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## PERSPECTIVES

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# My Top 10 Peeves

Clifford S. Asness

*The author discusses a list of peeves that share three characteristics: (1) They are about investing or finance in general, (2) they are about beliefs that are very commonly held and often repeated, and (3) they are wrong or misleading and they hurt investors.*

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Saying I have a pet peeve, or some pet peeves, just doesn't do it. I have a menagerie of peeves, a veritable zoo of them. Luckily for readers, I will restrict this editorial to only those related to investing (you do not want to see the more inclusive list) and to only a mere 10 at that. The following are things said or done in our industry or said about our industry that have bugged me for years. Because of the machine-gun nature of this piece, these are mostly teasers. I don't go into all the arguments for my points, and I blatantly ignore counterpoints (to which I assert without evidence that I have counter-counterpoints). Some of these are simple, so perhaps the teaser suffices. But some deserve a more thorough treatment that hopefully I, or someone else, will undertake. Some are minor, truly deserving the title "peeve," and some, more weighty. In each case, as befits an opinion piece, it's not just my discussion of the peeve but the very prevalence of the peeve itself that is my opinion. I do not extensively cite sources for them. I contend that they are rather widespread throughout the land of financial media, pundits, advisers, and managers. Thus, citing one or two sources would be unfair, and citing them all, impossible. Therefore, please feel free to disagree not just with my discussion of the peeves but also about their very existence! Without further ado, here is a list of things held together by only three characteristics: (1) They are about investing or finance in general, (2) I believe they are commonly held and often repeated beliefs, and (3) I think they are wrong or misleading and they hurt investors.

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### 1. "Volatility" Is for Misguided Geeks; Risk Is Really the Chance of a "Permanent Loss of Capital"

There are many who say that such "quant" measures as volatility are flawed and that the real definition of risk is the chance of losing money that you won't get back (a permanent loss of capital). This comment bugs me.

Now, although it causes me grief, the people who say it are often quite smart and successful, and I respect many of them. Furthermore, they are not directly wrong. One fair way to think of risk is indeed the chance of a permanent loss of capital. But there are other fair methods too, and the volatility measures being impugned are often misunderstood, with those attacking them setting up an easy-to-knock-down "straw geek."

The critics are usually envisioning an overvalued security (which, of course, they assume they know is overvalued with certainty) that possesses a low volatility. They think quants are naive for calling a security like this "low risk" because it's likely to fall over time. And how can something that is expected to fall over time—and not bounce back—be low risk?

What we have here is a failure to communicate. A quant calling something "low risk" is very different from a quant saying, "You can't lose much money owning this thing." Even the simplest quant framework allows for not just volatility but also expected return.<sup>1</sup> And volatility isn't how much the security is likely to move; it's how much it's likely to move versus the forecast of expected return. In other words, after making a forecast, it's a reflection of the amount you can be wrong on the upside or downside around that forecast. Assuming the quant and non-quant agree that the security is overvalued (if they don't agree, then that is an issue separate from the definition of risk), the quant has likely assigned

it a negative expected return. In other words, both the quant and the non-quant dislike this security. The quant just expresses his dislike with the words “negative expected return” and not the words “very risky.”

A clean example is how both types of analysts would respond to a rise in price unaccompanied by any change in fundamentals now or in the future. On the one hand, those who view risk as “the chance of permanent loss” think this stock just got riskier. Viewed in their framework, they are right. On the other hand, quants tend to say this stock’s long-term expected return just got lower (same future cash flows, higher price today) rather than its risk/volatility went up, and they too are right!

It is also edifying to go the other way: Think about a super-cheap security, with a low risk of permanent loss of capital to a long-term holder, that gets a lot cheaper after being purchased. I—and everyone else who has invested for a living for long enough—have experienced this fun event. If the fundamentals have not changed and you believe risk is just the chance of a permanent loss of capital, all that happened was your super-cheap security got super-duper cheap, and if you just hold it long enough, you will be fine. Perhaps this is true. However, I do not think you are allowed to report “unchanged” to your clients in this situation. For one thing, even if you are right, someone else now has the opportunity to buy it at an even lower price than you did. In a very real sense, you lost money; you just expect to make it back, as can anyone who buys the same stock now without suffering your losses to date.

