Low risk does not always mean low returns

Aruna Giri N.

The field of finance is a fascinating one. It is blessed with many myths, riddles, puzzles and mysteries. One such myth is that one needs to take high risks to earn high returns. In other words, low risk means low or safe returns.

The truth can't be farther from this.

Ironical as it may sound, the safest asset by conventional yardstick is also the riskiest. By conventional wisdom, stability in price (low âeta) means lower risk, taking cue from fancied capital asset pricing model (CAPM). By this standard, US treasuries with its remarkably serene movement, should be the least risky. Is it genuinely so?

SANER APPROACH

Steering clear of the noise of CAPM and its darling â (which defines volatility as risk), saner and simpler commonsensical approach defines risk as potential permanent loss of purchasing power.

By this definition, an asset is risky if the potential return falls short of erosion in purchasing power in the investment horizon (meaning inflation adjusted) or vice-versa, not by how volatile the asset is in the interim.

Investors (in US treasuries) lured by its impeccable stability in price (low â and hence mistaken as low risk) could be blissfully oblivious to live grenades in the form of potential erosion in real value (loss of value due to inflation), leave alone the risk of crash in bond prices resulting from popping of bubble.

MISUNDERSTOOD CONCEPT

As the foregoing analysis shows, risk is a misunderstood concept in the investment universe. Most misconceptions in investments revolve around the fanatic following of this sacred (but less factual) CAPM model and its deity âeta.

The critical dimension in assessing risk-reward equation is not "volatility", but the time profile of the investment.

In short-term, the risk-reward equation as defined by traditional "Beta / volatility" in general is right. But the moment the time horizon is extended to long-term, the equation turns upside down. One does not need to go too far to find anecdotal evidence to this.

Take the case of debt funds. They are considered safe and low risk. While it may be true in the short-term, in the longer-run it is not so difficult to see how these funds could burn a hole in the rising interest-rate or high inflationary scenarios.

MISGUIDED NOTION

While the notional damage done by âeta extends across investment spectrum, the most glaring one is in the misguided risk-reward notion on small-, mid-cap space in equities. Followers of CAPM /â model shun small- and mid-cap segment treating them as highly risky (because of high volatility), whereas in reality, they are less risky and more rewarding going by less flashy definition of risk, i.e., permanent loss of value over investment horizon, as volatility gives opportunity to buy cheap enough with substantial margin-of-safety (high downside protection).

But the caveat of course is, it needs to be backed up by strong research. Low-risk-high-return opportunities are abound in this space for patient and savvy long-term investors (disciplined enough to do diligent home work).

To quote Mr Warren Buffett, "The risk comes from not knowing what you are doing." That probably captures the essence of risk-reward equation.

(The author is CEO & MD, TrustLine Holdings Pvt Ltd. The views are personal.)