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A Reality Check on Stock-Market 'Anomalies'

WSJ Wealth Expert Wesley Gray discusses his takeaways on research about anomalies in the market. PHOTO: GETTY IMAGES/ISTOCKPHOTO

By

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Investors looking to take advantage of "anomalies" in the stock market may want to read this first.

Three academics have been making waves in the investing community with a paper published earlier this year that challenges much of the research out there about market "anomalies." In the paper, "Replicating Anomalies" Lu Zhang and

his colleagues, Kewei Hou and Chen Xue, spent nearly three years compiling and replicating 447 market anomalies identified in academic literature.

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Their takeaway, as a recent WSJ article nicely summarized: "Most of the supposed market anomalies academics have identified don't exist, or are too small to matter."

To be sure, the paper is so dense we even created a blog post that outlines, "How to read the Lu Zhang paper." But what is inside is of great value to everyday investors.

In fact, this paper will make you question deeply held investment beliefs. For example, do you believe, like many investors do, that searching for high-dividend yielding stocks is a sound approach for generating higher returns? Think again.

I recently sat down to talk with Prof. Zhang and here are five of my most important takeaways:

1. The market is probably more efficient than you think. The professors rebuilt and backtested 447 documented so-called market anomalies. On the face of it, 447 anomalies would seem to suggest the market is pretty easy to beat. But they found that 54% of these anomalies cannot be replicated.

And it gets worse...much worse. If one minimizes the effect that small-cap stocks have on the results, 85% of the anomalies cannot be replicated. Think about that: Among relatively liquid securities, only 15% of the strategies analyzed can be replicated.

For most investors, these results suggest we avoid the newest backtested strategies hitting the market and focus on fairly generic low-cost broad-based index funds.

2. The classic investing factors–value and momentum–survive scrutiny. Value, generally represented by portfolios of cheap stocks, holds up well in the analysis, earning higher expected returns than the general market and growth stocks. Momentum, or strategies that hold onto winners, also hold up. Important

to note, the simplest momentum strategies, based on past returns, hold up the best relative to fancier momentum strategies (e.g., momentum strategies related to earnings surprises).

Investors should take this as a warning when looking at momentum-based funds: Be skeptical of complex momentum strategies that tell a great story, but may not be backed by the evidence.

3. Cheap companies with high return on equity generate the highest expected returns. My first question when reading this paper was simple: What strategy will generate the highest expected returns over the long-haul? I asked Prof. Zhang and got a fairly direct response: low investment companies with high return on equity.

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In other words: Buying baskets of stock in small companies that are cheap (i.e., value) and have high returns on equity (i.e., quality). For many Warren Buffett aficionados, this should come as no surprise. He has often preached, "...Price is what you pay, value is what you get."

4. Portfolio construction matters. A lot. When forming a portfolio there are a lot of decisions to be made that go beyond the "factor" or process. For example, small caps or large caps? Should you equal-weight or market-cap weight the positions (akin to the S&P 500 Index)? How frequently should the portfolio be rebalanced? Monthly? Quarterly? Annually?

The unfortunate conclusion from the paper is that portfolio construction may end up driving more of your performance than the underlying factor. But these general rules seem to capture the big muscle movement takeaways from the massive research project:

- Small stocks are preferable to larger stocks
- Equal-weight is better than market-cap weighting
- Rebalancing more is better than rebalancing less

5. Don't believe everything you read. This paper represents a large-scale replication effort to help the academic-research profession summarize what works and what doesn't. Of the 447 potential factors, a mere 15% pass an initial replication test. And these verified factors represent strategies investors have known about for decades. For example, buy cheap stocks, buy winners, buy quality and so forth.

In short, there isn't much new on the scene these days, despite piles of academic research suggesting there are potential gold nuggets throughout the marketplace. Even academics can confuse themselves and make life more complicated than it really needs to be.

And be skeptical of fund-management companies that hire famous academic researchers with the hope of improving their offerings. One must always ask the real question: Is this fancy professor being hired to help the process? Or is the hire a marketing ploy to sell a product?

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MARKET EFFICIENCY MOMENTUM INVESTING PORTFOLIO CONSTRUCTION

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