Lazard
Perspectives

Can Anything Get in the Way of Investors' Appetite for Risk?

Global equity markets have been in an extraordinary risk-on period that has not been good for low-risk stocks, which trade at a growing discount to the market. However, if rising yields, a longer-than-expected period of inflation, or weakening demand stops the party, we believe low-risk stocks with strong fundamental characteristics could become more attractive.

LAZARD
ASSET MANAGEMENT

The Teflon markets are alive and well in a period of bountiful risk appetite. Sell-side analysts are resurrecting charts illustrating another prolonged period without a 5% drawdown, while investors marvel at the strength of the equity markets even as the global economy is still very much feeling the effects of the COVID-19 pandemic.

To understand just how high the market's appetite for risk has been since mid-2020, it helps to look to the emerging markets. Historically, when the higher risk emerging markets have vastly underperformed developed markets, it has indicated that markets have entered risk-off mode, to the detriment of global equities. This was true during the global financial crisis, the commodity crash of 2015, and the Asian financial crisis of 1997. But it isn't true now.

In July, the 8.5% gap between the MSCI World Index and the MSCI Emerging Markets Index was one of the biggest differences in monthly performance of the last 30 years. This appeared to reflect concerns about a more unpredictable Chinese regulatory environment and how it may bring forward a potential economic slowdown in China, as well as the economic risks lagging vaccination rates continue to pose to the growth outlook in developing economies relative to major developed economies. Nevertheless, developed equity markets finished the month up and continue to register enormous year-on-year and year-to-date gains.

Against this backdrop, we wanted to probe deeper into the nature of "risk" in this "risk-on" environment, what could sour the taste of risk for investors in the current market, and where the opportunities may lie when and if the appetite for risk fades.

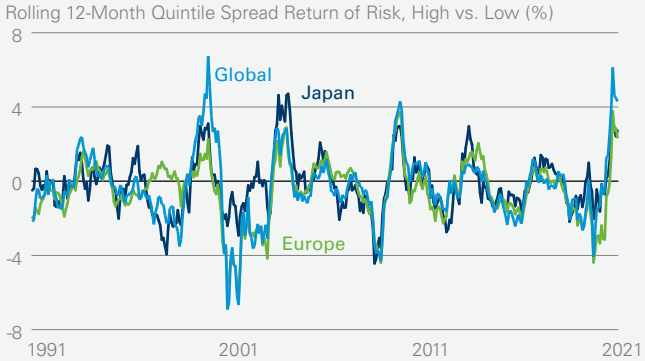
Putting Recent Investor Risk Appetite in Context

To help illustrate the market's appetite for risk over the past few months, we assessed the performance of high-risk versus low-risk stocks. We sorted stocks from high to low risk, compared the monthly performance of the average stock in the top 20% to that of the average stock in the bottom 20%, and calculated the rolling 12-month performance for that measure (Exhibit 1).

We can see that the performance differential follows a cyclical pattern that clearly mimics the highs and lows of the broader market performance—when the market is doing well, high-risk stocks tend to do better than their low-risk counterparts. The exuberance we are seeing now exceeds the level of performance dispersion between high- and low-risk stocks during the peak of the dot-com bubble.

To further investigate the tendency for low-risk stocks to underperform in up markets, we also looked at their performance compared to a representative market return (Exhibit 2). The pattern remained the same. However, it is striking how deep the drawdown in low-risk securities was during the COVID-19 recovery phase, as the market soared to record highs. The relative underperformance outstripped even the one in 2009, when the market dropped a great

Exhibit 1
The Last 12 Months Has Been an Exceptional Risk-On Period

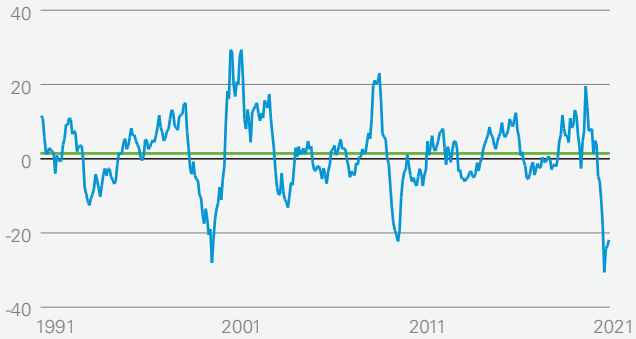


As of 30 June 2021

This chart reflects the rolling 12-month average quintile spread (top 20% less bottom 20%, as ranked by a given factor) return for an equal-weighted combination of a selection of risk-based metrics. The metrics are 3-year beta against local market index using daily returns, 12-month daily volatility, forward earnings per share dispersion of FY2 broker estimates, and debt to equity.

Source: Lazard, FactSet, S&P Global BMI

Exhibit 2
Low Risk vs. the Market: Exceptional Drawdown



As of 30 June 2021

This chart reflects the combined rolling 12-month average performance of a selection of risk-based metrics compared to the equal-weighted universe return. The metrics are 3-year beta against local market using daily returns, 12-month daily volatility, forward earnings per share dispersion of FY2 broker estimates, debt to equity, and the average of this measure over the whole period.