If you can hold the position, you may be correct (a chance that can approach a certainty in some instances if not ruined by those pesky “limits of arbitrage”).<sup>2</sup> For example, when my firm lost money in 1999 by shorting tech stocks about a year too early (don’t worry; it turned out OK), we didn’t get to report to our clients, “We have not lost any of your money. It’s in a bank we call ‘short NASDAQ.’” Rather, we said something like, “Here are the losses, and here’s why it’s a great bet going forward.” This admission and reasoning is more in the spirit of “risk as volatility” than “risk as the chance of a permanent loss of capital,” and I argue it is more accurate. Putting it yet one more way, risk is the chance you are wrong. Saying that your risk control is to buy cheap stocks and hold them, as many who make the original criticism do, is another way of saying that your risk control is not being wrong. That’s nice work if you can get it. Trying not to be wrong is great and something we all strive for, but it’s not risk control. Risk control is limiting how bad it could be if you are wrong. In other words, it’s about how widely reality may differ from your forecast. That sounds a lot like the quants’ “volatility” to me.

Although I clearly favor the quant approach of considering expected return and risk separately, I still think this argument is mostly a case of smart people talking in different languages and not disagreeing as much as it sometimes seems.<sup>3</sup>

## 2. Bubbles, Bubbles, Everywhere, but Not All Pop or Sink

The word “bubble,” even if you are not an efficient market fan (if you are, it should never be uttered outside the tub), is very overused. I stake out a middle ground between pure efficient markets, where the word is verboten, and the common overuse of the word that is my peeve. Whether a particular instance is a bubble will never be objective; we will always have disagreement *ex ante* and even *ex post*. But to have content, the term *bubble* should indicate a price that no reasonable future outcome can justify. I believe that tech stocks in early 2000 fit this description. I don’t think there were assumptions—short of them owning the GDP of the Earth—that justified their valuations. However, in the wake of 1999–2000 and 2007–2008 and with the prevalence of the use of the word “bubble” to describe these two instances, we have dumbed the word down and now use it too much. An asset or a security is often declared to be in a bubble when it is more accurate to describe it as “expensive” or possessing a “lower than normal expected return.” The descriptions “lower than normal expected return” and “bubble” are not the same thing.

As a current example, take US government bonds. They are without a doubt priced to offer a lower prospective real return now than at most times in the past (as, in my view, are equities). But could it work out? With an unchanged yield curve, which is certainly possible, you would make a very comfortable 4%+ nominal (call it 1%–2% real) a year now on a 10-year US bond, and to find a case where bonds worked out from similar levels, one only has to utter the word “Japan.” Does this make bonds a particularly good investment right now? No. Does it show that they do not satisfy the criteria for the word *bubble*, thereby demonstrating how the word is overused? Yes.

## 3. Had We But World Enough, and Time, Using Three- to Five-Year Evaluation Periods Would Still Be a Crime

Nobody, including me in this essay, wants to deal with the very big problem that we often do not have enough applicable data for the investing decisions we make. We evaluate strategies, asset classes,

managers, and potential risk events using histories the statisticians tell us are too short or too picked over. These histories are generally insufficient and very vulnerable to such things as data mining, *ex post* selection of winners who don't repeat (though it's generally churlish to be horribly disappointed when your monkey who typed *Hamlet* produces only *Coriolanus* next time), and simple randomness.

