Compendium of lessons for investors

A review of 'Expected Returns. An Investor's Guide to Harvesting Market Rewards' by Antti Ilmanen, published by Wiley Finance, February 2011, 594pp, price: £45/€54

This is a welcome new compendium on "the general topic of expected returns from investment". It uniquely combines the current state of financial theory and empirical evidence with useful practical guidelines. The choice of title 'Expected Returns' clearly puts the emphasis on the sources of returns available in the markets. It also condenses one of Ilmanen's key messages, that investors should concentrate more on 'expected' performance and 'forward-looking' tools (instead of the more comfortable extrapolation of historical data).

An enormous breath of topics is covered in the book. Part I starts off with the historical record of market returns, followed by an overview on theories of return determination.

Part II identifies 12 main sources of return in three groups. There is no consensus about the number and definition of return-generating factors in the market, and new ones seem to be 'detected' every month.

The author then moves on to 'dynamic strategies', a second and more questionable pool of return sources, and some already feel out-of-date after the recent financial crisis.

In Part III, Ilmanen evaluates more old and new investment themes, including seasonal, cyclical and secular return patterns; new concepts such as endogenous risk and feedback loops; forming return expectations and forecasting models; and portfolio management issues such as diversification, leverage, time horizon, active vs passive, costs and others.

No short summary could do justice to the amount of concepts and ideas presented in the book. The busy practitioner will find 'takeaways for long-horizon investors' in the last chapter.

Finance theory is changing: current academic views are more diverse, less tidy, and more realistic than they used to be (page 10). This book presents all possible extensions, revisions and upheavals of the classic paradigm of modern finance, the paradise lost. Ilmanen takes the rational approach to market analysis as far as possible, with a particular preference for time-varying risk premia and multiple systematic factors. Irrationality comes in as explanation of last resort. "Behavioural finance literature is fun and offers stories for most observed empirical anomalies, perhaps too easily,"(page 87).

Unfortunately, the advances in finance have not resolved certain fundamental dilemmas. Empirical evidence cannot distinguish between rational and irrational explanations. Even worse, risk premia remain unobservable ex-ante and of limited significance ex-post.

Ilmanen knows his data, mostly from US markets, and gives all thinkable health warnings on their interpretation. "Any observed return predictability is mild, possibly spurious, and rarely robust," (page 17).

Could there possibly be anything missing? Yes, there is no proper institutional perspective on investing. Terms like supply-demand effects, market frictions, political cycle, taxes, regulation, pension liabilities and institutional governance are mentioned but there is no systematic account of their significance for "expected returns".

Ilmanen's approach could look eclectic but he does not hide his preferences, especially for value (versus growth), yield, risk factor diversification (versus traditional asset class allocation), "prudent leverage", and "view-based" active management, conscious of costs.

"My recommendation for true long-horizon investors is contrarian. Save ammunition in good times and gradually take advantage of episodes when liquidity and other premia widen out, while recognising that nobody can be a perfect market-timer," (page 374). In the end, that sounds not so different from what juniors heard from their seasoned investment colleagues some time ago, well before the days of modern finance.

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