Source: Lazard, FactSet, S&P Global BMI

The Recovery Period for Low-Risk Relative Performance Has Varied Significantly

		Subsequent Periods		
Low-risk trough	Prior 12 months	1 year	3-year average	5-year average
July 1993	-12.58	-0.06	1.68	4.36
February 2000	-28.10	29.31	17.63	8.50
March 2004	-11.61	-0.91	0.29	3.87
February 2010	-22.31	-2.64	-0.20	0.21
June 2021	-21.88			

As of 30 June 2021

This table reflects the magnitude of the four deepest drawdowns of low-risk stocks relative to the market and the subsequent annualized performance of low-risk stocks compared to the overall market one, three, and five years later.

Source: Lazard, FactSet, S&P Global BMI

deal further prior to the recovery, clearly illustrating the headwinds low-risk strategies have had to battle of late.

As the table in Exhibit 2 shows, these "peaks of risk appetite" are typically not sustained for any great length of time. Over the last 30 years, the recovery of low-risk stocks after the most significant drawdowns, as measured by their performance compared to the overall market, has varied considerably. In the aftermath of the dot-com crash, lower-risk securities delivered immediate and significant outperformance. After other periods the recovery of relative performance took a number of years.

However, it's also important to note that lower-risk securities have outperformed by an average of 1.4% in 58% of all 12-month periods between 1991 and the present. The drawdown now is extraordinary, but over the long term, low-risk securities have outperformed more often than not.

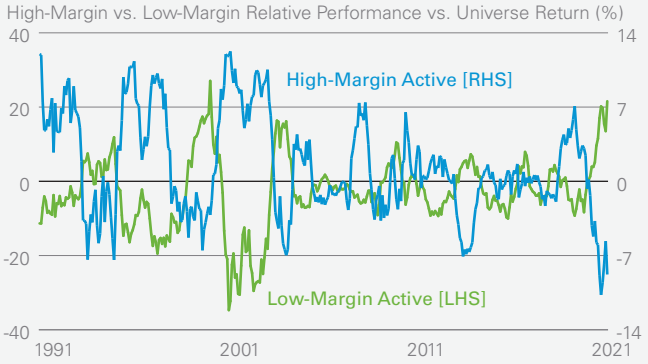
How Long Can Money-Burning Companies Keep Getting Free Money?

Clearly, the market is in an unusually robust risk-on period that we would not expect to favor low-risk stocks based on historical patterns. But assessing the performance headwinds for low-risk strategies by looking only at the performance of risk in isolation fails to capture the investment considerations used by more sophisticated lower-risk managers. Typically, experienced investors understand that low-risk strategies can underperform the market for extended periods, and as such, look to augment their portfolios by undertaking a thorough assessment of company fundamentals.

Still, high-quality stocks have faced their own performance issues lately. We separated out the performance of the highest- and lowest-margin companies using a similar methodology as above, and compared them to the overall market on a rolling 12-month basis. We can again see a sharp divergence in performance that is arguably unprecedented in magnitude (Exhibit 3). Because the bottom 20% of low-margin companies are by and large loss-making businesses, it's clear that there has been an extraordinary preference for loss-making businesses over profit-making enterprises. The significant outperformance of young, disruptive growth stocks early in the pandemic, including many "COVID winners" that benefited from a work-from-home environment in sectors such as technology and pharmaceuticals, likely exaggerated the divergence.

The growth trade lost its grip eventually, but a quality trade did not ascend in its place. After Pfizer announced its favorable vaccine results in November, beaten-down, profitless cyclical companies staged a sharp recovery. It seems highly unlikely that

Exhibit 3
The Preference for Low Margin to High Margin Is Unprecedented



As of 30 June 2021

This chart reflects the rolling 12-month cumulative active quintile return (average return top 20%/bottom 20% of stocks, as ranked by a given factor, minus equal-weighted universe return) for high- and low-margin companies, respectively.

Source: Lazard, FactSet, S&P Global BMI

this significant outperformance from unprofitable enterprises will continue, and if that's true, it would benefit fundamentally oriented, low-volatility investment strategies that favor established and durable levels of profits and cash flows.

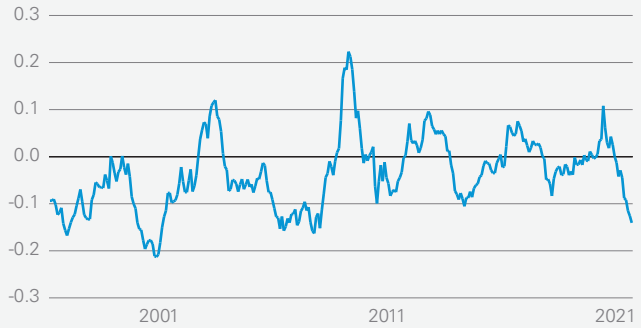
What Is a Low-Risk Stock? The Answer Is Changing

Having noted that low-risk stocks have been facing extraordinary headwinds for quite some time, we think it's important to note that the characteristics of low-risk stocks have been changing, too. Securities that trade at a discount to the market and low-risk stocks increasingly overlap. This may be an important indicator about which stocks will prove to be defensive in the next market drawdown. There has been a huge shift in the monthly cross-sectional correlation between volatility (a proxy for risk) and one of our proprietary tools, the Lazard Advantage value indicator, which is designed to account for both industry and regional or structural differences (Exhibit 4). Based on our findings using this tool, it appears that volatility and value are negatively correlated to a degree not seen since the mid-2000s.

