Editorial

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I have been looking recently at models that explain style investing. In a previous editorial, I looked at the impact of macro-economic factors in determining style returns. Here we want to look how style factors may explain stock returns or how they may co-move with stock returns. At one level we have papers of the Fama-French school, which use style factors to explain cross-sectional variation in stocks; there are many of these, indeed not all of them are interesting. Masters' dissertations with titles like 'Value and Growth in the New Zealand Equity Market; some Empirical Findings,' can cause a great deal of anguish to a sensitive reader. Discussions as to the nature of the excess return, whether it be alpha or risk premium, tend to be a little more interesting. Papers that try to model the style outcomes in terms of accounting ratios and dynamic processes seem quite a lot more interesting. These tend to be very rare, and we hope to publish one in this vein in a future volume of *JAM*.

To me, at least, attempts to relate style investing to psychological aspects of the investor are very interesting indeed. The most well known in this category is the paper by Barberis and Shliefier, 'Style Investing',

published in the *Journal of Financial Economics* (2003). We look forward to publishing some extensions to this approach in *JAM* in the immediate future. The essence of the ideas behind this approach is that investors have a fixed asset allocation for equity in the short run and move funds around based on their recent relative performance. If they increase their demand for value, they reduce their demand for growth. Correlations are now endogenous and reflect, *inter alia*, the way the stock is being classified. Readers with some memory of the late 1990s equity market will recognise some of the phenomena being described.

What remains to be done in this area, other than more polished extensions of the existing approaches? Certainly, one line of analysis I would like to see would be theoretical and applied model-building that captures the capacity of a style. How many billions can active quant put into style rotation before liquidity risk makes the expected returns unattractive?

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