do low volatility stocks outperform in the long term?
The market preference for low volatility stocks does help them to outperform. We, however, need to understand the underlying causes for low volatility in share prices, which is lower business and earnings volatility. The list of lower volatile businesses keep changing and hence active management is required to anticipate businesses which are likely to have significant terminal value and ability to generate free cash flows with lower volatility. In general, markets do not like nasty negative surprises and prefer predictable businesses which help low volatility stocks to outperform.

Which sectors are offering relatively better value as of now?
As has often been stated by us and to paraphrase, value lies in the eyes of the beholder. The declining and benign interest rates have bid up growth stocks significantly and these stand exposed to volatility in the Federal Reserve funds rate and the multiples thereof. We need to bear in mind that the current market rally has been on the back of earnings' growth and PER expansion. Some of this euphoria can wither away should inflationary pressures persist. In terms of absolute value where dividends yield cover cost of capital and are at reasonable valuations, PSU stocks seem to fit the bill.

markets consistently in the long run. Riskiness in finance is defined by the volatility. High volatile stocks are considered risky and low volatile stocks less risky. When it comes to risk-adjusted returns, again the low volatility stocks have an edge as in the long run the low volatile stocks deliver better risk-adjusted returns than the high volatile stocks. Low volatility stocks across geographies, whether in the markets of the US, Japan or Europe, have shown a tendency to outperform the market indices in the long run and that too on a consistent basis.

Identifying Volatility Stocks

Low volatility stocks are the ones where the price movement is less volatile on a relative basis. For example, large-cap stocks are considered less volatile as the price movement variations in the large-cap stocks is less volatile when compared to small-caps and mid-caps. One of the main reasons behind the stock prices being less volatile is the steady earnings trajectory. With steady earnings growth QoQ and YoY, the stock price will always tend to remain less volatile. Usually, it is found that low volatility stocks are the ones with consistent earnings growth, high return on capital employed and predictable cash flows.

Usually, low volatility stocks or companies are with proven brands in the markets and enjoy market leadership in their respective business segment. Further, low volatile stocks also have a sustainable business model and strong balance-sheet. The table below highlights the consistent performance of the low volatility stocks in past few years. One of the most effective ways to identify such a set of low volatile stocks is to scan the

Rahul Sharma, *Co-Founder,* Equity 99

Low volatility stocks do outperform in the long term as the well-known power of compounding suggests. The low volatility pressure on investment returns enhances the performance of less volatile stocks. Low volatile stocks are safe stocks in the sense that they yield decent and consistent returns over longer periods of time. There are several other reasons why low volatility stocks perform better over time. An integral reason is the limited availability of quality, sustainable, stable and liquid stocks.

BSE Low Volatility index and Nifty 100 Low Volatility index. In the Nifty 100 Low Volatility index, the 30 least volatile stocks are included and only those stocks that feature in the derivatives segment are included as index constituents.

Conclusion

The pursuit for long-term investors is always to maximise the risk-adjusted returns. In simple words, investors always aim for higher returns but the risk should also be minimised at the same time. A discerning investor always wants the best of both the worlds i.e. returns and risk. Low volatility is the clear answer to those discerning investors looking for higher risk-adjusted returns. Low volatile stocks often emerge from the basket of quality stocks with consistent performance in earnings and superior operational performance.
Low volatility stocks have proven to deliver consistent market-beating returns and also have proven to have lower draw-downs.

Contrary to the perception, low volatility stocks have not only emerged as the best option for capital preservation during the downturns but also have emerged as lead gainers whenever the markets have staged a recovery. The concept of risk-adjusted returns is not intuitive to most beginners in the equity markets. However, any investor who has spent several years in the market and has gained maturity knows the importance of maximising the risk-adjusted returns. When it comes to beating the market, it is important to realise that each investing strategy has its unique strength and limitation.

It is futile to bank on any single investment strategy that may beat the markets consistently, always. If as an investor you believe that the markets are inefficient in terms of information and one can beat the market in the long run, the low volatility strategy is definitely one of the useful strategies that can be trusted for its consistency and relative safety. It will be wrong to presume that low volatility stocks are only for capital protection and that they outperform during the bear market. There is enough evidence of low volatility stocks outperforming the frontline indices on a consistent basis.