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PRACTITIONER'S DIGEST

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ACTIVE INVESTING AND THE EFFICIENCY OF SECURITY MARKETS PAGE 5

Russ Wermers

The aggregate money managed by passive investment funds have grown exponentially during the past decade. What is the impact of an increasingly "passive world" on the price efficiency of security markets? This article addresses this important issue by providing a broad discussion of the role of active management in contributing to market efficiency, which has the potential to benefit all investors, active and passive.

The article argues, using a survey of peer-reviewed scholarly literature, as well as some widely-cited practitioner articles, that active managers, in aggregate, provide important positive externalities to other investors through:

1. The rapid incorporation of value-relevant news into stock prices,
2. Trades that reduce the level of stock mispricing that results from potential systematic behavioral biases of the mass of investors in the economy,
3. The disciplining of corporate executives through the incentives of active managers to closely monitor and eliminate value-reducing actions, and
4. The provision of liquidity to other investors, thereby reducing their trading costs.

The study argues that the above-noted benefits are magnified in small- and mid-capitalization stocks, which increases the availability of capital among such smaller companies in the economy at a rational price, and which, accordingly, disciplines managers of such companies in favor of making investments in only projects that are value-enhancing for the economy.

Although the literature cited by this study mostly covers active U.S. equity managers, the conclusions of this article can be extended to broadly apply to active managers across other markets, including fixed-income and non-U.S. equity markets, as well as active managers in non-public markets.

INVESTMENT STYLE VOLATILITY AND MUTUAL FUND PERFORMANCE PAGE 25

Keith C. Brown, W. V. Harlow and Hanjiang Zhang

It is well established that the investment style characteristics adopted by the manager of an equity portfolio can have a tremendous impact on the fund's subsequent performance. Numerous studies have shown that emphasizing firm-related attributes, such as price-earnings or price-book ratios, market capitalization levels, or return momentum patterns, in a portfolio can significantly influence its investment outcome. Less well understood, though, is the role played by the manager's ability to maintain a consistent commitment to his or her chosen investment style. In particular, is there any performance advantage enjoyed by a manager who is able to maintain a less volatile (i.e., more consistent) style mandate over an otherwise comparable fund exhibiting more style volatility?

In this paper, we examine the relationship between a fund's level of style volatility and the future risk-adjusted returns it produces. We begin by developing a holdings-based statistic to measure the volatility of a fund's investment style characteristic profile over time. Using a survivorship-free universe of mutual funds over a three decade-long sample period, we find that, on average, funds with lower levels of style volatility significantly outperform more style-volatile funds on a risk-adjusted basis. We show that style volatility has a distinct impact on future fund performance compared to fund expenses or past risk-adjusted returns, with unintentional changes in style volatility being the main determinant of the overall effect. We conclude that deciding to maintain a less volatile investment style is an important aspect of the portfolio management process.

There are practical implications from these findings for asset owners and managers. Chiefly, it appears that the ability of a portfolio manager to maintain a dependable degree of predictability in their investment style—whatever that mandate may be—is a valuable skill to possess. Indeed, maintaining a consistently low level of style volatility is one of the ways in which superior managers can signal their investment prowess to potential investors. Further, while profitability exploiting tactical style adjustments in a portfolio remains possible, our findings strongly suggest that maintaining a stable and predictable style profile can be useful in helping managers avoid chronically poor performance. This, in turn, is likely to increase the changes that they remain employed. At the very least, style volatility is another element that should be considered when assessing fund performance.

LENDING TO LOSE: WHO BUYS NEGATIVELY YIELDING BONDS AND WHAT IT MEANS FOR INVESTORS PAGE 62

Vineer Bhansali

In this perspective piece I discuss the demand and supply of negatively yielding bonds. This is a recent and relatively unprecedented phenomenon in financial markets. Why would anyone buy a negatively yielding bond rather than just hide their money under a mattress (i.e. earn zero yield?)

To understand why one would lend to lose, I classify buyers into three categories, i.e. "forced buyers", "speculators" and "non-financial government entities". Each one of these buyers has a different motivation for buying negatively yielding bonds, but collectively they create an excess demand for these

bonds that is potentially a great distortion in the context of what history has demanded of investment: a positive return in exchange for lending money.

I explore the motivations and main drivers of the motivations for different classes of buyers of negative yields, and conclude that the demand for bonds that are guaranteed to lose money can locally be justified by a variety of rational reasons.

However, while locally rational, this conclusion raises important questions about global financial stability. Do negative yields mean that the bond market is distorted due to demand and supply mismatch, and if so what are the consequences if there are unforeseen macro-economic shocks? Can an unwind of the negative yield universe prove to be dangerous for asset classes and asset allocation? If so, what can investors do to protect themselves from such events.

IDIOSYNCRATIC RISK AND WHEN TO TILT TOWARD VALUE PAGE 76

Jason D. Fink and Kristin E. Fink

The outperformance of value relative to growth portfolios is a well-known phenomenon. However, the source of this outperformance is not agreed upon. Scholars such as Fama and French (1992) argue that the return difference between value and growth portfolios are representative of a systematic, priced factor in the economy. In contrast, researchers such as Lakonishok *et al.* (1994) find that value stocks tend to outperform growth stocks for behavioral reasons. The distinction has significant implications for practitioners. A systematic risk earns a positive expected return. A behavioral quirk generates no such expectation. And of course, both effects may be present, making it difficult both to uncover the true factor and to capitalize on the expected return.

We hypothesize that if behavioral forces are the primary driver behind value-growth outperformance, then that outperformance would be primarily observable during times in which arbitrage of the behavioral reaction are difficult. Pontiff (2006) argues that the primary holding cost faced by arbitragers is idiosyncratic risk. This would imply that during times of elevated idiosyncratic risk, it is difficult for arbitragers to capitalize on these behavioral forces. If the source of the value-growth spread is systematic risk, there is no reason to expect such an association.

We find that when idiosyncratic increases, the outperformance of value correspondingly increases. Conversely, when idiosyncratic volatility is low, the outperformance is significantly reduced. This is consistent with an at least partial behavioral explanation for the outperformance, and an indication that value may not be a reliable source of expected return, except during times of inhibited arbitrage.

COMOVEMENT, LIQUIDITY AND ASYMMETRIES PAGE 90

James X. Xiong

Institutional investing and index trading have increased significantly over the last half-century. It has meaningful implications for the relationship between liquidity and return comovement. Through appropriately normalized returns and trading volumes, I directly measure this mechanical relationship across stocks over time and report a few interesting findings.

First, return comovement has increased with basket trading. Moreover, negative comovements tend to be larger than positive ones, which indicates an increased downside comovement risk for investors. Second, the liquidity level has dramatically increased due to increased trading volume, but in the meantime, the impact of comovement on liquidity has also increased. More importantly, the impact of comovement on liquidity can be quantified and forecasted by a power-law function, and explained by a liquidity supply model.

Finally, I show that the disappearances of the three well-documented asymmetries (asymmetric volume, asymmetry in non-market volatility, and positive skewness for individual stocks) are all associated with increased basket trading and short selling. In contrast, asymmetric correlation still survives, and it is mainly driven by a larger negative three-sigma comovement because selling is more contagious in downturned markets.