FACTOR TIMING

Contrarian Factor Timing is Deceptively Difficult

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The increasing popularity of factor investing has led to valuation concerns among some contrarian-minded investors, and fears of imminent mean-reversion and underperformance. In this paper, the authors find that despite their recent popularity the most common factors or styles, namely the value, momentum and defensive styles, are not, in general, markedly over-valued as measured by their value spreads.

More broadly, tactical timing, whether of markets or factors, always seems to hold appeal for many. The authors look at the general efficacy of value spreads in predicting future returns to styles. At first glance, valuation-based timing of styles appears promising. This is not surprising as it is a simple consequence of the efficacy of the value strategy itself. Yet when the authors implement value timing in a multi-style framework that already includes the value style, they find somewhat disappointing results. As value timing of factors is correlated to the standard value factor, it adds further value exposure, but as compared to an explicit risk-targeted strategic allocation to value, value timing provides an intermittent and sub-optimal amount of value exposure. Thus, according to the authors, tactical value timing can reduce diversification and detract from the performance of a multi-style strategy that already includes value. Finally, the authors explore whether value timing works better at longer holding periods or at extremes, still finding fairly weak results.

Contrarian value timing of factors is, generally, a weak addition for long-term investors holding well-diversified factors including value and, specifically, not sending a strong signal on stretched valuations today.

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