INVESTMENT FOCUS: Gambling and Beta – Why people pay for excitement

In a rational market, investors tend to expect higher potential returns to compensate for higher investments risks. As a result, we logically expect the safer assets to provide lower returns and high-risk assets to yield high returns. Below we are going to cast doubt on the long-held belief – or myth, as some might call it that higher-risk, high-beta stocks produce higher returns.

Whether we like to admit it or not, we all probably agree that we still have investors who are dazzled by what are typically classified as “high beta” stocks. High beta stocks are known for exhibiting high price momentum and high growth. These stocks are expected to rally more than the market in good times and fall more than the market in bad times. However, investors who own these stocks are all too willing to take on added risk in hopes of getting higher payoffs. Let’s look at one of the behavioural biasness behind investors love affair with high beta stocks.

Looking at irrational gambling behaviour may shed some light on why investors prefer high beta stocks. Think about someone who gambles online or loses significant sums playing blackjack at a casino. They very likely view gambling as a low-risk, high-yield proposition. In reality, it’s the opposite; a high-risk, low-yield proposition. The pay-outs of every casino game always favour the casino which is called the “house edge” or “house advantage.” No matter what gambling game you choose to play, the odds of the casino winning your money are greater than the odds of you winning the casino’s money. For example, for each bet on the roulette wheel, the casino keeps 5.26% of winnings on average. Blackjack, the most popular table game, returns a bit more in winnings than roulette, but it too is subject to what is called the house edge. Why then is playing Blackjack so attractive to so many people? One reason is that people tend to (optimistically) assign more weight to the probability of winning than is justified objectively. Second, people like the idea of spending a very small amount with the possibility (no matter how slight) of winning big. Similarly, with “High Beta” Investing, tends to high-risk stocks for the slight possibility of jackpot size returns.

Quality stocks tend to exhibit low Beta

So far, we have focused on why investors are so attracted to high beta stocks. Let’s now consider whether they get rewarded for selection of good quality stocks.

The practice of ranking stocks based on a quality score is well-established and has been engrained in the investment process of asset managers, especially those following a value and quality strategy. Benjamin Graham also affirms the importance of quality stocks on his book “The Intelligent Investor”:

“The risk of paying too high a price for good quality stocks – while a real one – is not the chief hazard…the chief losses to investors come from the purchase of low-quality stocks at times of favourable business conditions…”

Quality is a multi-faceted concept and what makes a “high quality” company to investors can be subjective even though there is still little consensus on what constitutes quality, and what sets it apart from the other well-known risk factors such as size and volatility. While the definitions of even these familiar risk factors can vary, there is a general agreement on the basic traits of these factors. A case in point is the way value stocks are identified using financial ratios notably price-to-book and price-to-sales that are widely adopted measures by lot of asset managers and to a large extent, all aim to evaluate how cheap a given stock is with respect to its fundamental value. The same cannot be said of quality, principally because quality has multiple facets. At the most basic level, some asset managers restrict their definition of quality to a single metric, and we on the other hand at BlueAlpha focus on quality business with high returns and strong cash generation. However High-quality companies are less volatile than low-quality companies because they are profitable and more stable entities, which helps them ride the peaks and troughs of business cycles.

Conclusion

The notion that high beta stocks should earn higher average returns than low beta stocks has been a cornerstone of most asset managers. Portfolios of low-beta stocks have produced higher risk-adjusted returns than portfolios of high-beta stocks. For investors, this is a sort of “Holy Grail” - higher returns with less risk. The fundamental question now facing investors is whether they are willing to forego the short-term thrill of owning so-called glamour stocks in exchange for the ultimate reward of achieving their long-term investment goals.