Too often, we default to thinking like, "We have to make decisions, and even if historical data are inadequate, you have nothing better to offer, so we'll use what we have." I think there is something better. Investors should elevate judgment (not minute-by-minute judgment but judgment in portfolio and strategy selection) and a consistent philosophy to be more equal partners with data.<sup>4</sup>

But all of these issues are subject for a much longer piece. Here, I set my sights (and peeve) on easier game. Not only are insufficient data often driving our decisions, but the data we have are often used with the wrong sign. I refer to the three- to five-year periods most common in making asset class, strategy, and manager selection decisions. One of the few things we do know is that over three to five years, pretty much everything has shown some systematic, if certainly not dramatic, tendency to mean revert (especially when one accounts for and avoids the powerful effect of momentum at shorter horizons). This means that when we rely on three- to five-year periods to make decisions—favoring things that have done well over this time period and shunning things that have done poorly (note the past tense)—we aren't just using data meaninglessly; rather, we are using data backwards. Essentially, with a disciplined approach, value and momentum are both good long-term strategies, but you don't want to be a momentum investor at a value time horizon. That's precisely what many of us who use three- to five-year periods end up being.

#### 4. Whodunit?

The war continues over whether the 2007–08 financial crisis was caused by government or by the big banks. This debate is another clear candidate for a far longer exploration, but a few peevish jump out. Those who have read some of my other work will, I hope, be pleasantly surprised at the nonpartisan nature of my ire here. My first peeve is with the idea that we will ever find, or should find, one real culprit. When any bubble bursts (yes, I remember Peeve 2 and still choose the word "bubble") and a global financial meltdown follows, nearly everyone shares some blame. You can't get a good bubble off the ground without government, the financial industry (including not just bankers, who are often

the named party, but the whole real estate industry, the entire mortgage finance industry, rating agencies, and others), and regular individuals (nobody wants to lay any blame on Main Street; where is the political hay in that?) acting stupid and short-sighted (e.g., quitting real jobs to flip houses).

My second, and more important, peeve regarding this issue is that the typical narratives and debates conflate two events. We had (1) a real estate/credit bubble in prices that, upon bursting, precipitated (2) a massive financial crisis. The collapse of the real estate/credit bubble did not have to lead directly to the financial crisis. See the tech bubble's deflation for a clear counterexample.<sup>5</sup> The questions of who should shoulder what share of the blame for the real estate bubble and who should shoulder what share of the blame for the financial crisis do not necessarily lead to the same answer. There are basically two sides here: What you might call the progressive "left" wants to blame Wall Street, and what you might call the libertarian "right" wants to blame government. Both sides act like they're arguing with each other even though the blame-the-government side is mostly talking about the creation of the real estate bubble and the blame-the-banks side is mostly talking about the financial crisis. They are both being, perhaps, rational—if not always honest—debaters, and without picking a winner, I'd say they are both focusing on what's best for their argument. But much of the time, they are not really debating each other. Although perhaps it is ultimately hopeless because of inherent difficulty and all our personal biases, until we treat these as two separate, deeply related,<sup>6</sup> but sequential events to which all major parties contributed to some degree, we haven't a prayer of really understanding what happened and making serious headway on reducing the risk of it happening again (which, by the way, I don't think we've done much of—a peeve for another day).

#### 5. I Would Politely Request People Stop Saying These Things

**"It's a stock picker's market."** I don't know what it means to say, "It's a stock picker's market." It may mean the whole market isn't going straight up now so you have to make your money picking the right stocks, but I don't understand why active managers would suddenly get better at stock picking at those times. Note that I do think a valid use of this concept may occur when, after adjusting for market moves, there is not a lot of dispersion in stock returns, meaning that individual stocks tend to move in lockstep, leaving little idiosyncratic volatility—a necessary (but not sufficient!) ingredient to generate

outperformance (assuming one is unwilling to lever up smaller differences at these times). But that's a quant measure, and I don't think that's what many people mean by this comment. I think they mean, "We will have to pick stocks now because the market isn't making us money the easy way." To the extent I'm wrong, I withdraw the peeve (is there a specific form I need to file for that?).

Similarly, you often hear financial professionals say such things as, "Forecasting market direction from here is exceptionally difficult" in a tone conveying, "Gee, this is really strange." Well, I think forecasting the market over short-term horizons is always exceptionally difficult. If they said, "Our market-timing forecasts are mostly useless most of the time, but right now, they are completely useless," I suppose I'd be OK with it, but I'm not holding my breath that they will.

