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Steve Forbes, Forbes Staff
"With all thy getting, get understanding."

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Efficient Market? Baloney, Says Famed Value And Momentum Strategist Cliff Asness

Cliff Asness, Chief Investment Officer at AQR Capital Management, sat down with me to discuss his unique quant strategy. A video and transcript of our conversation follows.

Steve Forbes: Cliff, thank you for joining us. You approach investing with an even more unusual background. Can you first tell us about AQR?

Cliff Asness: Sure. It stands for Applied Quantitative Research.

Forbes: Which already tells you something.

Asness: Yes. It definitely is a quant firm. I do let people believe that I'm the A in AQR on occasion. I'm one of the founding partners but I'm not the A. An easy way to think about what we do is we came out of academia. This is more than 20 years ago now, so we're certainly not academics. But I was a teaching assistant and he was my dissertation advisor, Gene Fama, who just won the Nobel prize.

A lot of what we do, a fair amount original at our firm, a lot of it taken from academia, is to say, "Can we make clients real money with this stuff?" If academics find that this type of stock or this type of currency or this type of commodity wins on average, is that something you'd actually want to bet on, can do in a practical way and what forms can you do it in?

And today we manage about $100 billion. It goes anywhere from very traditional long-only equities, try to do a little better than the benchmark, all the way up to market-neutral, very diversified levered hedge funds. But it all gets down to the same kind of thing. What have we and others found that seems to work over the long term, that we think we understand why it works and can be implemented in a practical way? And not everything can.

Forbes: Isn't it all about probabilities? You can't predict the future, but do you feel you can find patterns that generally hold up?

Asness: It's all about probabilities. And I love that you put it that way. I don't think it's different necessarily for non-quantitative firms. We just might acknowledge it a little more explicitly. But I'm in a business where if 52% of the day I'm right, I'm doing pretty well over the long term. That's not so easy to live with on a daily basis. I like to say, when I say a strategy works, I kind of mean six or seven out of 10 years. A little more than half the days. If your car worked like this you'd fire your mechanic. But we are playing the odds. Some famous findings, cheap stocks, defined simply, price-to-book, cash flow, sales.

You can try to do better, but define it simply. Beat expensive stocks. They beat them on average with a small margin and you want to own a ton of them and be underweight or short a ton of the expensive ones because something like this for one stock means almost nothing.

Forbes: In a moment we'll discuss the seeming paradox of Fischer for that high-risk, low-risk.

Asness: Oh sure.

Forbes: But sum up your philosophy then. That you believe that numbers and study can give you that edge.

Asness: I do believe numbers and study can give you that edge. I think it has to be blended with a fair amount of both economic and common sense. One danger of people who look at numbers, even people like myself, is that you will simply assume what has worked in the past will continue to work.

Forbes: Rear view mirror.

Asness: Rear view mirror. We call it data mining in our field. There are really only two cures for that. Having a real consistent investment theory that even if you see evidence to the contrary it would take a lot for you not to believe that. Like if you believe cheap beats expensive and you find some weird market where for the last, whatever period you could test, expensive beat cheap, it would take a lot to budge me from that. So having a philosophy.

And then what the geeks call an out-of-sample test. In English, "All right, I've tortured the data here. Can I go look somewhere else? Can I go test this in another country? Can I go look at another asset class?" If I told you value and momentum, you're about to talk about Fischer's low beta phenomenon. If I told you we went to go look at bond markets, and pretty exact analogies for these things do help you choose bond markets.

Forbes: Oh, we're talking about bond markets, currencies, bonds.

Asness: Those are out-of-sample tests. That's something you haven't looked at yet. I started my career in 1990 so I'm on 24 years of an out-of-sample test. That was not a particularly helpful one 24 years ago. I was at Goldman Sachs and to tell them, "Here's what we do. Let's wait 24 years and if it really works well, let's pounce." It might have been intellectually honest, but not too helpful. But looking around the world, finding it holds up, take common sense things, a lot of them out of academia, cheap beats expensive. Sadly for pure efficient markets guys, good momentum tends to be a good thing in the short-term.

