Style Investing: The Long and the Long/Short of It

Many investors agree that applying systematic tilts away from a passive, capitalization-weighted portfolio is a good idea; fewer agree on how best to capture these style-based returns.

Long-only, or "smart beta", strategies apply tilts (typically within equities) to give exposure to styles such as value, momentum, size or low-risk – that is, they overweight stocks that are relatively cheap, have recently outperformed peers, have a small market cap, or are classified as low risk or high quality. These tilts aren't always explicit, as some smart beta strategies emphasise a portfolio goal rather than a rule for picking securities, for example, maximum diversification or minimum volatility. However, all these approaches result in deviations from market capitalization weights that in practice imply certain systematic style tilts.

The same principles can be applied in a long/short context. That is, going long cheap assets and short expensive ones, long outperformers and short underperformers, etc. These strategies are variously called "alternative betas" or "alternative risk premia" (and even other names); in this piece, we refer to them as "style premia." Unlike smart beta, we find that style premia can be applied in multiple asset classes, with little or no traditional beta exposure.

Long-only versus long/short

Each approach to style investing has its merits, and we see a role for both applications, even for the same institution. There is little doubt that long/short approaches can provide better diversification to portfolios dominated by market-directional risks, and they can more efficiently capture style premia. However, long-only approaches are typically easier for many institutions to adopt because they involve less peer risk (they have lower tracking error to conventional portfolios and benchmarks), they have greater capacity, and they do not require the use of leverage, shorting or derivatives.

Before turning to practical examples of long-only and long/short applications of style investing, we note that this distinction has clear implications for fees. Long-only smart beta returns are dominated by their market beta, which can be accessed at very low cost. As a result, we think smart beta fees should reflect the fact that they are mostly market beta with a small amount of "smart." In contrast, long/short approaches seek to capture the entire style premium and none of the beta, thus we think their fees should reasonably be higher (they typically offer several times more style exposure – and thus have lower capacity – than a smart beta portfolio). As such, investors should try to determine how much they are paying for cheaply accessible market beta versus uncorrelated style premia.

Building a long-only style portfolio

The first step is to identify the most useful styles. Within equities, we find decades of evidence across multiple geographies for a few styles. For example, AQR's research[1] analyzing historical data on value, momentum and profitability in US stocks has shown that the stocks that rank the highest on each style have significantly outperformed stocks that rank the lowest.[2] Strikingly, we find that this tendency is "monotonic" – within each style, the top quintile outperformed the second-best quintile; the second-best outperformed the third-best, and so on *(see Figure 1)*.

While data is useful for identifying promising styles, it's also important to have economic explanations for why these styles have performed well and may be expected to continue to do so over the long-term. The excess returns from value, for example, might be compensation for the risk of investing in distressed companies more likely to suffer in weak markets (cheap companies might be cheap for a reason) or might be explained by "glamour" stocks being overpriced by investors willing to pay for (over-extrapolated) growth prospects. As with many economic phenomena, it's likely that there isn't one certain explanation; rather, multiple theories in combination can explain the performance of styles. The key is that there exist reasonable and intuitive explanations to provide comfort that the performance of styles may likely persist.

Style premia can be effectively harvested in a long-only portfolio of stocks by evaluating each stock against several lowly-correlated styles, and then over- or underweighting according to its combined attractiveness. The resulting tilts can be scaled to ensure a meaningful and manageable amount of active risk, while avoiding the use of leverage, shorting or derivatives.

Building a long/short style portfolio

We believe an even broader, more diversified and more efficient approach is to combine long/short styles in multiple asset classes. The use of leverage, shorting and derivatives may enable the efficient and market-neutral implementation of styles in many contexts, while also allowing for reasonable risk and return targets given the increased diversification and pursuit of higher risk-adjusted returns. Four styles – value, momentum, carry and defensive[3] – have generated positive returns in many different contexts, including stock and industry selection, equity country selection, fixed income, currencies and commodities.[4]

An analysis of market data from January 1990 to June 2013[5] found that diversified style premia theoretical portfolios delivered both positive risk-adjusted returns (Sharpe ratios ranging from 0.9 to 1.3) and diversification from equity-directional risk (correlations to global equities ranging from approximately –0.1 to +0.2). Thus, a well-diversified combination of style strategies in several asset classes may provide attractive risk-adjusted returns uncorrelated with long-only asset-class premia *(see Figure 2)*.

