FACTOR/STYLE INVESTING

Building a Better Core Equity Portfolio

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Traditional active portfolio management relies on an investor's ability to identify individual stocks that will outperform the market, or on finding a manager to identify those stocks. However, investor experience and economic theory have not been encouraging. A new approach, style investing, offers what we believe to be a better alternative to active management.

Style investing seeks to capture sources of returns that are supported by economic theory and by decades of evidence across stocks, sectors and geographies. Unlike the traditional approach to active management, which relies on unique investment theses for each stock, styles focus on more pervasive, persistent, and deeper sources of excess returns. These include value, momentum and profitability.

In this paper, we provide background and economic intuition behind value-, momentum- and profitability-based investing, and we examine their performance. We find that while hypothetical portfolios of each strategy has outperformed a core benchmark over the long term, each has also suffered multiyear periods of underperformance — though, interestingly, they have not underperformed at the same time. This suggests that a portfolio of complementary styles may be able to provide more-consistent outperformance. We believe it should more reliably beat core benchmarks.

Combined with our focus on such passive-investing elements as portfolio construction and diversification, we believe that style-based investing represents a better approach to active management. AQR's approach to core equity investing seeks to provide three additional sources of returns, each of which has been shown to provide better risk/reward tradeoffs than both the broad market and traditional core strategies.

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