Forbes: We'll discuss that in a minute. Sort of the investing equivalent of horoscopes.

Asness: Low volatility. Low beta, like you mentioned. And then make sure it works, or at least doesn't utterly fail in a very broad way. And that you can implement it cheaply. It's not a pithy one-line philosophy but it sums it up.

Forbes: How do you defend your approach? Not in the specifics, but the whole thing on indexing. We all know Malkiel and others, Charlie Ellis, will tell you that if you have the discipline to stick to an index, low fees. Your fees are relatively high. Wouldn't you just be better off saving all that brain power and just riding the wave?

Asness: Sure. Off the bat I'll tell you my two investing heroes, and there are a lot of good ones to choose from, are Jack Bogle and my dissertation advisor, Gene Fama. So I can't sit here and put down indexing too much. And in fact when I'm asked, "What advice would you give individuals who are not going to dedicate themselves to this and what not," I tell them, "The market might not be perfectly efficient, but for most people acting as if it is," and this is not the only way to get to an index fund, but it's one route to get to it, it's certainly one route that implies an index fund. I tell them to do that.

Having said that, there are a lot of ways to get here, but there's a central paradox to efficient markets. Efficient markets says you can't beat an index, the price contains all the information. For a long time we've known, academics have known, that somebody has to be gathering that information. The old conundrum: What if everyone indexed? Prices would be wildly inefficient.

So I do take what ends up being an arrogant view, and I admit it, that on average people don't beat the index. Here are the mistakes they make. Here are the risk premiums you can pick up. I do think it's somewhat profitable, and we want to be some of the people helping make the markets efficient and we think you get paid for that. So that is both how I reconcile it and how I sleep at night.

But if an individual came to me and said, "What should I do?" I don't say, "Pour your money into my fund," because, for one thing, they don't know that much and if we have a bad year they won't stick with it. I tell them, "Study the history a little bit, just a little bit, and put it in the most aggressive mix of stocks and bonds that you wouldn't have thrown up and left in the past. And go to Jack Bogle to get it."

Forbes: One of the papers your firm put out had the word which seems to go against quantitative, and that is intuition.

Asness: Yes. Well, intuition, when I say intuition, I think we use that word for the shock value, admittedly.

Forbes: It works.

Asness: As much as intuition I mean common sense. And common sense as it applies to economics. And it does tie in with what we've already been talking about. If you find a non-intuitive, non-common sense result, don't do it. We have an investment philosophy that we apply again and again and again. We don't reinvent it in each place.

Our economic intuition has been, for quite a long time, that cheap things beat expensive. That that can be quite a painful route on its own that could be made more consistent by waiting until they start to get better. That if on top of that you can add low risk and a decent positive carry that's great.

That many arbitrage strategies pay you, perhaps rationally, for taking the risk. And let me give you my favorite example. I'm sure you've heard of it a million times, everyone talks about it. It's the Super Bowl effect. Right? Everyone knows this part. Buy when a team from the NFC wins. But fewer people know that part of the rule is also buy if an NFC team wins or if a team in the AFC but from the old NFL. A few moved over.

And this is a great example of data mining. They had to tweak the rule, I believe because of the Pittsburgh Steelers. I could be wrong. I hope – I can't promise you, we all break, there's weakness and sin in all of us — but I hope there's no amount you could show me that worked where I would do it, because it's just patently silly. If it worked for 600 years in a row, maybe even I'd break. I hope not, though.

So when we talk about intuition we're talking about in building a process. We don't just do what's worked in the past. We don't change our process. Let me give you one more example. Japan is pretty much the only market in the world where momentum has been a failure for 30, 40 years and value has been about doubly as good as it's been elsewhere. We still do both. Because the chance that you'd find one place that's looked like this, that looks odd, even if it's 50/50 everywhere, the right answer is 50/50 everywhere, is quite large. So our intuition overrides the data again.

Forbes: Quickly go over what you call the four styles of investing, starting with value.

Asness: Well, first of all, we go past being exposed to traditional markets. We're not talking about that. We do believe markets go up over time and they're great wealth creators, so by no means when I talk about these do I mean stocks for the long run isn't going to be a great investment.