**"Arbitrage."** The word "arbitrage" in academia means "certain profits," whereas in practical investing, arbitrage often means "a trade we kind of like." Some in the industry adhere to a perhaps reasonable middle ground: that arbitrage is not riskless, but unlike much of investing, it involves going long and short very similar securities and betting on a price difference. I can live with that. But it is clear that many use it in the loosest sense and, therefore, strip it of its meaning.

**"There is a lot of cash on the sidelines."** Every time someone says, "There is a lot of cash on the sidelines," a tiny part of my soul dies. There are no sidelines. Those saying this seem to envision a seller of stocks moving her money to cash and awaiting a chance to return. But they always ignore that this seller sold to somebody, who presumably moved a precisely equal amount of cash off the sidelines.

If you want to save those who say this, I can think of two ways. First, they really just mean that sentiment is negative but people are waiting to buy. If sentiment turns, it won't move any cash off the sidelines because, again, that just can't happen, but it can mean prices will rise because more people will be trying to get off the nonexistent sidelines than on. Second, over the long term, there really are sidelines in the sense that new shares can be created or destroyed (net issuance), and that may well be a function of investor sentiment.

But even though I've thrown people who use this phrase a lifeline, I believe that they really do think there are sidelines. There aren't. Like any equilibrium concept (a powerful way of thinking that is amazingly underused), there can be a sideline for any subset of investors, but someone else has to be doing the opposite. Add us all up and there are no sidelines.<sup>7</sup>

## 6. The First Step Is Admitting It

To me, if you deviate markedly from capitalization weights, you are, by definition, an active manager making bets.<sup>8</sup> Many fight this label. They call their deviations from market capitalization—among other labels—smart beta, scientific investing, fundamental indexing, or risk parity.<sup>9</sup> Furthermore, sometimes they make distinctions about active versus passive based on why they believe in their strategies. You can believe your strategy works because you're taking extra risk or because others make mistakes, but if it deviates from cap weighting, you don't get to call it "passive" and, in turn, disparage "active" investing. This peeve may be about form over substance—marketing versus reality—but these things count.

In particular, some of the discussion these days about "smart beta" refers to it as "a better way to get market exposure." It's not. It may indeed offer added return, and many who offer smart beta do it with value tilts (which I like). But whether it is profitable and a good idea is an issue separate from whether it is active or passive. Calling it "a better way to get market exposure" frames it incorrectly. A smart beta portfolio, SB, is equal to a cap-weighted index, CW, plus the deviation of SB from CW. For those who like really simple equations:  $SB = CW + (SB - CW)$ . The expression  $(SB - CW)$  indicates a kind of simple long-short portfolio (for smart beta, it's usually designed so that the net SB is not really short anything) representing a bet. Note that this is not unique to today's smart beta discussion. For instance, the justly famous Fama-French HML portfolio is simply a long-short portfolio.<sup>10</sup> If you add it to a cap-weighted index, you don't get "better market exposure"; you get market exposure plus a separate bet on value investing. Like HML, the tilt from CW to SB also may be a good bet if offered at a fair fee (again, I love some of these strategies as if they were my own).<sup>11</sup> And, relating this to the topic of fees, of course they matter a lot. By my definition, an active portfolio does not have to have high fees (the fair fee depends on the size of the deviation from cap weighting, the expected risk-adjusted performance per unit of deviation, and the uniqueness of the active tilt). But again, a tilt, even if fairly priced, is still an active bet.<sup>12</sup>

I think people should call a bet a bet. If you own something very different from the market, you're making a bet and someone else is making the opposite bet. You might believe in your bet because you are being compensated for taking a risk, because the market has behavioral biases, or because your research is just that good. Your bet might be low or high turnover. But, regardless, you aren't passive.<sup>13</sup>

## 7. To Hedge or Not to Hedge?

There has been a flurry of discussion regarding hedge fund performance these days, with the highlight (or low light) being a rather priapic cover of *Bloomberg Businessweek* on the topic. But much of the discussion of hedge fund returns is just not cogent. Here, I feel a little like a brother to other hedge fund managers (not in the true fraternal sense but in the sense of “Nobody picks on my brother but me”).<sup>14</sup> When other people overstate the virtues of hedge funds, I become a critic, as my firm has been quite a few times in the past. But when other people attack them unfairly, I defend them.

