

the tortoise & the hare



| Going deeper into the world of return premia

There are some investment firms in the marketplace whose investment thesis and philosophy lies in chasing the latest investment fad, re-positioning portfolios based on gut feel or regularly exchanging managers in the pursuit of capturing recent strong performance. At MASECO we believe that this exercise is futile over the long term. Over the last 10 years our investment philosophy has aimed to consistently identify return drivers in the market and capture them in an efficient way in your portfolio.

When researching fund managers to utilise as components of our portfolios the most important quality we assess is the quality of the academic research that supports the beliefs on which the managers build their processes. On that basis I have continued to develop our investment proposition.

Until quite recently our clients were sourcing market beating return premia by buying groups of single bonds and single stocks with similar characteristics. In the bond arena one attempts to capture return premia for longer versus shorter maturity bonds, known as the term premium and lower versus higher credit quality, known as the credit premium. On the equity side, one would pursue the premia for value and small cap stocks. Earning a premia for tilting portfolios towards stocks with higher profits is also now considered mainstay, although it has really only been accepted and implemented as such over the last five years. All the equity premia have been researched in academia as combinations of long and short positions but

so far only a few investment organizations have attempted and succeeded in implementing them.

Today I will take you into the world of return premia that one can explore in asset allocation. They are sometimes referred to as “style premia” or “alternative risk premia”. Asset allocation premia are related to what you already know because some ideas work on both a security as well as a market level, such as value and momentum. But asset allocation premia are pursued in a different way, by buying and simultaneously selling positions to neutralise taking on more of the risks already inherent in standard bond and equity allocations, such as interest rate risk or equity market risk. Additionally, asset allocation premia can come from other asset classes such as commodities, currencies or volatility. (For more background [please read the Tortoise and Hare Dec 17 issue](#)).

As I have previously highlighted with my co-authors in our research publication in the Financial Analyst Journal¹, besides a strong rationale, the robustness of empirical evidence presented in academic journal publications is key to developing a conviction that any return premium exists and will continue to exist. Ensuring that a return premia is ‘robust’ is to ensure that the return premium is statistically significant over many long term time horizons, across multiple geographies or even in different asset classes. Many supposedly new premia fail to meet that hurdle and only a handful of premia have survived academic scrutiny.

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Value Premium

Let me start with value, as most of us are used to the value premia tilts in our equity portfolios. An equity index is nothing but a combination of multiple individual securities. So why not believe in a value style premium on a market level if one already holds that belief on a security level? So if one country specific index looks cheaper on the basis of index level price-to-book ratio versus another one, a value investor should prefer it over the other and buy a future contract on that cheaper market index, while simultaneously selling a futures contract on the more expensive market index. For example buying the Russell 3000 Value index and selling the Russell 3000 index.

Momentum Premium

Momentum investing pursues the tendency for a security's price to continue its recent performance in the near future. Investors initially underreact to news and subsequently show herding behaviour and overreaction. Momentum strategies compare one security's momentum versus that of another and take a long position in the one with the higher momentum and short position in the asset with the lower momentum. If an asset's price momentum is instead used in isolation to make an investment decision, the investment strategy is often labelled "trend following". Most people would cite an article by Jegadeesh and Titman in the Journal of Finance in 1993² as the starting point of the academic debate of momentum; that premium has been "discovered" only one year after Fama and French³ first discussed value and small cap. The momentum premium in the shape of trend following has already made its way into our clients' portfolios last year ([Please re-visit the Tortoise and Hare Aug 17 issue](#)). A recent academic paper⁴ (2013) has presented robust empirical evidence on both value and momentum and its title gives away its main conclusion: "Value and Momentum Everywhere".

Carry Premium

Now we turn our attention to the carry premium. The concept requires an investor to buy the higher yielding asset and sell the lower yielding one. Higher yield is a compensation for losses in "bad times". Early academic research related to the carry premium already appeared in the 90s, with Mees and Rogoff in 1983 publishing an article⁵ related to currency carry - the premium most of you already know and to which you are exposed. Other research expanded the idea into bonds⁶ in 1995 and into

commodities⁷ in 2006. More recently, in their paper⁸ headed "Carry" Kojien, Moskowitz, Pedersen and Vrugt present a thorough overview and robust empirical evidence on the subject.