But these are four styles where if you over- and under-weight against an index, or go long and short in a more hedge fund-type portfolio, we think both academic and practitioner, a lot of this has been done by applied people, their research says there's a return where your longs beat your shorts.

Not only that, it's not very related to the direction of the market. When your longs beat your shorts doesn't always work. Remember, I told you in the beginning you get those 52% of the days. And I'll be geeky and use the term, it's not very correlated to the direction of the market. And that's kind of the holy grail of investing. To find various investments, of course, and I know you know this, that go up over time — there's no substitute for going up — but that go up at different times.

To us, the academic literature has produced a ton. If you want to be a cynic, they've produced too many. A lot of smart people with even smarter computers will turn out a lot of past results and we have hundreds of different effects. The blank effect. The silliest ones are things like the Super Bowl, the sunspot effect.

But when someone searches every piece of data and it's not that silly, it involves an accounting variable, even if ultimately it's silly when you drill down, it's harder to dismiss. What we did was kind of almost a self examination of going through and saying, "Of all these things we've been reading about for years, many of which we've been implementing, if we had to bet the ranch," now we're quant, so we never bet the single ranch on anything but over the long-term, if we had to really say, "What are the biggies that we would be most confident in?" They have to have worked for the long term. Data still counts. They need to have great intuition. They have to have worked out of sample, that thing I was talking about before, after they've been discovered. If they were discovered in 1970, how'd they do after that? A telltale sign of something that was dredged out of the data is discovered in 1970. Wonderful for the first 70 years of the century and terrible for the last 30 years.

And it has to be implementable. Meaning, there are some things that academics and others look at that when you try with real world transactions cost in a real world portfolio, you find, "Gee, gross, I made a lot of money but net Wall Street made a lot of money. I didn't make a lot of money."

Came down to four. Value. Cheap beats expensive. Famous is in U.S. stocks. For me it's very related to Graham and Dodd value. It's the same intuition. But where most Graham and Dodd investors will use it to pick a handful of stocks we'll say the thousand cheapest on our favorite measures will beat the thousand most expensive. We're betting on a concept more than a specific firm, but looking for the same ideas. The second is momentum. Values.

Forbes: That is almost like saying you eat chicken entrails in the minds of some. Or horoscopes.

Asness: I'm absolutely aware of that. Now picture this, Steve. Gene Fama was my advisor. I had to go to him, and he's heard this story many times, and tell him, "I want to write my dissertation on price momentum." When I was younger sometimes I'd call this the two newspaper strategy.

Forbes: Is this what you got for me? Yikes.

Asness: And then I mumbled the second part intentionally. And, by the way, I find it works really well. Because it's a perfect Chicago dissertation to say, "Look, these crazy people on Wall Street use price momentum. Doesn't work at all. They're wasting their money." We have found, and this has held up and tons of academics have looked at it, that not just individual stocks in the U.S. but around the world, stock markets, bond markets, currencies, where to be on a yield curve, show a decent tendency to keep doing what they've been doing over the last six to 12 months. It is distressing to fans of perfectly efficient markets. Again, it's a small edge. It is not an arbitrage opportunity where you get free money. So it doesn't make the market wildly inefficient.

Second of all, and maybe this is why Gene let me graduate, is I certainly didn't say, "Do it alone." I said, "It really works well with the value strategy." Value tends to hold something for a longer term. Lower turnover. Tends to be negatively correlated.

I'll give you the value part. I still think of value as the hero of the story. You're a manager long cheap and short expensive. I'm the momentum heretic. I'm long good momentum, short bad momentum. A good year for you is usually not my best year. Think about it. It works in the math but also in spirit. When value's being rewarded you would not think it's a particularly good time for momentum.

If there's any magic to the finding, and I'm still amazed by it, is while we hedge each other a bit, more than a bit, both of us make money if we follow it with discipline over time. So writing my dissertation on momentum was bad enough. This is still what I believe. It wasn't a graduation strategy. But saying one should do momentum with value, not instead of value, was wise on all fronts. I didn't get to the other two. I'll make these quick.