Is a regime shift underway? Are value stocks likely to be more defensive in the next downturn than the market currently assumes, given that they are negatively correlated with high-risk stocks? If so, fundamentally oriented low-volatility strategies are likely to have a meaningful value exposure for the first time in nearly two decades. In our June 2021 paper, "As Uncertainty Soars, A Moment for Core Quantitative Investing,"[1] we showed that the overlap between value and quality is greater than at any point in the last

Exhibit 4
Not since the Mid-00s Have Value and Volatility Been So Negatively Correlated

Cross-Sectional Correlation of Lazard Advantage Global Value and Volatility



As of 30 June 2021
Source: Lazard

two decades, meaning that value stocks are increasingly likely to be high-quality stocks. This further supports the conclusion that companies with attractive fundamentals trading at a significant valuation discount can be a core feature of well-constructed low-risk portfolios.

When Will the Music Stop?

In the face of such imperturbable markets, what are the factors that could turn investors' appetite for risk into a scramble for safety? Paradoxically, exceptional equity market strength has gone hand in hand with significant GDP volatility as the economy has stopped and started with off-again, on-again pandemic-related restrictions. If vaccines continue to prove effective and the Delta variant subsides, we could see yields move higher, causing expensive, volatile growth stocks to falter, as Main Street thrives and Wall Street weakens.

Equally, a flattening of the yield curve through the middle of the year has been in large part driven by the assumption that the current high levels of inflation are transitory. Should supply bottlenecks persist longer than expected, causing inflation to remain stronger for longer, concern about stagflation may arise. The economy may not dip into recession as a result, but yields could rise, hurting higher duration equities as the long-term risk-free rate increases and investors rotate to stocks with durable and near-term cash flows.

Last, global consumer demand could disappoint in 2022 if it turns out that many purchases were already brought forward, causing supply bottlenecks to ease and inventories to soar. Any signs of weak demand would likely move investors to gravitate back toward low-risk securities.

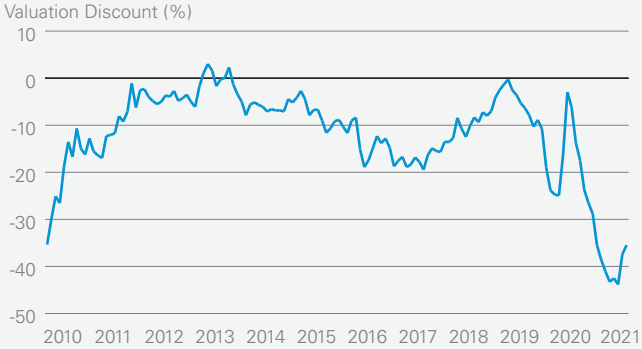
Conclusion

In the last 12–18 months, low-risk and highly profitable businesses have been noteworthy market laggards, while value stocks are increasingly exhibiting low-risk characteristics—a new and interesting development, in our view. When aligned with earlier evidence that value stocks are of increasing quality, we conclude that fundamentally driven, low-risk portfolios are increasingly likely to trade at a substantial discount to the market.

The Lazard Global Managed Volatility strategy, a low-risk strategy that incorporates company fundamentals, is trading at a higher valuation discount to the market than at any point since its inception in 2010 (Exhibit 5). Rarely has the strategy identified this level of opportunity and been so distinct from the way the market is weighted in terms of specific stocks, sectors, and countries.

Many investors have been fortunate enough to bank exceptional equity returns over the past year. It is likely that the flexibility to build equity portfolios that deviate from the benchmark will be key in protecting and building on these returns in the months and years ahead. Should the market lose its appetite for risk, investors may not want to be caught out in a strategy that mirrors a benchmark that has recently soared to new heights.

Exhibit 5
The Lazard Global Managed Volatility Strategy's Discount to the MSCI World Index Is at Record Levels



As of 30 June 2021
Valuation discount of the Lazard Global Managed Volatility strategy is calculated using an equal-weight combination of P/E and Price to Cash Flow. Investment characteristics are based upon a portfolio that represents the proposed investment for a fully discretionary account. This information is for illustrative purposes only and is supplemental to the "GIPS® Standards Composite Information.
Source: Lazard, FactSet, MSCI

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Notes

1 There, as here, we used cross-sectional correlations to proxy for overlapping properties that stocks may exhibit.

Important Information

Published on 15 September 2021.

LRX255208