FACTOR/STYLE INVESTING

The Limits to Arbitrage Revisited: The Accrual and Asset-Growth Anomalies

July 1, 2011

It is puzzling that such straightforward asset pricing anomalies like the well-publicized accruals and asset-growth effects are seemingly overlooked by investors. In this paper, we seek to understand the extent to which the anomalous returns associated with these two effects can be attributed to higher arbitrage risks due to the lack of close substitutes.

Our paper focuses on the risks associated with arbitraging those two well-known anomalies. We show that the return link for both effects exist predominantly among stocks with high idiosyncratic volatility (IVOL), suggesting that arbitrageurs face higher arbitrage risk resulting from a lack of close substitutes. Investors seeking to profit from these anomalies must bear substantially higher risks with their trading positions.

This risk meaningfully increases the costs to arbitrage away the anomalous effects likely explaining their persistent existence. Investors may not be able to outperform the market on an after cost basis even if seemingly significant mispricings are identified and persist over time.

More broadly, our paper raises awareness among practitioners of the importance to thoroughly investigate the arbitrage risk from the lack of close substitutes when exploring and implementing alpha signals. Our straightforward methodology could be a useful approach for practitioners to verify the realistic opportunity to profit from an array of identified investment signals.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.