Forbes: Carry?

Asness: Carry strategies. Carrying is most famous in the currency world. We simply buy high yielding and sell low yielding currencies. Nominal or real. It's a very similar strategy. Of course to make an interest rate joke, nowadays it's buying low yield currencies and selling even lower yield currencies. There aren't exactly a lot of high yielding currencies out there.

This strategy's not for the faint of heart. To avoid a technical term, it blows up occasionally. With those blowups it's been a very good strategy long-term. Would not bet the ranch, to use that again, and that's a dangerous phrase for me again on it, but would I have it as a small part of my portfolio? Yes. But it's not the only place that carry exists. In the bond market a steep yield curve is carry.

Forbes: They're priced at carry.

Asness: Yes. Precisely. If markets don't move a steep yield curve outperforms a flat yield curve. Carry, sometimes the way I think about it is it's not really the lazy man's strategy, but it's the man who predicts stasis. Prices don't change. Carry is what you get.

And in that market, in the commodities world and a few others, not only does carry hold up but it doesn't have the currency carry property of really hurting you when the world falls apart. Currency carry does. And anyone listening should know that I like it but in a modest amount, because that one will get you when it's painful to be gotten. The final one has gotten popular in the last few years. It's buying low volatility or, even more specifically to a geek like me, low beta stocks. Stocks that move less with the market.

Forbes: Low risk.

Asness: Low risk. Thank you. We can just say low risk. Two colleagues of mine, Andrea Frazzini and Lasse Pedersen, I think, I'm biased, but I think they wrote the bible on this recently. But they are quite clear that they are re-popularizing and broadening the tests, with 40 more years of data to add, something that was found by Fischer Black way back in the late '60s, early '70s.

In the late '60s, early '70s Fischer Black found that low risk and high risk stocks, defined multiple ways, he used beta, nowadays we define it multiple ways. Low risks did about as well, if not better, than high risk. That's tough to reconcile with theory. If you really believe that, why would you buy them all? Fischer actually suggested this. A guy named Wayne Wagner gave us a copy of a memo. Fischer Black I believe wrote it. There were famous names in there. David Booth, a few others, from the early '70s at Wells Fargo. Where Fischer said something like, I'm paraphrasing here, "This is what we should do. Instead of index funds we should do an index fund of low beta stocks with a small amount of leverage."

Forbes: A low beta index?

Asness: "Because it's lower risk we can get a little extra return out of it safely with leverage." I can only assume, I don't know the truth of what happened afterwards, they didn't do it. And it was the time before index funds were popular, so I'm sure they looked at Fischer and said, "Fischer, we can't sell index funds. We're not walking around trying to sell leveraged low beta index funds, or whatever the heck you're talking about."

I will tell you, you don't have to really feel bad for most of these guys, they all did phenomenally. But this would have been one of the most incredible funds in the world. We wrote — and I say we, I was not a co-author, some people at my firm — looking at Warren Buffett's returns. No disrespect meant. Doing something 40 years ago is more impressive than a geek looking back 40 years and saying what would have worked. But a big part of his returns is buying lower risk firms and applying some leverage to them.

Another thing that my colleagues have done is extend that way past individual stocks. You can look at a market and say, "This market. Make it up. Germany moves more with the world. Is a higher risk country than France."

Forbes: Well, explain. One of the papers talks about Germany versus France. Cheap country, expensive country. Like a stock.

Asness: When I say we've tested these things and it applies to all four of them: value, momentum, carry and low risk. Outside of just stocks. Stock picking we talk about the most. It's kind of the lingua franca of our field. Everyone can talk about stock picking. They all know what you mean.

If our group has added anything, and I think we've added a lot at the edges and we've been writers in this literature, I think we've been most early on saying, "Well, if these things work for real reasons, not just accidents of the data, they should work for other investing decisions we haven't looked at yet. Like what country to put your money in."

Well, you can pretend a country is an individual stock. It's a conglomerate. The DAX is a conglomerate. Vladimir Putin approach to investing. I'm just going to take the whole country. That's a terrible joke that's going to date this entire talk. But treat the country as an individual stock. Imagine your favorite measure.

