# Investing with style

**Paul Myles explains the broader diversification benefits that occur when investing using styles**

In traditional diversified investment portfolios, returns are typically thought to be determined by two principal drivers: market exposure (beta) and fund manager skill (alpha). If, however, you deconstruct the alpha element, you can identify a third set – 'styles' and the intrinsic outperformance of 'premia' that they generate.

### What is a style?

In technical terms, a style is a quantifiable characteristic of a group of stocks or bonds that determines the risk and return of that group. In practical terms, it is a potentially important source of diversification and added value for your portfolio.

The most recognised equity styles are typically either valuation-based, calculated by using 'book-to-price' and 'price-to-earnings' ratios, or growth-based using measures such as 'earnings growth'. Well-known investment styles include Value, Size, Momentum, Quality, Low Volatility and Growth at a Reasonable Price (GARP).

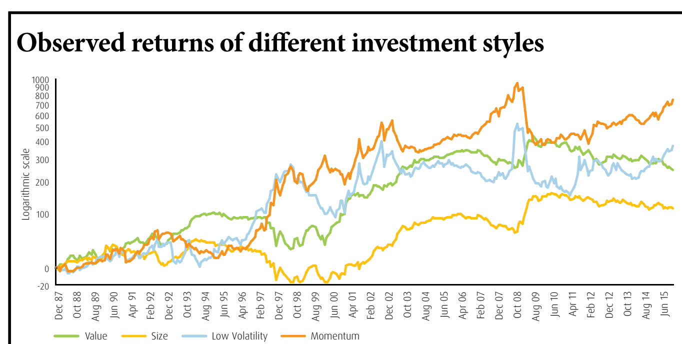
Having been identified in academic studies as long ago as the early 1990s, styles are not new. With markets suffering heightened levels of volatility, an increasing number of professional investors are waking up to the benefits of styles: broader diversification with relatively low correlation.

Another reason that style investing is becoming more popular is performance. Analysis has shown that many styles deliver consistently positive returns over multiple periods and at an acceptable level of risk. But as past performance can be no guarantee for the future, should investors reasonably expect these characteristics to persist?

### Why do styles work?

Some argue that the persistent positive returns are a compensation for taking risk – this is very much an efficient market point of view. Others say that these returns are the result of behavioural biases in investors – e.g. mistaking a good company for a good investment. Our view is that it is likely that both effects play a role. What is crucial is that under each hypothesis the efficacy of styles can be expected to persist.

**Observed returns of different investment styles**




Source: BMO Global Asset Management, December 1987 to December 2015. For illustrative purposes only. Universe: MSCI World. The returns represent observed outcomes of zero investment portfolios that go long the top 20% of stocks with each particular attribute and go short the bottom 20%, rebalanced monthly, and do not include any transaction costs. This information is not a representative investment strategy but an indication of the efficacy of each style.

### Do style characteristics persist over time?

We believe that, in reality, both the efficient market and behavioural explanations make contributions to the persistence of styles. That said, it doesn't really matter where the effect comes from as both can be expected to persist on their own merits. For the efficient market/risk compensation theory, risk does not go away. While you may lose on shorter periods, over longer-term horizons you can expect to be rewarded. For behaviour, people's natural biases have been ingrained for thousands of years and you can't expect that to change in just a couple of decades.

The counter argument to this expectation of persistence is that the markets are getting ever-more efficient. But styles are not technical arbitrage opportunities, the very fact the majority of assets are still being managed in the traditional way means that there is less chance of these style effects disappearing.

### Applying styles

The best known application of style investing is to use styles as a complement to long-only equity portfolios. This is, in our opinion, a worthwhile way to manage a long-only equity portfolio that can be expected to have better returns than a passive portfolio and lower management fees than an equivalent active portfolio. It is, however, by no means the only application of style premia investing.

Style premia investing offers the opportunity to create a market neutral long/short portfolio that not only generates good absolute returns with controlled volatility but will also exhibit a low correlation with the primary risks in multi-asset portfolios e.g. equities and bonds.

So with the potential for more reliable and less correlated returns at a lower cost, it seems that by investing 'with style', you can have your cake and eat it.

**Written by Paul Myles, director, institutional business, BMO Global Asset Management**

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