A S S E T   A L L O C A T I O N

Expected Returns: An Investors Guide to Harvesting Market Rewards

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Finance theories have changed dramatically over the past 30 years, away from the restrictive theories of the single-factor CAPM, efficient markets, and constant expected returns. Current academic views are more diverse, less tidy, and more realistic. Expected returns are now commonly seen as driven by multiple factors.

Some determinants are rational (risk and liquidity premia), others irrational (psychological biases such as extrapolation and overconfidence). Expected returns on all factors may vary over time.

This book covers the general topic of expected returns on investments. The traditional paradigm among institutional investors focuses too much on historical performance and too narrowly on asset class allocation. This book argues that investment decision making should be broadened beyond the asset class perspective and a wider set of inputs should be used for assessing expected returns.

The book considers in detail a wide range of return sources: major asset classes (stocks, bonds, and alternative investments) and strategy styles (value, carry, momentum, and so forth) as well as risk factors (such as growth, inflation, and liquidity). The main inputs — beyond discretionary views — for investors to judge expected returns are (1) historical performance, (2) theories, and (3) forward-looking indicators. A better understanding of these inputs and a better balance among them is needed.