The big disconnect here is that hedge funds are not fully hedged vehicles (I have long lobbied for hedge funds that fully hedge—see Asness, Krail, and Liew [2001]—but it’s still not the reality on the ground). But they are also not fully long the equity market. Many hedge funds have averaged about 40%–50% equity exposure over the long term, although that number certainly has varied through time.<sup>15</sup> So, in some years, like the current one, the press runs story after story about how hedge funds are being trounced by long-only stock indices (as an aside, out of simple familiarity, the press also focuses on the US stock market, which is trouncing the world this year, even though hedge funds tend to be more global, making the comparison seem more dire). In other years, when markets are down, commentators can oddly be overly generous to or overly critical of hedge funds. Sometimes, they ignore all evidence that hedge funds are net long stock markets and can get shocked and dismayed that “so-called uncorrelated” hedge funds are down at all with the market, even if they are down substantially less. In contrast, they may laud hedge funds as heroes because they are down less than the market (because, although not fully hedged, the funds are rarely fully long the equity market either). On this most basic issue of market exposure, popular reports are almost always breathlessly, excitedly misleading in one direction or another—be it scorn or praise. It’s admittedly a hard thing to deal with because partial exposure is a more complicated story than having zero exposure or being fully invested (furthermore, as a group, hedge funds’ exposure can vary over time, and this exposure can vary tremendously across individual funds). But the solution cannot be to ignore the problem and always purport to have found something extreme.

More generally, in my opinion, there are great problems and great promise in the hedge fund world. Hedge funds carry out strategies that are quite valuable (producing return with low correlation with traditional markets), such as merger and convertible arbitrage, derivatives-based trend

following, macro trading based on value and carry that are not available in other formats, and even a level of bespoke stock picking I claim no expertise in evaluating but that certainly may be valuable (particularly in a stock picker’s market). The problem is that as a group, they do these things without hedging enough and, worse, they charge fees—especially performance fees—as if they were providing purely uncorrelated returns (this could be fixed by charging lower fees or performance fees based on a comparison with their expected passive net long position) on strategies that they often claim are unique to them (many are quite well known).

But I digress. My peeve is that hedge fund reporting, by both the media and industry, is almost always wrong, but in a fascinatingly varied kind of way depending on market direction and the inclination of the commentator. My hope is that this reporting and the whole hedge fund industry can improve and become a better value proposition for investors.<sup>16</sup>

## 8. I Know Why the Sage Nerd Pings

This peeve is about the rolling brouhaha over “high-frequency trading” (HFT); I believe it’s massively overwrought. HFT is mostly a good thing, not an evil conspiracy to crush Main Street. I should mention that my firm is quantitative and algorithmic but is not even close to being a high-frequency trader; we mostly have long-term views and tend to hold our positions for quite a while. But being quantitative and algorithmic is frequently, and incorrectly, mistaken for being high frequency.

I believe that most asset managers trade cheaper, and their investors are thus better off, because highly efficient high-frequency traders have largely replaced the traditional high-priced market making of the past. HFT is how modern market making in a technologically advanced world is done, and there is no going back (which doesn’t preclude continued discussions about regulatory tweaks; I’m not vouching for every individual high-frequency trader or every practice of their trading).<sup>17</sup> It’s cheaper because it smashed the old dealer and exchange cartel (providing a much lower barrier to entry for competing market makers), democratized flow information, and replaced very expensive humans trading a handful of securities with very cheap machines trading a great many.

To be more specific, I believe small investors, whose trade quantities tend to be fully satisfied by the size of the inside market quote, are obvious winners because the bid–ask spread is now much tighter. But traders who try to trade large amounts very quickly—and often foolishly, in my view—still benefit from lower costs because of HFT, in spite of

the protestations of some of them. This assertion is, admittedly, hard to prove or disprove, but I suspect that before HFT, big traders didn't see prices move as immediately (as they should in a more efficient market, which HFT has created). Although this initial lack of price movement may seem like a boon, you must recall that they were still facing a much larger bid-ask spread in those days. It is quite possible that they have mistaken that initially lower market impact with their all-in costs being lower in the old days (of course, in the old days, prices still usually moved substantially during the course of a large trade).

