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BOOK REVIEW

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EXPECTED RETURNS: AN INVESTOR'S GUIDE TO HARVESTING MARKET REWARDS

By Antti Ilmanen, Wiley Finance Series
(*Reviewed by Graham Rennison*)

Expected returns—forecasted long-term payoffs of investments or strategies—are essential ingredients in investment and allocation decisions. Whether subjectively assessed or explicitly estimated, they are notoriously difficult to get right, and small errors can have disproportionately large consequences. In "Expected Returns: An Investor's Guide to Harvesting Market Rewards", Ilmanen provides a uniquely comprehensive guide, combining diverse schools of thought from academia with real-world trading experience and practicalities.

The key theme is that "investors should collect risk premia from diverse sources…" and, "…take return measurement seriously". In this vein the book is ingeniously and intuitively structured around "the cube". The cube categorizes potential sources of risk premia into three interlinking dimensions: asset classes (stocks, bonds, credit, alternatives), strategy styles (value, carry, trend, volatility) and risk factors (growth, inflation, liquidity, tail-risks).

Ilmanen covers each of the resulting twelve return sources in detail, first analyzing historical evidence from an impressive wealth of long time series data. Despite carefully adjusting for secular biases, such as the great inflation moderation of the last thirty years, Ilmanen emphasizes the limitations of historical data for estimating future returns. He moves on to discuss more theoretical approaches as well as the use of current market measures, such as the bond yield or price-to-earnings ratio on a stock.

Underpinning the discussion is an important question: Why should there be a positive expected return at all? Ilmanen outlines the two distinct branches of finance theory that attempt to provide an explanation. In a "rational" version of the world with efficient markets, persistent long-term rewards are only available to investors taking on a risk that others in the market do not want (there are no "free lunches"). In a version of the world that permits some "irrational" investors, on the other hand, certain behavioral traits lead to persistent opportunities for profit. Examples given of irrational pricing include the consistent underperformance of glamorous "growth" stocks due to excessively optimistic earnings extrapolation, compared with unloved, dull "value" stocks. Similarly, "lottery-ticket" like investments offering the potential for rare, large, get-rich-quick returns are systematically overpriced across asset classes.

Throughout the book, Ilmanen offers interpretations of the components of the cube from both the rational and irrational angles, acknowledging that the most compelling worldview incorporates elements from both lines of thinking.

A recurring and related theme is that risk premia are especially justified on investments or strategies that tend to lose money in "bad times" (economic downturns or crises) when incurring those losses is most painful. Compelling examples include selling different forms of financial disaster insurance such as shorting equity volatility or writing senior default protection, as well as exposure to illiquid investments such as real estate and private equity. Conversely, risk premia could be small or negative in diversifying investments such as government bonds and trend strategies. The fact that trend strategies appear to demonstrate abnormally high returns and be a good diversifier is acknowledged to be an unsolved puzzle.

In a series of later topics Ilmanen makes the case for greater use of survey data in disentangling market expectations from risk premia. For example, an upward sloping yield curve could reflect either expectations of rising interest rates, or it could reflect a risk premium for holding longer duration debt, or—more likely—a combination of the two. He also touches on the fascinating concept of endogenous feedback effects in returns, generated from investor crowding into popular strategies, and, briefly, on timing indicators for active strategies.

Despite the author's humble health warning, "we should recognize the limits of our understanding… [particularly] in making predictions and in trading based on them", this detailed yet eminently readable book will be invaluable for active and passive investors alike. Incorporating structured thinking on expected returns will enhance active trading and allocation decisions. It will also aid passive investors in identifying and quantifying diverse sources of risk premia, and in designing optimal portfolios to harvest them.