Forbes: You can do a pun on Crime-A.

Asness: Crimea. Yes. Sure. And I can view part of my career as the charge of the light brigade. If a country is viewed as an individual stock, imagine you took a very simple approach to value. And we do think you can be much subtler than this. But to keep it simple, price-to-book is your favorite measure of value.

What's the price-to-book of the country? It's the market cap of the whole country divided by the book value of the whole country. If Germany is selling for a two and France is selling for a one, people are much more optimistic in Germany. Either that or they view it as much lower risk. Either way. There are two competing theories. You have to bear with me that I'm assuming an optimistic German in this scenario. But on average, an expensive country that's more optimistic or lower risk doesn't return as much. Higher price-to-book does not reward you. Lower price-to-book does.

We found the exact same things, and momentum. Of course we did all the countries, not just France and Germany, like my examples. But value worked. Momentum worked. When carry could be applied; we don't apply it to equity markets because it ends up looking too much like a value strategy. Dividend yield and these other ones. But to bond markets, currency markets and others, carry applies.

And viewed as risk. Not viewing it as valuation but looking at the actual risk numbers. The Fischer Black numbers. Lower risk countries outperformed, or at least matched, the performance of higher risk countries, which isn't supposed to work. And then we were today equities, tomorrow bonds, the next day currencies. What does value mean for these? For bonds it's real bond yield. Yield over inflation. For currencies it might be purchasing power parity.

Again, we've been working on these for almost 20 years now, so there's more depth to the models that I'm conveying, but the concepts, all four, wherever we can apply them, held up nicely. They didn't work perfectly or else we wouldn't have to bother doing them in 20, 30 places. But they worked over the long term.

Forbes: Say a few words on, it sounds almost a theology of efficient markets.

Asness: Sure. This far into the interview you still think I could say a few words? I'll give it a shot. We just have written on this. We thought we were in a good position. The Nobel prize committee, as you well know, split the last Nobel prize. One went to my dissertation advisor, Gene Fama. Another went to Robert Shiller. A third went to Lars Hansen. We feel bad. We leave Hansen out. He's very deserving. It's simply he's not on the same spectrum of controversy of the two.

Myself and a colleague, John Liew, wrote a long piece looking at this fight. And it's a little bit academic. They're very polite about it and they like each other, so fight's maybe too strong of a word. But Gene does not think markets are perfectly efficient. First day or first week of class back in the '80s he told us that that's a crazy assumption. But he thinks it's a great starting point and they're mostly efficient.
Bob Shiller, and I don't want to put words in his mouth, thinks they're fairly inefficient. I hate to be in the middle. I have found in my career when it comes to a fire I'm more of a gasoline than a water thrower. I'm rarely in the middle. But on this one, myself, my firm and my co-author come out..

Forbes: Which is why you didn't become an academic?

Asness: Maybe. Maybe. But we come out somewhere in the middle. We think markets are better than any other alternative. To believe that markets work, to believe that free enterprise works, believe it works better than government bureaucrats, you do not have to believe it's perfect. You need to believe it works better than a panel of 20 experts making industrial policy.

So every once in a while if I say markets aren't perfect somebody assumes I hate markets. That's not the case. I'm a giant fan of markets. But we don't go as far as Gene. Gene, he makes great arguments and he's a smart guy and when I debate him I walk away questioning everything I'm about to tell you.

But we believe that there are odd, occasional bubbles, rarely, but that word is allowed. A real efficient marketer like Gene, that word's not allowed.

The tech bubble. I call it the tech bubble so you can tell what I think. I think that was a real bubble. I think it was very hard to make money from. If you identified it too early you lost. We talk about in our paper how Bob Shiller deserves a lot of credit for screaming about it, but if you listen to him from day one in 1996 he's still not right. We're still not back to those prices. So there is a big difference between saying bubbles exist and saying it's a real great way to make your career to identify them. Timing can be difficult. So on that front we're more towards Shiller, because we acknowledge the existence of bubbles. But we're more towards Fama because people like Shiller, to be honest, see a lot more inefficiencies than we do.

