In recent years the idea of beta - an asset's sensitivity to moves in the market - has fallen out of fashion as investors have looked for risk-adjusted returns and worried about other types of risk. New research, however, suggests that this is wrong, and that beta does matter. Beta is "useful both as a measure of risk and as a tool for portfolio selection", say Javier Estrada of IESE Business School in Barcelona and Maria Vargas of the University of Zaragoza, writing in the latest Journal of Applied Finance.

They looked at so-called 'black swan' events - monthly moves of 5 per cent or more in global equities since 1973. They found that in negative black swan months, sectors and national stock markets with high betas (measured over the previous 60 months) did worse than low-beta markets and sectors. This means that beta is a useful predictor of which stocks will do worse if the market generally does very badly. Beta does what it is supposed to do.

Of course, we can't see black swans coming, so this is little help in picking stocks. But something else is. Estrada and Vargas looked at what would have happened if you had bought high-beta national markets after big falls in global equities, and bought low-beta ones after big rises. The idea here is that markets mean-revert over longish periods, so they rise after a fall - which benefits high-beta stocks - and they fall after a rise, to the relative benefit of low-beta stocks. They found that such a strategy would have beaten a passive investment in global shares since 1973, with only slightly higher volatility; the Sharpe ratio on the strategy is higher than that on a passive investment. A similar thing is true, over a shorter period, for investing in high- or low-beta sectors.

Buying high-beta assets after a big fall in the market, and low-beta ones after a big rise, can therefore give good risk-adjusted returns. In this sense, beta works.

This is not necessarily a free lunch. After a fall in global markets we often feel anxious and so loath to buy high-beta assets. And after a rise, we feel confident and so reluctant to buy defensive ones. The returns on this strategy are therefore a reward for overcoming our natural instincts.
But here's a quirk. Since 1973 there have been more big rises than big falls in global equities, so this strategy would have invested in low-beta assets more often than in high-beta ones. In this sense, the fact that beta investing works is yet more corroboration of the theory that defensive investing is often a good idea.

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