Real Danger of Hot Stocks

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Is popularity dangerous? A new study suggests that investors seeking extra return on a portfolio without taking on more risk may be able to get it by selecting unpopular equities.

The study authored by Roger Ibbotson, Yale finance professor emeritus, and Tomas Idzorek, president of Morningstar Investment Management takes as its starting point a basic premise: Risk is unpopular. As a result, all other things being equal, investors only take on more risk for a higher expected return.

This is why we expect a greater return on stocks than bonds, of course; that's consistent with the capital asset pricing model and the efficient market hypothesis.

There are other dimensions of unpopularity, beyond risk including illiquidity and small-cap and value stocks, although risk is implicit in the first two of those. (Ibbotson and Idzorek note that value stocks, as defined by a low market-to-book or price-to-earnings ratio, are unpopular but not necessarily riskier, at least according to the standard deviation measure of risk.)

In general, however, investors prefer less risk, more liquidity and bigger companies, as well as more transparent information. When they don't get enough of this investment wish list, they expect a risk premium, and that gets priced into the market value of the investment.

WHEN POPULARITY MATTERS

Ibbotson and Idzorek's theory, however, is that investors eventually want a premium (i.e., excess return) for taking on unpopular stocks regardless of whether risk is at the root of the unpopularity.

To better understand and apply the theory, it helps to look at popularity that is persistent, or permanent, versus transitory.

Some popularity is relatively persistent such as the preference in mainstream western society for people who are tall and thin rather than those who are short and fat. Other popularity tends to be transitory. (Think hairstyles, like mullets or mohawks.)

In investing, popularity can be transitory as well. Various asset classes (stocks, bonds, gold) and industries (tech, real estate) have all encountered periods of flavor-of-the-month popularity.

To analyze the impact, the key for Ibbotson and Idzorek was to find a long-lasting dimension of unpopularity that would deliver the greatest excess future return while perhaps allowing investors to take on even less risk.

TARGET: SHARE TURNOVER

The authors used share turnover as a measure of popularity. Their reasoning: The most popular companies are the brand-name stocks that are in the news, which get more analyst coverage and have higher trading volumes.

Specifically, the measure used was the number of shares traded annually divided by the total number of shares outstanding both the number of shares publicly traded and those privately held Walmart (WMT) shares owned by the Walton family, for instance.

The study looked at the largest 3,000 publicly traded stocks over the 42-year period from 1972 through 2013. It then ranked the stocks each year by popularity and assigned them each to a popularity quartile. Each calendar year, the stocks were ranked again based on turnover in the previous year, and the stocks were reassigned to quartiles.

The Popularity & Performance chart below shows the striking results. Across the whole time span, the least popular quartile that is, the stocks with the lowest turnover clocked in a 15.51% average annual return. That amounts to nearly twice the 8.27% annualized return of the most popular stocks.

Was the excess return compensation for taking on more risk? Not over the period studied. The chart shows that the annualized standard deviation of the least popular quartile was 20.18%; the most popular quartile, by comparison, actually had a much higher annualized standard deviation of 28.35% suggesting that this measure of unpopularity actually gives higher returns with less risk.

To see whether the higher returns were tied to excess volatility, the authors next took each popularity quartile and sorted into sub-quartiles according to the stocks beta that is, the volatility relative to the broader market. The Impact of Volatility chart below reveals the results as being quite sporadic in all quartiles except the least popular quartile, where lower-beta stocks generally delivered higher returns than more volatile stocks. This shows that popularity is a much stronger predictor than beta, Ibbotson notes.

The authors also sorted each quartile of popularity into sub-quartiles by standard deviation to look at overall volatility. As you can see, high volatility stocks had noticeably lower payoffs only in the popular quartiles.

I wondered whether the results were consistent over the 42-year period, since the costs of trading stocks fell dramatically over that time frame and could have affected share turnover. But the authors say there was no decline in the overall tendency for unpopular stocks to outperform although there have been periods of time where the reverse held true. (One example was the late 1990s, when tech stocks were popular and surged before the crash.)

Overall, the authors conclude that picking unpopular stocks and avoiding popular stocks are to key to earning excess returns.

They believe their popularity findings are consistent with the two most popular investing philosophies. The efficient markets philosophy states that premiums become permanent when investors demand excess return which they do for unpopular stocks. The principles of behavioral economics, meanwhile, would suggest that popular stocks that are in the news and highly traded tend to be overpriced.

UNDERSTAND THE CAVEATS

There are a few caveats to apply here.

First, the study was back tested - and any back-tested study can be the result of selective data-mining. And because correlation is not causation, the past results may not be predictive of the future.

The authors, however, believe the outperformance will persist - although they note that the dimensions of popularity, as well as their relative importance, may change over time.

The study also implies a frictionless world without transaction costs or taxes. Both costs and taxes would clearly take away from the returns - especially in the early years of the study, when the cost of buying and selling individual stocks was quite high.

A strategy based on unpopularity could also be tax-inefficient, due to high turnover as unpopular stocks become more popular - although advisors can mitigate this by implementing the strategy within a qualified account.

Finally, there’s a worry about a kind of Moneyball effect. Risk-adjusted premiums tend to diminish once they are discovered, so unpopular stocks might become more popular as more investors focus on them.

Both authors say such a shift would actually help short-term performance, as more investors pour money into the unpopular stocks. And while the long-term premium could decline, Ibbotson suggests that advisors and investors might find new ways to define unpopularity.

TAKEAWAYS FOR ADVISORS

Both authors, who manage large portfolios, say they are implementing the findings themselves. Morningstar Investment Management is indirectly using the results in its management of $169 billion under management, Idzorek says, while Ibbotson is putting them to work at Zebra Capital Management, where he is chairman and chief investment officer.

Indeed, any planner can implement the strategy for clients by screening for low turnover stocks. But understand the returns and standard deviations of the unpopular quartile were based on having 750 equally weighted positions. Fewer positions would likely have higher volatility.

While the authors believe the unpopularity premium will persist, we don't know for sure, especially now that it's been identified. Meanwhile, there are costs involved in buying the stocks and generating the turnover needed to keep the portfolio focused on unpopularity.

If the above seems a bit too risky, you may only need to wait a short time for a more efficient way to implement. After all, Idzorek says, it's probably only a matter of time before someone creates an unpopularity index fund.

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