Forbes: Now, given your approach, and just do a minute on your fund, but your universe. You have the four styles of investing. 1,500 stocks, 20 indices, 10-year bond. Say fully invested almost short circuits your brain.

Asness: Yes. I get asked sometimes, "Are you fully invested?" First of all, this fund is designed to be ..

Forbes: By the way, there's AQR Style Premia Fund.

Asness: AQR Style Premia Fund. Thank you for mentioning it. And we do, across our firm, different designs. Some investors come and say, "I really want equity market exposure and I want you to try to beat that." And this fund we designed from scratch to take these four things that we think are known, have come out of the literature, that we think we do very, very solid versions of, diversify across them and implement in a risk-controlled but market-neutral way.

Every one of these four styles everywhere we do it, remember, stocks, currencies, bonds, is long and short very close to an equal amount. And so therefore it's been our experience and our hope going forward that we will make money over time but when we have tough times, which will happen, we don't run from that, it will hopefully not be the same time markets are having tough times. So we spread our bets long and short and do as many different things as you can.

Quants. I saw you smiling when you were saying how many thousand stocks, how many different this. That's because, while hopefully I'll argue is an intellectually honest way, quants are and should be cowards. I gave you four things: value, momentum, carry and low risk.

Forbes: Some areas you've got 12 value indicators across industries.

Asness: I'm doing an oversimplification. We might measure value 12 different ways to try to be robust. Any one way can be imperfect or break.

Forbes: Well, you make the point in your literature, one industry, one value indicator, could be absolutely irrelevant to another one.

Asness: I'm leaving out a fair amount of the gory details under the hood. I'll do it for you if it's a dare. I'll follow you home and tell you about it all night.

Forbes: Maybe we should keep in mind what Bismarck said. There are certain things you should not see being made, like sausages.

Asness: And long short value portfolios, perhaps. But when I say we're natural and intellectually correct to be cowards, imagine you found an individual stock that had all these characteristic, even all of the sub-ways we measure it. The founder could get hit by a bus the next day. Their best product someone else could figure out a better one the next day.

The last thing you would ever do is take a big, concentrated single bet based on a quantitative result. A individual may or may not be able to get that right.

And, again, I'd be not quite as cynical as Gene, but not quite as optimistic as a lot of the fund management industry that this is easy. But I know a quant method is not the way to do it. A quant method is playing the odds that this style works more than it doesn't. Therefore you don't want to be exposed to individuals. So when you correctly, because everyone does, smile at how broad what we do is, there's a reason for it. We're spreading our bets.

Now, when you ask about fully invested, a good question back is when you're long and short and targeting a certain amount of risk, and we do and they're geek measures. We target 2/3 of equity market risks. The swing should be about 2/3 of equity markets. It's a rough approximation. Through time, by being long and short, what does fully invested mean? We're long and short.

So there are times when the world is riskier, when our positions are smaller. You might say, "Oh, you're less than fully invested now because your positions are smaller." I would come back and go, "Well, maybe. Maybe not. We're only smaller because we think the world's scarier." So I do think when you get into a world of long and short and trying to create something uncorrelated, and I don't think there are many ways to create something uncorrelated, broadly speaking I think there are really two. Go balance long and short and do something like we're doing, or simply not mark things to market. That's meant to be a bit sarcastic.

If you don't tell people the prices it looks very uncorrelated. And there are some investments that go that route. So I don't think we have a choice. I think it's a wonderful option to have something that is unrelated to the market direction. But you do have to start thinking about things like, "How much risk am I taking?" as opposed to the standard language, "Am I fully invested?" "How much risk am I taking?" is a fair question. "Are you fully invested?" Guys like me, either we give a long winded speech like I just gave you, or we panic and have nothing to say.

Forbes: So since you gag at the idea of individual stocks, maybe even sectors, looking at stocks and bonds, are they both overpriced?

Asness: Yes. They are. And let me be careful to say you're picking value. When you say overpriced, you're picking one of our four themes. You're picking the right one if you're a very long-term investor. If you're going to say, "What are the next 10 years going to look like?" Don't look at momentum, certainly. Don't look at carry and don't even look at low risk. Value has some power to forecast the next decade.

