Risk And Return In A Risk-On Era

The Relationship Is Not As Symmetric As You Might Think

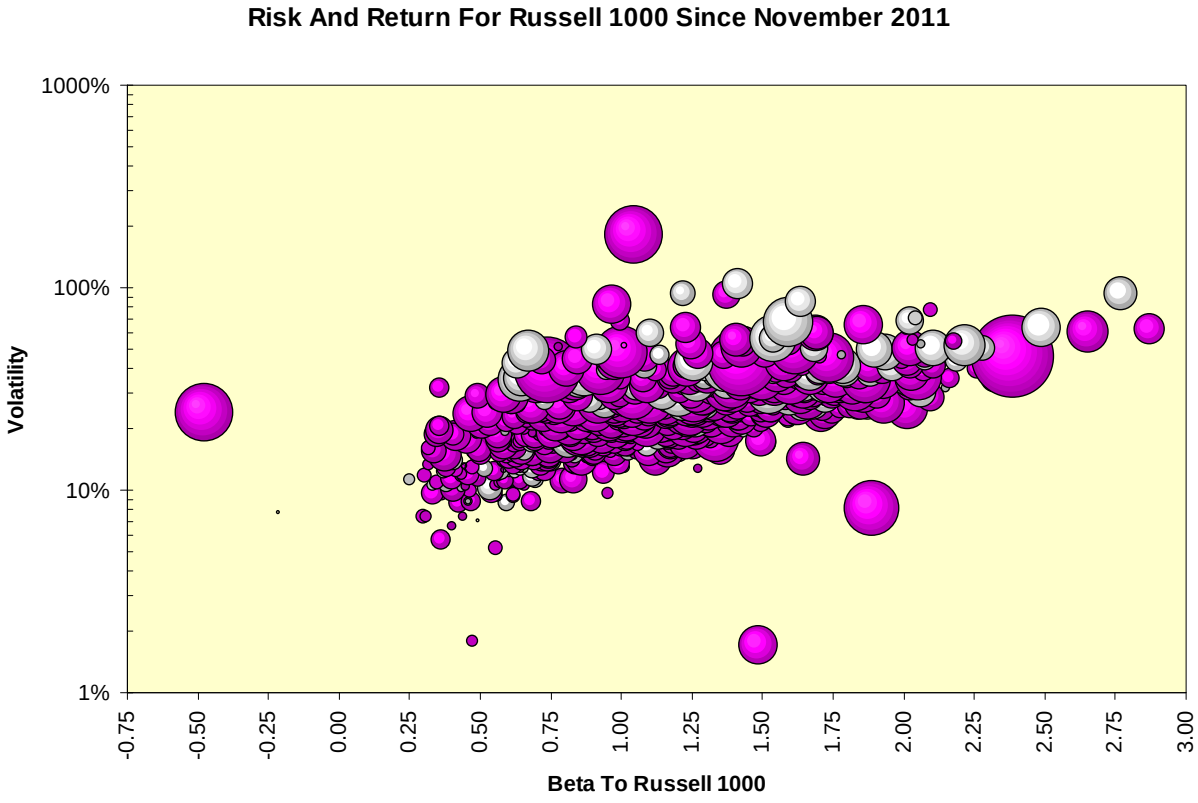
The principal purpose of language is to associate sounds and their visual representations with concepts and actions. It does not matter what the first person calls something as long as the second person acquires an understanding. As an aside, I have marveled over the years at how ancient stargazers managed to convince their audience that those few points of light actually represented a bear or a dog or a bull or some twins; moreover, different cultures managed to produce different constellations, all of them equally obtuse. Me; I can pick out the Big Dipper and that is about it.

Somewhere along the line market commentators, on whom ancient astrologers have nothing in the creativity department, latched on to the terms "risk-on" and "risk-off" and convinced those in various spots on the spectrum from the Great Unwashed to the Not-So-Great Washed they possessed the equivalent of understanding the night skies. Why, we even have exchange-traded notes such as the Fisher-Gartman Risk-On and Risk-Off (ONN and you guessed it, OFF) purporting to represent swings in these tidal forces.

Returns In A Risk-On Period

While the notion returns rise during a risk-on period is accepted even if the definition of what a risk-on period is nothing more than a subjective conjuring, does it follow that individual stock returns are associated with higher-beta and more volatile stocks? Here I will use the members of the Russell 1000 index since the end of November 2011 and the betas, or relative variances, of these stocks to this index as the raw material. Volatility will be realized close-to-close volatility and not implied volatility.

The map of returns as a function of these two variables is presented below; positive returns are in magenta and negative returns are in white. The diameter of the bubbles is depicted with the absolute magnitude of the return. If higher returns were associated with higher-beta and more volatile stocks, we would see a preponderance of large magenta bubbles in the northeast corner of the chart and the white bubbles commiserating amongst themselves in the southwest corner. Not only do we not see it, the relationships are not there statistically.



If you are curious, and you probably are, the highest beta issues in the sample are industrial manufacturer Manitowoc (MTW), Groupon (GRPN), industrial manufacturer Terex (TEX) and coal miner Alpha Natural Resources (ANR). With the exception of Groupon, none of these fit the stereotype, do they?

The issues with the greatest realized volatility were AOL (AOL), hardware-retailer Orchard Supply Hardware (OSH) and conferencing-hardware manufacturer Polycom (PLCM). As hardware stores are the only ones I enter on my own free will, I am amazed at Orchard's appearance on this list.

What can we conclude here other than periods we perceive to be risk-on have higher returns? My answer is higher returns are not linked in practice with higher realized measures of risk. Will this cause anyone to rethink the conventional wisdom of risk and return moving together? Not a chance.