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PRACTITIONER'S DIGEST

The "Practitioner's Digest" emphasizes the practical significance of manuscripts featured in the "Insights" and "Articles" sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.

WHAT HAPPENS WITH MORE FUNDS THAN STOCKS? ANALYSIS OF CROWDING IN STYLE FACTORS AND INDIVIDUAL EQUITIES PAGE 4

Ananth Madhavan, Aleksander Sobczyk and Andrew Ang

The proliferation of funds juxtaposed against the decline in individual stock listing since the mid-1990s raises questions about crowding in individual stocks or style factors. We examine two questions for all US-listed equity active mutual funds and exchange-traded funds: (1) How concentrated are the holdings across funds, and have they changed over time? and (2) How common are the factor exposures across funds even though their stock holdings may differ. The analysis is relevant for investment managers and regulators concerned about crowding.

ACTIVE INVESTING AS A NEGATIVE SUM GAME: A CRITICAL REVIEW PAGE 29

Geoffrey J. Warren

Sharpe (1991) puts forward the proposition that active investing must be a losing pursuit in aggregate, as it amounts to a zero sum game in gross terms and negative sum game after costs. This article takes a critical look at the underlying concepts and assumptions behind Sharpe's proposition, with the aim of gauging whether it supports the idea that passive funds should be preferred over actively managed funds. The discussion draws on some of the related research on active management, and is supported by simple modelling to illustrate the concepts.

The broad conclusion is that Sharpe's proposition is not water-tight upon closer examination, and is insufficient to sustain the general conclusion that indexed funds should always be favoured over active management. Rather, the evidence indicates that whether active or passive management is likely to deliver a better outcome depends on the situation. The case for an active approach can vary with investor circumstances, including fee paid, type of mandate, ability to identify skilled managers and

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objectives. It may also vary with the asset category being considered, with some evidence that an active approach may do better outside of US pooled equity mutual funds. The main message is: 'it depends'.

THE MAGIC FORMULA: VALUE, PROFITABILITY, AND THE CROSS-SECTION OF GLOBAL STOCK RETURNS PAGE 52

Douglas W. Blackburn and Nusret Cakici

This paper investigates the global performance of Greenblatt's (2006, 2010) Magic Formula trading strategy. We find that a variation of the Magic Formula indeed produces significant long-short and long-only returns in North America, Europe, Japan, and Asia. Large returns are observed in large cap and small cap portfolios, when value- and equal-weighting, and after controlling for size, book-to-market, momentum, profitability, and investment factors.

Additional sensitivity tests are conducted. Constructing portfolios based on deciles relative to quintiles improves the performance of the strategy, and the strategy yields higher returns during period of high sentiment as compared to low sentiment periods. Last, we provide performance results for twenty-two developed countries and for ten sectors. Overall, our paper provides significant global support for Greenblatt's Magic Formula investment paradigm.

ASSET PRICING, ASSET ALLOCATION AND RISK-ADJUSTED PERFORMANCE WITH MULTIPLE GOALS AND AGENCY: THE GOALS AND RISK-BASED ASSET PRICING MODEL PAGE 89

Arun Muralidhar

Investment managers require a consistent asset pricing model, asset allocation recommendations and risk-adjusted performance measures (or the "three facets of investing") to be effective in managing portfolios. Incorporating three critical realities of investing into these models (i.e., that investors have many stochastic goals, seek to delegate to skillful agents, and maximize risk-adjusted relative returns) provides recommendations on the three facets that are markedly different from the foundational papers of Modern Portfolio Theory (MPT). In fact, this paper uses the investment policy statements of (two) major investors, with explicit statements of absolute and relative risk tolerance, as the primary basis of the model. The paper then derives a normative Goals- and Risk-Based Asset Pricing Model (GRAPM) that includes these three realities of investing and articulates the three facets. With Goals-based Investing (GBI), increasingly the norm among investors, this paper provides useful guidance to investors to achieve their objectives for the given goal.

GRAPM exploits a simple idea that a relatively risk-free asset for one stochastic goal is a risky asset for another, and vice versa. These two assets, plus the traditional absolute risk-free rate of MPT, allow us to triangulate to establish returns for all other assets based on the return of any goal-replicating asset and multiple correlations. This approach creates a "pair-wise equilibrium" for all assets (and potentially a general equilibrium)—very different from MPT—and also lends itself easily to a new asset pricing model with heterogeneous investors (i.e., each investor has a unique goal). It also provides useful asset allocation recommendations to investors with clear articulation on optimal allocations to

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the hedging asset, the risky asset and cash for a given absolute and relative risk budget. GRAPM incorporates a "risk-aversion" parameter that is also easily observable, unlike MPT, and appears to explain why seemingly similar investors can have markedly different asset allocations or expected returns. Hence, this approach takes a positive approach of using active investment behavior to derive normative recommendations on the three facets of investing.

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