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Equity Risk: Managing What We Do and Do Not Know

GREG FORSYTHE, CFA, senior vice president, **Schwab Equity Ratings®**, explains how managing investment risk involves more than just bracing for the unknown.

Former Secretary of Defense Donald Rumsfeld was once chided for saying that there were "known unknowns" and "unknown unknowns" regarding our Middle East engagements. But his subtle distinction includes wisdom that applies to investing.

You can never eliminate risk from investing, since the future inevitably has unknown unknowns. An asteroid hitting New York would have enormous economic repercussions, but there's no way to protect our portfolios against such a remote risk.

On the other hand, risks of known unknowns can be managed to some extent. We know stocks and bonds take turns outperforming one another; we just don't know when one or the other will lead. We know equity market leadership rotates among economic sectors, but we can't easily predict when a given sector will do its best or how long it will last. Therefore, we diversify our investment portfolios across stocks, bonds and market sectors to help minimize the risks of these known unknowns.

So is risk management nothing more than maintaining a diversified portfolio of funds or ETFs that's consistent with your financial goals and risk tolerance? For many investors, the answer is "yes." But Schwab research has found that individual stock investors can use a risk-oriented perspective to do more than just brace for the unknown.

The perceptions of risk

A fundamental tenet of investing is that risk and return are intertwined. Any investor would prefer to earn high returns with little risk. But such opportunities are rare and fleeting, as market prices tend to adjust quickly to bring risk and return back into apparent alignment. Notice that market price adjustments are always based on perception, as future reality is unknown. If we could determine where investor perceptions of risk are most likely to be inaccurate, we could create a systematic process to identify potentially mispriced stocks. Good news—it is possible!

RISK: Valuation

Probably the most commonly used metric for assessing a stock's valuation is the price-to-earnings ratio (P/E). Regardless of whether you use reported or forecasted earnings per share, P/E ratios vary widely. Stocks with low P/Es, such as electric utilities and health insurance companies, are often perceived as having low growth potential or uncertain futures. Stocks with high P/Es, such as information technology and biotechnology companies, are typically expected to grow fast enough to make it worthwhile to pay a higher multiple of current earnings.

So which stocks tend to be riskier, ones with low P/Es or ones with high P/Es? Historical evidence indicates convincingly that P/E ratios don't accurately reflect future realized risk. Stocks with high P/E ratios tend to be more volatile than the average stock, and their returns tend to be lower than market averages. While stocks with a high P/E typically show above-average earnings growth, their earnings growth rates often fall short of optimistic consensus forecasts, leading to P/E contraction and poor relative returns.

LESSON: High P/E multiples indicate a high risk that future earnings growth will be disappointing. Avoid stocks with P/Es above 30 and stocks with P/Es that are more than 1.5 times their historical sales growth rate, forecasted EPS growth rate or current return on equity.

RISK: Earnings expectations

A firm's quarterly earnings report is a periodic reality check of actual performance versus expectations. For

P/E ratio

Price-to-earnings (P/E) ratio is a valuation ratio that shows how much investors are willing to pay for a dollar of a company's earnings.
The ratio is calculated as: Market value per share ÷ Earnings per share = P/E ratio.
The higher a company's P/E ratio, the more the market is willing to pay for each dollar of its earnings.

KEVIN MIYAZAKI

Beta A measure of the price volatility of a given investment compared to the overall market. A beta above 1 is more volatile than the overall market while a beta below 1 is less volatile.

example, when a firm reports actual earnings per share below the consensus (the mean) forecast of brokerage analysts who follow the stock, the firm is said to have reported a "negative surprise." Often the stock falls quickly upon the news, as disappointed shareholders sell and analysts cut their forecasts of future earnings.

It might seem that an upcoming earnings report falls into the known unknowns category. We know a surprise might be forthcoming. We don't know if it will be positive or negative, nor do we know if we will react quickly enough to take advantage of the news or protect ourselves from it. But historical evidence strongly suggests otherwise. Stocks that report negative earnings surprises in one quarter have high earnings expectation risk in later quarters, as they usually are much more likely to continue reporting negative earnings surprises. Additionally, when analysts cut earnings forecasts for stocks, those stocks are more likely to report future negative earnings surprises.

LESSON: Recent negative earnings surprises and negative forecast revisions from brokerage analysts indicate high short-term earnings risk. Avoid the stocks of such companies. More generally, avoid buying stocks that are within two weeks of reporting earnings.

RISK: Volatility

Investment risk is most often defined in terms of price or return volatility. When you examine asset classes or diversified portfolios, riskier assets (stocks vs. bonds) and portfolios (growth vs. income funds) tend to deliver higher long-term returns as compensation for bearing higher risk.

But this risk/return alignment breaks down for individual stocks. Historical evidence shows that volatile stocks tend to provide lower returns than more stable stocks! Academic researchers still struggle to explain this strange behavior, which follow-up research has shown is displayed in stock markets across the globe. That's enough evidence for me.

LESSON: High stock-price volatility carries the risk of being penalized by future return performance. Avoid stocks with a beta value above 2.0 (see definition to the left) and those with stock price charts that show significantly greater volatility than their industry group and the overall market.

What about low-risk stocks?

We've learned that higher-risk stocks tend to provide lower returns and should be avoided. Fortunately, the pattern works in reverse, as well. Stocks with low valuation multiples, low price volatility and recent positive earnings surprises have lower overall risk than investors perceive and have historically delivered above-average future returns. Lower risk and higher returns—what's not to like?

SEAN McCABE

See page 2 for important information.