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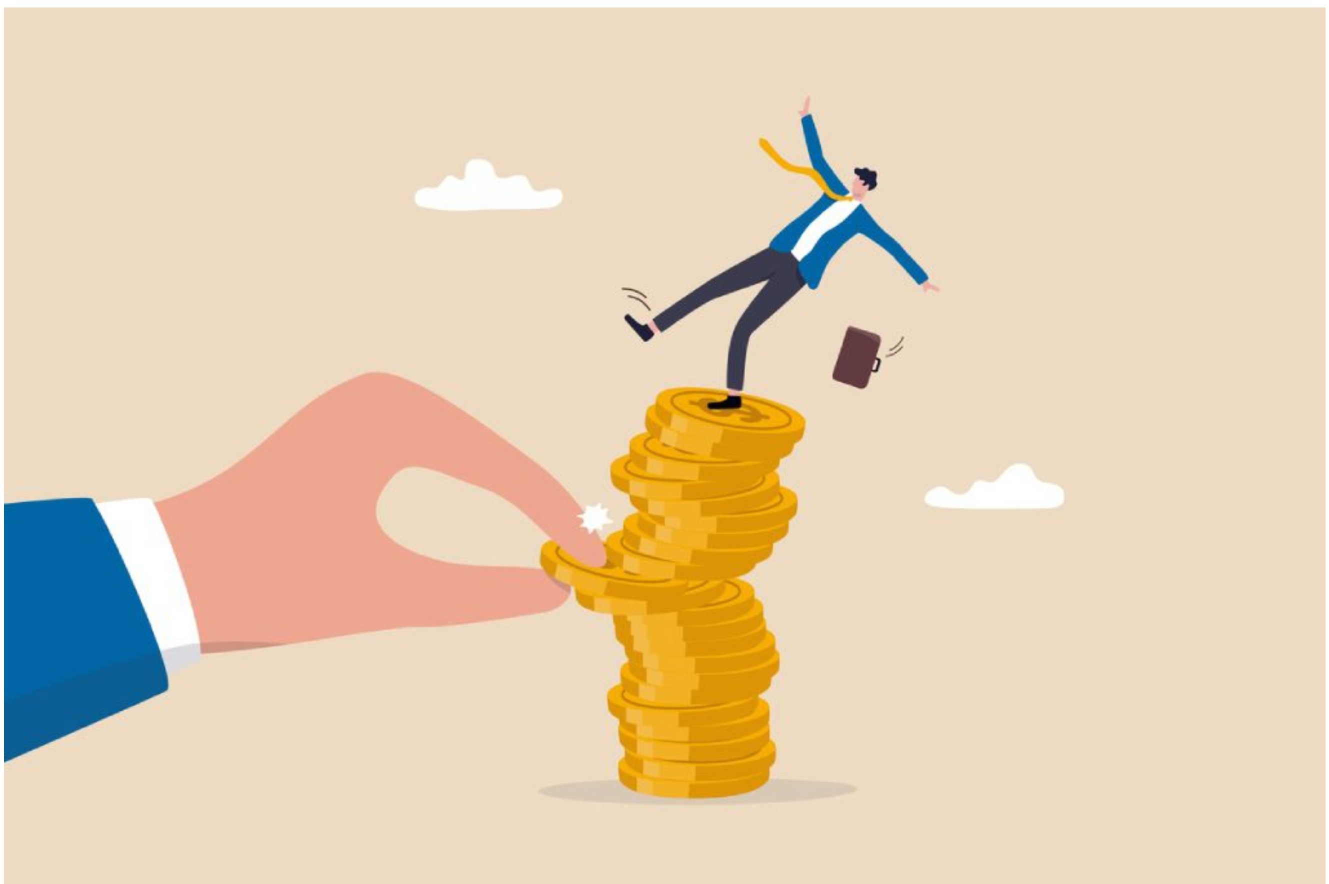
A comforting read in times of stock market volatility

Worried about your market exposure as stock prices go wild? Take comfort: with terminal wealth in mind, more volatile stocks are not necessarily riskier.



August 8, 2014

In a series of articles, **Javier Estrada**, professor of finance at IESE, has questioned the traditional lumping of risk with price volatility when *long*-term investments are considered. To

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paraphrase a successful investor named Charlie Munger: If an investor's goal is higher terminal wealth, does it really matter if the ride to get there is bumpier?

In "Rethinking Risk (II): The Size and Value Effects," Estrada looks at the conventional wisdom about risk and return in the stock market. Looking at "value" vs. "growth" and "small" vs. "large" stocks, Estrada offers a novel viewpoint for long-term investors looking to minimize risk.

Risk and the three-factor model

With diversified portfolios of small, large, value and growth stocks trading in the United States, Estrada revisits a famous study by Eugene Fama and Kenneth French from 1992. In that oft-cited study, Fama and French found that small stocks outperformed large stocks and value stocks outperformed growth stocks. Fama and French then introduced their widely accepted "three-factor model" for investors, which suggests increasing investment returns by increasing exposure to the stock market, taking both size and value factors into account.

Yet, Estrada notes that the study "implicitly argues that small and value stocks are riskier than large and growth stocks, and therefore the higher expected return is simply a compensation for a higher exposure to risk." Is this right? Estrada thinks not — for those who are saving for retirement (in 20-plus years) or otherwise have a long view in mind.

The long view

Looking at 20- and 30-year holding periods for diversified portfolios of small, large, value and growth stocks from 1927 to 2013, Estrada finds that small and value stocks consistently offer more upside and less downside potential than large and growth stocks. In other words, if risk is defined by terminal wealth, small and value are not riskier, only more volatile. That holds true even in the rockiest of market conditions. Estrada analyzes 68 and 58 overlapping 20- and 30-year holding periods, respectively, in his 87-year time frame to confirm these results.

"Return and risk are to finance what benefit and cost are to economics; that is, the two variables at the heart of most decisions," writes Estrada. In this article, Estrada proposes that investors look at the risk variable differently, with a long view in mind.

More info

"**Stocks vs Bonds: Where the Risk Lies**"

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"**Retire at Your Own Risk**"

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