So, why the inflamed opposition? Well, some market participants who, before HFT, used to provide liquidity in more traditional ways are simply annoyed that their business has been taken by those who provide it more cheaply. These more traditional types generate many of the negative comments about HFT (some have based entire business models around rants about HFT coupled with more traditional and more expensive services).

Still other participants, such as some large asset managers, have long resisted adapting to the new market, not only refusing to "go electronic" but also ignoring the important fact that nearly everyone else already did. They are starting to change now, but for a long time, quite a few seemed to find it easier to complain than to modernize. I suspect that many speak negatively about HFT, even though it makes them better off, for the simple reason that they don't understand it, and they are speaking to, and for, those who also don't understand it. Good anti-progress rants have always been popular. After all, until the 1700s, they still burned quant geeks at the stake.

A new and advanced technology always creates critics and predictors of all kinds of doom. I've heard HFT blamed for some bizarre things. I've heard it blamed for bubbles. How high-frequency traders who go home flat (close to no positions held) every day create bubbles is beyond me. I've heard it blamed for why some markets and strategies seem more correlated today than in the past (again, how this can be true is beyond me). I've heard some say HFT causes volatility (on net, you would expect the opposite from market makers), even though volatility in this age of HFT has mostly been very low except for the bursting of the decidedly low-frequency housing bubble (thankfully, I've not yet found anyone who believes high-frequency stock trading made people pay crazy amounts for housing). I've heard it blamed for hurting investor "confidence." That may be true but only because people are telling investors such silly things about it. It's rather circular logic to blame HFT for this fact.

Although it's not all they do, market making—that is, taking the other side of whoever is trading and making some fraction of a bid-ask spread for it—is indeed the core economic activity of HFT.<sup>18</sup> Once we see that market making is the core activity of HFT, we can also see that it is being compared with a mythical gentle giant of the past, the old-school market makers who allegedly often stopped crashes in their tracks by buying securities at prices they knew were way above current market prices. These heroic figures risked their own bankruptcy to save the financial world. Why do I call this a myth? Perhaps because it has happened zero times in financial history. It is not now and has never been the business of a market maker to go broke buying securities at the wrong price in a crashing market. Furthermore, no regulations or exchange rules are going to make them do so. In fact, it is in chaotic times that market makers have tended to make their biggest profits, hardly indicative of any noble "take one for the team" ethos during tough times.

By the way, of course there have been glitches, and some were quite scary. That will happen with any new technology, and it will happen more when the system is complicated and organically grown in separate places, which it most certainly is now. But these glitches have actually been more about electronic trading than HFT (again, a longer explanation is needed, but these are far from the same), and you would have to turn the clock much further back to eliminate electronic trading in addition to HFT. But you usually don't hear that from the critics and those in the press who find HFT a convenient villain for nearly all investing scares but who won't blame electronic trading in general because doing so would be a little too Luddite even for them. Of course, as with any new technology, a continued industrywide effort to reduce technological problems, make disparate systems work and play nicer together, and modify and streamline regulation (including market structure design) is appropriate and quite possibly overdue.

To add to my general peeve that HFT is extremely misunderstood and maligned, there is a misperception that HFT firms are making money hand over fist and are a serious drain on the investing economy. HFT firms, as a group, make money, but they make far less money in aggregate than most would guess (which befits the hypothesis that they offer the customer a better deal on liquidity) and certainly less than old-school market makers made in the past. So, this is a tempest in a teapot. And if the histrionic complainers (who are protecting their own interests or trying to benefit from the hysteria they're creating) win, it can have some very bad consequences for markets and investors

(for example, see the recent imposition by some European countries of financial transaction taxes, which have already proven to be failures).

