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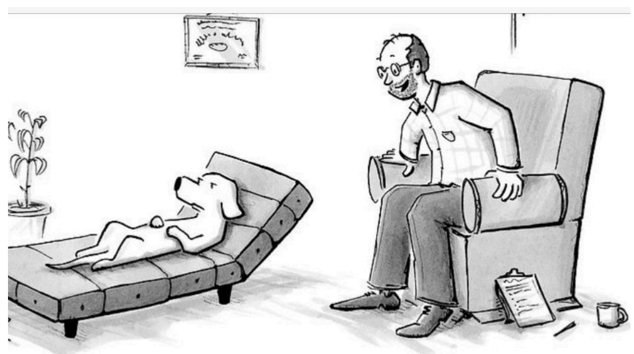
An investor will take on more risk only if they expect higher returns in compensation. This principle is a cornerstone of financial theory, yet when you look at the state of the world today, you have to wonder whether this is really true.

Risks to growth -whether geopolitical or vast government spending, are becoming increasingly problematic. Yet stock markets across much of the world are at or within touching distance of record highs. More, in America and Europe, the extra yield from buying high-risk corporate bonds over government one's is close to its narrowest in over a decade.

A common explanation for frothy markets is that investors have become reckless or outright irrational. *Or perhaps the relationship between risk and return is simply not there*.



"Who's coping with his fear of the vacuum? Are you coping with your fear of the vacuum? Are you? Yes, you are!"

Modern portfolio theory says a stock's uncertain future returns are distributed along a bell curve. The expected return lies under the peak, and risk is equivalent to the curve's variance (or spread). Yet stock returns do not follow a bell curve, they take extreme values too frequently and are asymmetric. Investor's do not regards the curve's full spread as risk, but just the side of it corresponding to losses. After all, what investor would be upset by an outsized return?

Equity risk premium means that stocks, being riskier, are expected to deliver better long term returns than government bonds. Yet an investor who bought American stocks at the start of the 19th century would have had to wait a century before their return beat that of bonds. By the middle of the Great Depression, stocks would have fallen behind again. In fact, a statistical test of the relationship between variance and return fails to establish a modest or consistent risk premium across all time periods. Instead, where a risk premium can be observed, nearly three-quarters of it came during the 70 years following World War II
(1950-2000).1

A re-think of investing then may be in order, where instead of pricing of assets by their variance, investors should price them according to fears: fear of loss (FOL) and fear of missing out (FOMO). FOMO helps explain why investors would buy overpriced stocks (and speculative assets with no fundamental source of returns), while FOL describes how people actually think of risk far better than variance does.

Just like investors' mood and market dynamics, the balance between FOL and FOMO can vary dramatically with time and circumstance. Fear is a base human emotion and one that we factor into the calculus of our portfolio allocations. Mitigating downside capture during periods of market volatility is integral to successful investment outcomes over the long-term. How? By keeping client's invested across all market cycles.

Fear can -and is- measurable. The Chicago Board Options Exchange created the VIX, or Volatility Index to measure the 30-day expected volatility of the US stock market. Sometimes called the “fear index”, the VIX is based on the prices of options on the S&P 500 and is calculated by aggregating weighed prices of the index’s call and put options over a wide range of strike prices.[2]

The VIX is something that we keep a close eye on everyday, where the shifting dispositions of investors can send markets moving one way or the other, an often in dramatic fashion.

Thanks for reading!

Martin

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1. Source: The Economist August 6th, 2025 (https://www.economist.com/finance-and-economics/2025/08/06/want-better-returns-forget-risk-focus-on-fear?)

2. Source: Corporate Finance Insitute (https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/vix-volatility-index/)

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