Overview

A story of investing

Traditional paradigm focuses on **historical performance**, but they overlook **asset class allocation**. When thinking about return, we have to think in terms of three return sources:

- Asset classes: stocks, bonds, alternative investments
- Strategy style: value, carry, momentum, etc
- Risk factors: growth, inflation, liquidity

With this concept in mind, investors can try to boost expected returns by:

- beta: taking risks that produce attractive rewards for all market participants (beta risks)
- alpha: by skillful active management (alpha) which may involve exploiting regularities and market inefficiencies.

But why the traditional way of using historical returns to forecast future returns didn't work:

- Bias: Any sample selection may be biased. For specific funds and strategies, the historical performance data that investors get to see are often upward biased. This bias is due to the voluntary nature of performance reporting and survivorship bias
- Relevence: In principle, longer historical windows reduce sample specificity and enable more accurate estimates of average returns. However, distant historical data may be irrelevant due to structural changes, apart from lower data quality.
- Cycle: Expected returns may vary over time in a cyclical fashion, which makes extrapolation of multi-year performance particularly dangerous.

In the old days, finance theories consist of **single-factor CAPM, efficient market, constant expected return**. However, nowadays we focus on expected return that is driven by the sources we listed above. A very important aspect of view change is that: **required asset return has little to do with asset's standalone volatility, but has more to do with when losses can be expected to occur**. Interestingly:

- Forward-looking indicators such as valuation ratios have a better track record in forecasting future asset class returns than rearview mirror measures.
- Long-run expected returns for any investment tend to be especially high following adverse events.