Making the most of style investing

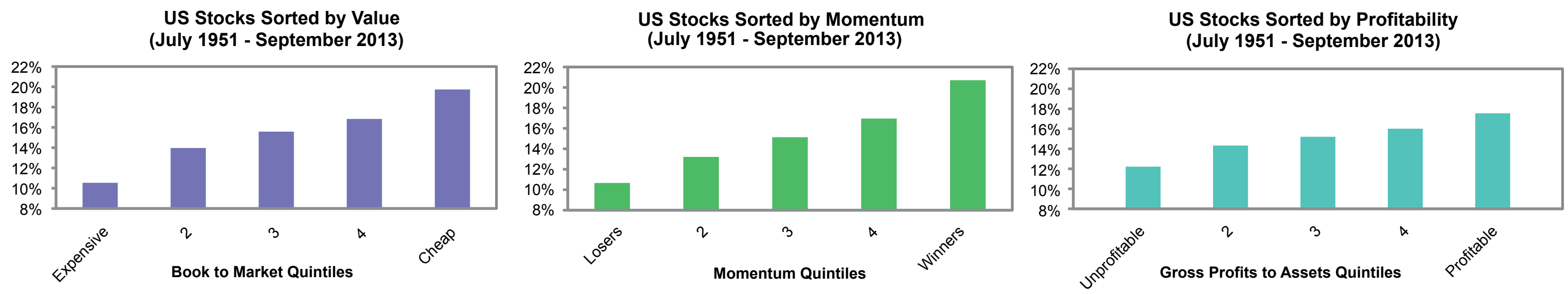
Whether investors choose long-only smart beta or long/short "style premia," we think they should broadly agree on two other portfolio design choices: 1) more styles are better than only one and 2) strategic diversification is better than tactical style exposure.

1. Many or just one?

Relative to a single-style approach, we generally find multistyle approaches provide better diversification, reduce transaction and other costs, and promote patience.[6] Two of the best-known and most-studied styles – value and momentum – have been shown to possess the rare combination of positive historical returns and negative correlations to one another. We think incorporating both styles should lead to more efficient risk-taking. So why do so many investors pursue just one, or pursue value in one fund and momentum in another, which can be less efficient?

Some investors may prefer the apparent versatility of this à la carte, single-style approach. They may choose the "best of breed" manager for each style tilt, but this approach can have its pitfalls – for instance, an inability to net positions, which reduces costs. Re-

Figure 1: Three Intuitive Styles for a Long-Only Equity Portfolio



Sources: Ken French Data Library, AQR. Value and Momentum quintiles based on decile-level information provided by Ken French. Profitability quintiles are based on CRSP/Compustat data, using the same universe as the Ken French Value and Momentum series. The profitability quintiles are based on a single factor – Gross Profits over Assets (GPOA). Returns are gross of transaction costs.

call the low correlations between these styles, which suggest that stocks that are attractive on the basis of value are unlikely to be simultaneously attractive on the basis of momentum. Thus the pure value manager is likely to be overweight (or long) many of the same stocks that the pure momentum manager is underweight (or short), in some cases resulting in a combined portfolio that looks a lot like the index, but with a lot more trading. We think these costs may be saved by a single manager who trades only on the net signal, overweighting a stock that is attractive on both value and momentum.

There's another benefit to combining styles: patience. Single styles have at times experienced (and may continue to experience) years of underperformance, many of which have been (and will be) quite painful. Because styles have shown potentially strong diversification benefits to one another, we believe a combination of many is likely to deliver more consistent returns than any single one. Investors who want to add style exposure to their portfolios may have an easier time sticking with a better-behaved, multistyle portfolio. For example, they may be less likely to drop a style that's fallen out of favour (or to add to a winner after a multiyear run-up).

2. Strategic or tactical?

We prefer strategic style diversification as a starting point because we believe it is much easier to identify styles that work well in the long run (and in many asset classes) than to tactically time them. In our research, we find limited tactical predictability in style performance, which should not be a surprising result (after all, why should this year's return from momentum be any more predictable than this year's equity market return?). Having said that, "style timing" is a major area of research in industry and academia, which could in the future lead to more promising results.

