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S&P more robust than EuroStoxx

Investors dismiss extreme risks

A guest contribution by Paul Skiba

European stocks are currently hip, while US stocks are considered overpriced. Investors who follow this trend may end in disappointment as they ignore extreme risks.

Institutional investors in particular are currently favoring European stocks. According to the usual valuation metrics, they seem cheaper than US equity. Moreover, recent economic growth figures in Europe are above the US level. Finally, the economic cycle in Europe is not yet as advanced as in the United States. Higher economic growth could therefore continue for some time.

The current preference for European stocks is also reflected in the exchange rates. The euro has appreciated against the US dollar since the beginning of the year by almost seven percent. Nobody speaks of the long-expected equality any more. Investors sell shares traded in US dollars and buy Euro titles. These shifts on a grand scale could prove to be a fatal mistake because they do not take into account the risk of possible extreme losses.

The risk of extreme losses can be measured using the “extreme Value-at-Risk” (eVaR). Originally this risk measurement came from natural catastrophe research, where it is used to indicate earthquakes and other disasters by evaluating smaller foreshocks. This approach can be applied to the financial markets. In simple terms, it investigates how often and how far a single value or a stock index deviates from its normal fluctuation range of a few percent in a particular period.

Tesla safer than VW

This approach provides astonishing results - especially in the current stock market cycle. Thus the eVaR of Tesla was constant below that of VW as of May this year. The spread did even increase although Tesla has only produced 84,000 cars in 2016. The Volkswagen

Group, on the other hand, manufactured 10.4 million vehicles last year. However, eVaR does not focus on fundamental dangers but on price risks. The measure does not ask for the "why", it shows purely how risky an investment is from a statistical point of view.

The comparison of Wall Street with the European stock markets provides a similar result. The risk of North American equities has developed sideways since the beginning of the year and even declined since spring. On the other hand, the risk of extreme price losses in the European equities markets has risen noticeably since March and is now well above that of American values.

Medium-term and long-term US stocks are also ahead

An investment strategy based on the eVaR, which sells stocks when the extreme risk is critical, and invests when the risk moves at a low level would historically have been extremely rarely invested in EuroStoxx. In contrast to the extreme risk of the S&P 500, which includes the 500 largest shares listed in the USA, where there have been only a few "de-investment" periods in retrospect. The bottom line is that the market there is more stable and, despite its current "underperformance", is better positioned against short- and medium-term setbacks than European stocks.

The importance of these extreme risks can be illustrated by a simple example: if a share falls by 50 percent, it has to rise by 100 percent, only to reach its initial level again.

In figurative terms, investors are currently jumping on the faster-moving train with European shares. However, if it's heading to a cliff, this could be the wrong strategy. Exactly that is to be apprehended.

Paul Skiba has been working since 2015 on the risk management of "BPM - Berlin Portfolio Management". He studied economics at the Mannheim and Dublin Universities as well as financial mathematics at Cass Business School in London.

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