P O R T F O L I O   R I S K   A N D   P E R F O R M A N C E

Which Risks Have Been Best Rewarded?

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An empirical study examines the consistency of rewards for bearing various types of risks in U.S. asset markets between 1985 and early 2002.

Bearing duration risk and equity market risk was amply rewarded, while bearing long-dated credit risk and buying credit-risky (low-grade) bonds realized puny average profits. Bearing short-dated credit risk gave the most consistent profits of all static overweight strategies, with an information ratio near one.

Wide break-even spread cushions may be one explanation for what may be considered superior reward for risk at short maturities. More fundamentally, market segmentation seems to be the main explanation, because the most consistent profit opportunities involve switching from Treasuries to top-rated non-government bonds.

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