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Remembering the father of low-volatility investing

Commentary: Robert Haugen believed that popular stocks are dangerous

By Jonathan Burton
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Bob Haugen was an *enfant terrible* of the Ivory Tower, a rebel economist with a cause.

For almost half a century, Haugen made it his mission to tell investors that a bedrock belief of investing is wrong: Greater risk does not necessarily equal greater reward. The most lucrative stocks to own, he said, are the boring, neglected companies that make money but not headlines.



Robert Haugen 1942-2013

And Haugen backed up this assertion with research showing that a portfolio of low-risk, low volatility value stocks consistently outperforms higher-risk, volatile growth rivals – not just in the U.S. but worldwide.

Trouble is, in an efficient market lower risk logically shouldn't give investors a higher return.

Both Haugen and his heretical views were dismissed as outliers by Wall Street and academia. The two institutions are rooted in Modern Finance and the conviction that risk and return are joined at the gut: Efficiently operating markets deliver dutiful investors a "risk premium" for the volatility and uncertainty they shoulder.

Not only did Haugen fundamentally disagree, he went so far as to argue that essential textbooks on investing and corporate finance are "dramatically wrong and need to be rewritten."

Haugen didn't spare the rod for the professional practitioners. Money managers, Wall Street analysts and their employers all benefit from selling these "story stocks," he contended; once retail buyers pile in, the early "smart" money profits from momentum-created demand.

Haugen's feisty criticism will have to go on without the critic. Haugen died late Sunday at his home in Durango, Colo. He was 70.

Last October I spoke by telephone with Haugen, who despite his illness was working hard and still hard-charging.

He railed against capitalization-weighted indexes — which account for most index mutual funds, exchange-traded funds and the benchmarks that active money managers try to beat. In this type of index, the largest stocks by market value are the biggest contributors to performance. But to Haugen, this approach essentially traps investors in high-priced stocks with low expected return and the potential for a big decline.

"It's totally wrong," he fumed. "It's totally wrong on all stock markets. It's upside down. There's no risk-return reward in the stock market."

Instead, investors should buy the lowest-volatility stocks that no one expects to do much. Said Haugen: "They become underpriced and produce terrific returns."

Haugen did live to see low-volatility investing gain popularity.

Several exchange-traded funds that follow a steady-Eddie strategy have sprouted in the wake of the global financial crisis. The biggest is the $3.1 billion PowerShares S&P 500 Low Volatility. Its 10.1% gain in 2012 underperformed the Standard & Poor's 500-stock index by almost 6 percentage points, but with less volatility. And since its May 2011 inception through 2012, the PowerShares fund gained 10.6%, handily beating the S&P 500's 6.4% gain.

"This has been a 50-year struggle for me," Haugen said in October about his quest to make low-volatility the accepted investment wisdom. "I've been trying to get it across to my colleagues in the profession. But if they accept this as being true, they're basically faced with their own obsolescence."

Thinking about Haugen's place in the panoply of finance and investing, it's safe to say that obsolescence will not be an issue.

— Jonathan Burton

http://www.marketwatch.com/story/remembering-the-father-of-low-volatility-investing-2013-01-07