Time-Varying Expected Returns

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Outline

- Shifting consensus on constant versus time-varying expected returns, thanks to empirical experience
- Long-horizon investors have a "natural edge" in contrarian asset allocation (timing)
- Exploiting any return predictability is not easy and should be done with humility

Evolving Minds on Time-Varying Expected Returns

- Market timing no longer has a bad name. The boom-bust cycles of 2000s have helped change the “conventional wisdom.”

- Professor John Cochrane (AFA 2011) argued that there had been a 100% reversal in academic thinking in the past 20 to 30 years:

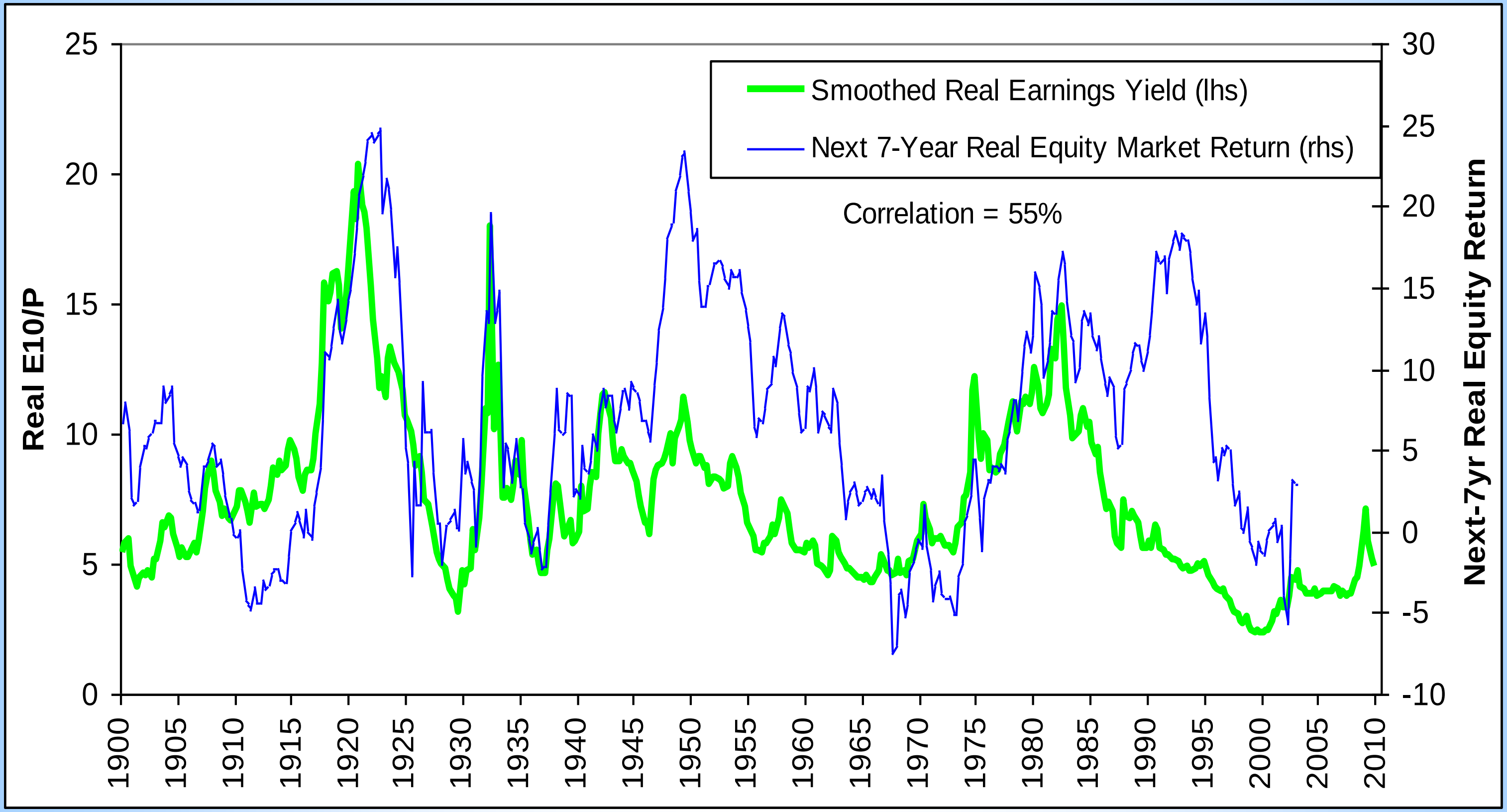
  The equity premium is no longer thought to be constant over time. All time-variation in market valuation ratios was once thought to reflect changing growth expectations (with an unchanging ex ante required risk premium), while now all such variation is thought to reflect changing required returns.

- Academic and practitioner debates continue, however

Return Predictability Evidence on Equity Premium

- Whatever the underlying reason for time-varying expected returns is (wealth-dependent risk aversion, changing volatility or demographics, sentiment,…), prospective returns are higher from better starting-valuation levels.

Valuation ratios have predicted subsequent multi-year equity market returns in the U.S.



Long-Horizon Edge

- If time-varying market risk premium reflects wealth-dependent investor risk aversion, “cool-headed” long-horizon investors may have a natural edge in timing

- Think of 2008: For most investors, risk appetite fell at least as fast as wealth, so the higher expected returns did not trigger a rush to buy.

- Long-horizon investors with *more stable risk tolerance* than the average investor can exploit these opportunities
  - ⇒ contrarian buying (or “liquidity provision”) amidst market distress
  - ⇒ arguably the most obvious way to capitalize on the long horizon

Not Easy

Positive empirical evidence about contrarian market timing boosting long-run returns and a compelling story telling why long-horizon investors have a natural edge here.

What is there not to like?

- Uncertainty about the forecast – both short-term and long-term
- Tension between valuations and views (structural changes)
- Concentrated risk-taking => poor diversifier
- Career risk, danger of procyclic capitulation: Early = Wrong

How To Do It?

If you do market timing, …

- …do it with humility
- …do it on many fronts
- …do it with multiple indicators
- …do it systematically (though maybe with a discretionary overlay)
- ...ensure that not fall for the trap of procyclic investing
- ...think hard about resources, governance, accountability
- ...evaluate success over a long horizon

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