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"What a Strange Trip it's been."

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While it only lasted a month, the market swoon that occurred in August was one strange trip for high quality, low risk stocks, especially when viewed through the lens of Beta.

Beta is a metric used by investors to gain insight into an individual stock's sensitivity to the normal gyrations of the stock market. Some investors buy lower Beta stocks because of a mistaken perception that they are less likely to disintegrate following company-specific bad news. Other investors prefer low Beta portfolios because they tend to go down less than the overall market during broad market declines. These investors hope to outperform down markets like the one seen in August 2013.

Including the declines following the Tech Bubble and Financial Crisis, the Russell 1000 is up 234% since the beginning of 1998. But as all investors know, the journey has been far from smooth, as 35% of the months posted returns worse than negative 1%. In 83% of these down months, low Beta stocks performed better than their high Beta brethren, as one would expect. Said differently, high Beta has rarely beat low Beta when Russell 1000 returns were worse than 1%, only in 11 of the 65 months (3 of the 11 occurred in 2007). Given the defensive characteristics of low Beta stocks in down markets and with the pain of the 2007-09 bear market still fresh in investor's minds, it's no wonder investors have been clamoring for low Beta portfolios.

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To measure the performance differential between low and high Beta stocks, investors and researchers commonly calculate the return difference between the 20% of stocks with the highest Beta and the 20% of stocks with the lowest Beta. In industry parlance, this is known as a "quintile spread" and is calculated monthly, quarterly or annually depending on the objective of the research project. Since 1998, the average monthly quintile spread, or the return difference between low Beta and high Beta stocks, is negative 0.41% per month. This suggests that low Beta generally lags high Beta. But in months when the Russell 1000 was down more than 1%, this spread reverses to a positive 5.39%. Historically, investors have been willing to sacrifice a little during up months (-0.41%) to save a lot in down months (+5.39%). It is this strong relative performance in down markets that has fueled the interest in "low Beta" investing.

Given the problems in the Middle East, the fear of a "QE taper", and looming budget fights in Washington, it was not entirely surprising that the Russell 1000 lost 2.8% of its value in August. What was surprising was that lower Beta stocks suffered one of those rare months where they performed worse than higher Beta stocks in a down month.

While there are numerous opinions on why low Beta didn't "work" in August, one explanation has to do with mean reversion. For the first six months of 2013, the Russell 1000 was up nearly 14% with low Beta stocks performing better than high Beta stocks. As noted previously, it is unusual for the slow but predictable growth of low Beta companies to lead a bull market. In more typical fashion, July showed very strong performance for equities with the Russell 1000 increasing 5.35% with high Beta finally out-performing low Beta. So, one explanation for low Beta's poor performance in August might have more to do with its atypically strong run earlier in the year. Low Beta stocks were simply getting too expensive. It may also be the case that the current recovery finally has enough momentum for investors to look past electrifying headlines and towards specific indications of sustainable growth. Assuming investors have

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finally accepted that this slow but steady recovery is for real, we could be seeing the gradual shift in investors' preferences to the high (but less predictable) growth of higher Beta companies.

Suggesting Beta is purely a measure of risk denies the reality that low Beta companies have different economic characteristics than high Beta companies. While most of the time low beta portfolios are defensive when the market drops, it is not always the case. Sometimes other considerations are just more important to stock prices than their statistical sensitivity to the direction of the market. August happened to be one of those months.