Volatility Premium

Finally, there is the so called volatility risk premium. Here the investor is trading volatility itself in the form of volatility futures or options. Like buying insurance on your life or your house, some investors are happy to pay a premium to someone else who agrees to buy volatility risk from them. As such, the volatility priced into the derivative instruments is more often than not higher than the actual volatility realized afterwards, an empirical observation already published⁹ and discussed in 1996 by Jackwerth and Rubinstein. The pursuit of this premium is usually limited to equity index volatility.

Other Premia

For completion, I want to mention briefly a couple of other premia. The profitability premium is one of the best ideas that the investment industry in its endless effort to come up with new terminology categorizes as "quality premia". Quality always consists of analysis of fundamental data, from company specific balance sheet or profit and loss statements. Because there are so many different bits of data to choose from when assessing a firm's quality or level of profitability, it is a bad summary term and investors need to understand each specific idea instead of just believing in a quality premium. For more details, please [see one of my first Tortoise and Hare articles](#)¹⁰.

On the other hand there is the so called low volatility premium. The low volatility anomaly hinges on the evidence that Haugen and Heins already produced¹¹ in 1975. While theoretical models would lead investors to believe that higher risk always results in higher returns, empirically that is not always the case for stocks. Empirical evidence was refreshed¹² in 2012 by Frazzini and Pederson in their paper "Betting against Beta". Reasons for this gap between evidence and theory have come from the behavioural finance angle and structural inefficiencies such as leverage aversion. Strictly speaking, this anomaly does not result in a premium, as empirically low volatility stocks have performed in line with and not above the market. But it creates an opportunity to get market like returns with less volatility than the market.

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Summary

In summary, on all these premia there is a high degree of academic coverage and robust empirical evidence, much more than I can cover in this short article. At MASECO this academic depth gives us sufficient conviction for our clients' assets to be selectively invested in pursuit of them. While today I reviewed briefly each premium in isolation, I will look at the pros and cons of investing into a combination of them next month. But for now I will leave you with the following summary:

Name	Motivation	Explanation	Trade
Value	Buy low, sell high	Risk of holding distressed asset, long-term overreaction to news	Cheap minus expensive
Momentum/Trend	Buy winners, sell losers	Investors return following behaviour, short-term overreaction to news	Relative outperformers minus underperformers
Carry	Harvest income	Compensation for crash risk, excess demand for capital	High yielding minus low yielding
Volatility Risk	Sell financial insurance	Investors are averse to extreme losses	Expected volatility minus realised volatility
Quality	Pursue sound fundamentals	Investors' difficulty to separate earnings from cash flow	Strong fundamentals minus weak fundamentals
Low Volatility	Be conservative	Most investors have limits on or are averse to leverage	Safe minus risky

As a side note, if someone is interested in reading a good book related to the topic of of this article, I can recommend "Expected Return" published by Antti Ilmanen in 2011. For those of you who don't want to go to this level of depth during the currently beautiful summer days, I suggest you remember the following:

Carry is the return you get if prices don't move. Quality is the return you get if fundamental data can predict price changes. Momentum is the return you get as the market interprets and attempts to price new fundamental data. Value is the return you get when prices and fundamental data have moved out of sync.

Sources:

- ¹ Beck, Hsu, Kalesnik and Kostka, 2016, "Will Your Factor Deliver? An Examination of Factor Robustness and Implementation Costs"
- ² Jegadeesh and Titman, 2013, "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency"
- ³ Fama and French, 1992, "The Cross-Section of Expected Stock Returns"
- ⁴ Assness, Moskowitz and Pedersen, 2013, "Value and Momentum Everywhere"
- ⁵ Meese and Rogoff, 1983, "Empirical Exchange Rate Models of the Seventies"
- ⁶ Ilmanen, 1995, "Time-Varying Expected Returns in International Bond Markets"
- ⁷ Erb and Harvey, 2006, "The Strategic and Tactical Value of Commodity Futures"
- ⁸ Kojien, Moskowitz, Pedersen and Vrugt, 2013, "Carry"
- ⁹ Jackwerth and Rubinstein, 1996, "Recovering Probability Distributions from Option Prices"
- ¹⁰ Kostka, 2016, "The Quality Premium An exciting new opportunity?"
- ¹¹ Haugen and Heins, 1975, "Risk and Rate of Return on Financial Assets: Some Old Wine in New Bottles."
- ¹² Frazzini and Pedersen, 2012, "Betting against Beta"

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