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Using Downside Risk Analysis to Evaluate Stocks

Investors burn the midnight oil looking for stocks with tangible upsides, yet they spend precious little time examining stocks on their short list for identifiable downsides that could result in poor performance. A stock's value can derive in large part from expectations that drive performance, for a time.

But does it have potential for real, sustained performance? Or, with the baggage of ill-fated characteristics that can create outsized expectations and overvaluation, is it destined to become the victim of its temporary success?

Downside Analysis

The best way to assess this is from downside analysis - evaluating groups of candidate stocks for relative degrees of characteristics that predict underperformance. The classic investing assumption is that higher risk means higher expected returns. But downside risk research by Revelation Investment Research, an institutional equities research firm, shows conclusively that the long-term reality is quite the opposite: lower risk means higher returns.

Revelation's approach could be viewed as contrarian in a market where everyone seems obsessed with upside. Its long-term research shows that the ultimate upside is actually absence of downsides. "So much time is spent looking at upside potential that people don't look enough at what could go wrong - where the holes are," says Greg Forsythe, Revelation's president.

Methodology

Revelation's methodology looks at downside risk levels regarding 19 research points that fall into three categories:

- Valuation: these factors include metrics commonly used by analysts, including earnings per share (EPS) growth, sales and free cash flow.
- Financials: including profitability trends and changes, revenue stability and debt.
- Sentiment indicators: including analyst forecast revisions, the persistence of performance surprises, share turnover and short-selling activity.

Some of these items come straight out of the standard analyst kitbag. What's counterintuitive is that some of the same factors widely associated with outperformance - profitability levels, extreme analyst price targets and high trading volume - also predict underperformance when present in certain measures and combinations. Stocks with these characteristics may be doomed to not live up to their high valuations.

"Many high valuations may be deserved," says Forsythe, a chartered financial analyst (CFA). "But we find that systematically, those with sky-high growth indications tend to fall short of expectations embedded in their market valuations."

Revelation determines the presence and degree of sentiment factors, some involving behavioral finance considerations, that play a role in elevating these growth projections. Thus, it identifies and quantifies downside signals inherent in certain types of overly rosy valuations, which will eventually be punished by a disappointed market.

Research Findings

Using the 19 research concepts, individual stocks are ranked in deciles according to their aggregate scores. The worse a stock's overall score, the more likely that it will underperform over the next three to 24 months. Revelation has applied this methodology on a weekly basis to 2,400 stocks, tracking performance from 2003 to 2018. "Stocks rated as having the most downside risk have consistently underperformed on a relative basis, while stocks with the least downside risk have outperformed," says Forsythe.

Moreover, he says, stocks that scored well for low downside risk had the least volatility, and those that scored poorly had high volatility. So, low-downside stocks identified in this research not only performed better, but were also more comfortable to own when a yo-yoing market was keeping investors up at night.

Value Investing

Many stocks with low downsides happen to lean toward the value side, but strictly speaking, they aren't value stocks. Value investing is predicated on the belief that low-priced stocks are likely to rise if the market is undervaluing them despite solid fundamentals. Many value stocks may seem like a great buy because they've become so cheap, but their price can keep declining after you buy them. You got low price, but with no upside in sight.

Downside risk analysis can show which value stocks have characteristics likely to bring them up - as well as the factors likely to bring growth stocks down. Like growth investors, devoted value investors often obsess over upside to the exclusion of downside considerations, relying on style box categorizations to indicate risk (as in, the growth category indicates presumed higher risk with higher expected returns and the value category, supposedly have lower risk and lower expected returns).

Yet downside risk analysis renders such assumptions concerning risk-return relationships moot. This is particularly relevant now that some market observers expect value investing, which has taken a beating since the Great Recession, to come back over the next couple years after a decade of dominance by growth stocks.

Regardless of what kind of market prevails, investors would do well to practice downside analysis by examining characteristics of stocks that have underperformed, going back years before their decline, and then looking for the same patterns in the buys they're considering today. In doing so, they'll be using risk management not as an add-on but as an engine to power their portfolios to higher returns and lower volatility. They can have their risk management cake and eat it too.