Even if investors could pick the right style 50% of the time, they could still be doing their portfolio harm – even ignoring transaction costs. This is because tactical calls usually imply deviating from a diversified base to a more concentrated portfolio, which means that an investor's (or manager's) timing skills must be good enough to overcome not only transaction costs but also the forgone benefits of diversification. That is a high bar to clear for the major styles, which have exhibited low or negative correlations with each other. Even worse for tactical timing, we find most investors' actual timing has involved multiyear return chasing that has generally detracted from long-term performance.

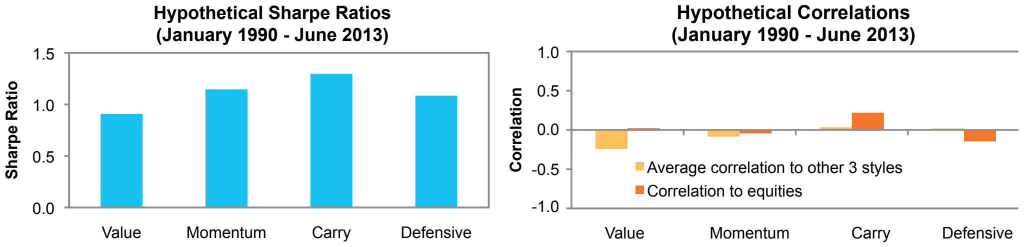
Finally, we believe many investors are "underinvested" in style premia, and a strategic allocation therefore may make sense regardless of current strategy "valuations" or other tactical signals relating to style premia strategies.

Smart Beta, Style Premia and the Search for Alpha

So how should investors think of styles? Perhaps confusingly, even long/short style premia strategies are sometimes referred to as "alternative beta." This is not a reference to traditional, market beta (after all, long/short style premia strategies are typically designed to be market-neutral); nor is it a reference to "alternatives," which can include relatively illiquid asset classes such as private equity and infrastructure (style premia strategies typically focus on liquid assets). Rather, it is based on the idea that strategies previously regarded as sources of "alpha" can, once they become well-known and implementable using transparent, systematic processes, be considered an alternative source of "beta," to be harvested alongside traditional market beta.

At the end of the day what we choose to call these strategies comes down to semantics. Irrespective of labeling, we believe style premia, whether applied in long-only or long/short portfolios, may provide investors much of the excess uncorrelated returns they hope to find from manager alpha, only in a more transparent and systematic framework, and at a fair cost. Because of this, we believe styles deserve meaningful consideration as strategic allocations in institutional portfolios.

Figure 2: Long/Short Style Premia May Offer Attractive and Uncorrelated Sources of Return



Source: AQR. Hypothetical performance of theoretical style portfolios, gross of transaction costs. Correlations are based on monthly returns. "Equities" is MSCI World Index. Each style is applied in multiple asset contexts, including stock and industry selection, equity country selection, fixed income, currencies and commodities Each strategy is designed to take long positions in the assets with the strongest style attributes and short positions in the assets with the weakest style attributes, while seeking to ensure the portfolio is market-neutral. Hypothetical results have certain inherent limitations, and are for illustrative purposes only and not based on an actual portfolio AQR manages. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE PERFORMANCE.

FOOTNOTES:

[1] Source: AQR internal white paper by Israel and Villalon (2013) "Building a Better Core Equity Portfolio." Profitability may be considered part of the broader defensive or quality style (Novy-Marx 2012) and (Frazzini et al. 2012). This list excludes size because we find the historical reward for small-cap investing to be less consistent than for other style premia, and because we emphasize liquid investments while size mainly reflects an illiquidity premium.

[2] US stock market data provides the longest histories on these strategies, but the general results hold in European and other markets where the data is shorter (but still spanning multiple decades).

[3] Here we consider long/short strategies that are designed to remain market-neutral in each asset class. It is, however, possible to apply similar ideas to market-directional trading. Indeed, a trend-following strategy — a time-series equivalent of the momentum strategy — which goes long (short) liquid assets after good (bad) performance and allows directional positions (when all markets in an asset class move in the same direction) could be added as a fifth style with strong empirical backing.

[4] Source: AQR internal white paper by Ilmanen, Israel and Moskowitz (2012) "Investing With Style."

[5] Source: AQR internal white paper by Israel and Maloney (2013) "Understanding Style Premia."

[6] As an exception, we see a standalone role for some risk-reducing styles (such as defensive equity or trend-following) when an investor's focus is on downside protection for their total portfolio.

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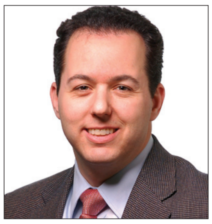

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