FACTOR/STYLE INVESTING

Understanding Expected Returns

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Investors tend to think of expected returns as a function of asset class risk, but this thinking may have led them to take on too much equity risk. For behavioral reasons, diversifying across investment styles, such as blending momentum and value, may offer greater returns for less risk.

The five styles that I emphasize are value, carry, trend or momentum, volatility and liquidity. All of these return sources have some time variation in expected returns, and investors should try to take advantage of those differences. They should not look just at the long-run historical average and think that it will always be the same.

Style diversification is more effective than asset-class diversification. If investors combine various asset classes, they can create a portfolio that is similar to a global market-cap portfolio. They will not get much volatility reduction because the market direction dominates, so their Sharpe ratios will improve only by a small amount. By combining various trading styles that have, on average, near-zero pairwise correlation, investors can add good diversifiers (which may also have attractive Sharpe ratios). With this approach, they can cut their volatility in half and double their Sharpe ratio, but it does require shorting and leverage.

Once institutions address the equity risk in their portfolios, they can find other ways to enhance returns at the margin. One way is market timing. It should not be a primary form of risk taking, but it can add value.

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