So I have to be real explicit. The way we run the fund is looking for the best combination of all four of these. We are running a day-to-day fund. I don't think value as a whole is a great tool for market timing unless it gets to tech bubble-like extremes, maybe. But right now my favorite measure of value, and I look at many, it's not the only one by any means, is Bob Shiller's P/E. It's gotten very popular. I've been looking at it since the late '90s. And that's about the 85th percentile expensive back to 1926. So only 15% of the time has it been more expensive. It's occasionally been way more expensive.

So percentiles, people can use them to be tricky. Statisticians have all kinds of tricks. 85th percentile. We're at 25 on the Shiller P/E. The 100th percentile hit in early 2000 was 45. So we're nowhere near, I would not call this a bubble, I would just call this an expensive market.

The real bond yield, and that's just a 10-year bond minus our best guess of what economists are forecasting for inflation. I say our best guess because we have their actual guess for 20, 30 years. Databases don't exist and we have to guess at what they were guessing before that. But that's also about the 85th percentile. The difference between them is relatively normal. People focus on bonds because it feels much more measurable. And it's not a commercial for bonds. 85th isn't so good. But both are very similar.

So for truly long-term investors I would not use this time to market. I still think returns will be positive so if you're out of the market for the next 10 years that's not going to help. And I don't think you're going to get the exact timing right. But I would lower my expectations. Whether you're a pension plan or an individual with a sheet of paper trying to figure out, "How much do I need to retire?" If we are right that these higher than normal prices, lower than normal yields, are going to lead to positive but lower than normal returns, well, you have to use those.

We think a 60/40 portfolio of U.S. stocks and bonds has averaged about 5% over inflation historically. We think even if valuations stay high — and it could be worse if valuations fall, regression to the mean, if those P/E's come down it could be worse — but even if they stay high we think they're paused to offer 2% to 3% over inflation going forward.

Forbes: Well, let's close with that point.

Asness: Did I bring you down too much on that?

Forbes: You've said 2.5% real return.

Asness: Yes.

Forbes: That sucks.

Asness: You are obviously well-versed in the technical quantitative terms, but, yes, versus history that sucks. And it's funny. It's actually about the worst ever. And if you heard me, I said bonds are 85th and stocks are 85th. Neither were the worst ever. But what's particularly rare is both are in the 85th bad at the same time.

Even in the peak of the tech bubble where stocks made a new 100th percentile bad in terms of valuation. If you were long it was a new 100th percentile good every day. But if you cared about valuation and you didn't like these things, they made a new 100th percentile every day, bonds were offering you a fat 4% real yield on government bonds just for showing up. So very often these things are, at least to some degree, offsetting.

Right now we have a time where I don't think, and some disagree, that there's a tremendous trade in or out of stocks versus bonds. And I don't think you want to sell them both if you're long term because timing that is not an easy exercise. You're very likely to hurt yourself, I think more likely than to help yourself. I think the best to do is yes, it might suck, but it's still positive. And it's still the deal that we're being given. And I'm just going to continue to say suck. This is kind of fun. If something sucks but is the best deal out there, the one thing you don't want to do is ignore the bad news.

Have a sheet of paper that says, "I can retire." And by the way, pension funds do it in a more sophisticated way with actuaries and other things, but it's not that different than individuals with a spreadsheet or a sheet of paper. "What do I have to earn on these assets to meet my needs?"

If you don't acknowledge the 2.5% real, and you don't have to agree with my precise numbers, but if you don't acknowledge that these are expensive and going to return less, and go, "Well, I think inflation's going to be more like 3% and they're going to make their normal 7% real, so I think that stocks are going to make 10% going forward," I think that would be heroic. I meant in stocks 60/40 is going to make 10% going forward.

If you use that and it doesn't happen, that's where the trouble lies. So I think this stuff, while it might be depressing and not useful to jump in and out, it's actually quite useful for making your plans because you know what you've got to do. And the world, sadly, is up against a harder challenge than it normally is.

Forbes: Cliff, thank you.

Asness: Thank you.
