OPINION

What the ‘volatility anomaly’ can tell us about a possible stock market bubble

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Are markets efficient?

Depends on whom you ask. If you ask academics who study and teach modern portfolio theory, they will say “of course markets are efficient.” But if you ask practitioners, like value investors, who put their money where their mouths are and make a living this way, they will say “of course markets are not efficient in the short run, but they tend toward efficiency in the long run.”

What does it mean for the markets to be efficient? It means that stock prices discount all publicly available information, correctly and accurately; they do not overact on the way up or the way down; the only way to earn higher returns is to take higher risk; there are no patterns in stock prices or strategies one can follow to consistently outperform; and that price and value are always the same. And so, if you side with academics you should invest in index funds and if you side with practitioners you should invest in actively managed portfolios, managed by portfolio managers who aspire to beat the index.

One key assumption for market efficiency is that we are all rational. That is, we are dispassionate calculating machines that analyze information rationally and make the correct decision. Psychologist academics, however, beg to differ. They argue that theories based on rationality should be treated with great deal of skepticism. And weaknesses in human nature and institutional biases make markets deviate from fundamentals in the short run.

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But research by psychologists has concluded beyond any doubt that humans are not rational, particularly when it comes to investing. Humans naively extrapolate past performance, they are overoptimistic and overconfident about their abilities and they herd. And professional portfolio managers have conflicts when they manage other peoples' money, which make them rebalance their portfolios and window-dress to affect their Christmas bonus, which also biases stock prices leading to the well-known "January Effect."

The theory of market efficiency originated at the University of Chicago, where academics in the 1970s produced research which demonstrated that markets were efficient. But fortunately for stock pickers, other academics in the 1980s started to produce research which showed that there were predictable patterns in stock prices, such as the January Effect and the "sell in May and go away" effect, and that different strategies, on average, produced unusually high returns even after adjusting for risk, such as the size effect, and the value effect.

But the most damning evidence against market efficiency is what is known as the "volatility anomaly." As I mentioned earlier, market efficiency implies that higher returns come only from taking higher risks. However, research by David. C Blitz and Pim van Vliet published in the Journal of Portfolio Management in 2007 showed that historically, in the long run, on average, the stocks that have done the best are the lowest-risk stocks. That is, the lower the risk, the higher the returns. Similarly, my own research also shows that value beats growth even though the value portfolio has a lower beta than the growth portfolio. This cannot happen if markets are efficient.

And here is an interesting finding related to the volatility anomaly, as reported in Verdad Weekly Research this month: The biggest winners since the beginning of the year have been the high-volatility stocks. That goes against the long-term historical evidence that low-volatility stocks outperform high-volatility ones.

In fact, if we dig deeper and slice the historical data a bit more finely, we discover that low-volatility stocks do not always outperform. There are periods over which they underperform. The times they underperform are either periods of bouncing from the bottom or periods of market tops. For example, as reported by Verdad, during market tops in July, 2000, May, 2001, and November, 2001, the trailing two-month low volatility less high volatility (excess) returns were minus-10.7 per cent, minus-10.3 per cent and minus-10.2 per cent, respectively. In market bottoms, November, 2002, April, 2009, May, 2020, and November, 2020, the two-month trailing excess returns were minus-11.2 per cent, minus-11.6 per cent, minus-11.4 per cent and minus-10.7 per cent, respectively. In June, 2026, the trailing two-month low volatility less high volatility return has been minus-10.3 per cent.

What do you think this may signify, given the AI-craze, a market top or a market bottom? You be the judge.

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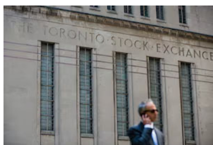

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