Finally, two specific elements of HFT raise concerns among some: the frequent use of cancel-and-correct orders and the speed at which transactions occur (it's the only aspect of finance I know of where the speed of light matters; our field's physics envy is finally bearing fruit!). But if you view high-frequency traders as mainly (not entirely) market makers, it is easy to see the reason for both of these aspects of HFT. If you are putting your willingness to buy and sell out there, as any market maker does, you are the one in danger from market moves if you do not cancel and correct your orders fast enough. That is, you can be caught trading on the wrong side of an off-market price. Ironically, being able to use speedy cancel-and-correct orders to protect themselves against having to do such off-market trades allows high-frequency traders to, on average, provide investors with tighter bid-ask spreads than would otherwise be possible. Of course, unrelated to market making, when news comes out, being able to move slightly faster than others is a slight advantage (only slight because your trade size is still limited) over customers and other, slower high-frequency traders. Although I believe this issue is small compared with the larger issue of market making, it should be noted that somebody has to be first, and investing in being the first to be able to act on news and profiting from doing so is at least as old as the Rothschilds allegedly profiting from learning of the outcome of the Battle of Waterloo first and almost certainly far older. Over time, slower investors should learn to avoid trading at these precise junctures because they are at an informational disadvantage (again, this applies to whoever was slower throughout history; it is not unique to HFT) and perhaps should pull their orders out ahead of major news announcements. Another possible application of speed is to simply be the first to win the customer trades at the current best bid or offer without any tightening of the bid-ask spread. Ironically, the failure to tighten bid-ask spreads further is often the result of overly large tick sizes (the allowable increments of price change), which are more a function of regulation and futures exchange monopolies than any failing of HFT. "Trying to be the one to serve the customer" sounds much less nefarious than normal descriptions of HFT speed but is more accurate.

But if being on the other side of a scary high-frequency trader really freaks investors out, they can just own an index fund and sidestep quite nearly the whole thing ("quite nearly" because even index funds trade a little). If you are trading up a storm

on your own, this is almost definitely good advice completely separate from the HFT issue.

## 9. Antediluvian Dilution Deception and the Still-Lying Liars<sup>19</sup>

Companies with executives who execute stock options still carry out buybacks to "prevent dilution." This is still idiocy. It may be time-honored idiocy, but it is idiocy nonetheless. The only rational reason for a company to carry out a buyback is that management believes its shares are undervalued.<sup>20</sup> To do so just to be able to tell shareholders, "See, you own as much of the company as you did before we handed out those stock options" is just nonsensical. It's wrong not on the math but on the relevance. Given the right amount of buyback, the shareholders can indeed end up owning as much of the company as before. So what? They now own as much of a company that happens to have a bunch less cash (i.e., the cash just used to buy back shares). Having a bunch less cash is worse! If the shares were overvalued, in fact, this act of financial camouflage directly hurts the very shareholders management is trying to assuage. Please don't take this too far: Issuing executive options as part of compensation may still be in the company's and other shareholders' best interest. But buying back shares to prevent dilution when they are exercised is a cosmetic silliness designed, in my view, to obscure the fact that option issuance is costly.

On a related note, the forces of good won the battle to expense executive stock options about a decade ago, yet many firms—abetted by some Wall Street analysts who apparently remember 1999–2000 with fondness instead of horror or perhaps remember it only as the year their braces came off—still report pro forma earnings before the necessary and legally mandated act of expensing them and somehow persuade people to use these silly numbers. It's amazing how hard it is to kill a scam even after you make it illegal to use it on the front page.

## 10. Bonds Have Prices Too (How Do You Think We Price Those Bond Funds?)

This misconception is perhaps the least harmful—in fact, it may even be helpful to investors—but is perhaps the most annoying to me (I'm not sure why; maybe it's because I've been hearing it the longest, given that I started in fixed income). Many advisers and investors say things like, "You should own bonds directly, not bond funds, because bond funds can fall in value but you can always hold a bond to maturity and get your money back." Let

me try to be polite: Those who say this belong in one of Dante's circles at about three and a half (between gluttony and greed).<sup>21</sup>

Bond funds are just portfolios of bonds marked to market every day. How can they be worse than the sum of what they own? The option to hold a bond to maturity and "get your money back" (let's assume no default risk, you know, like we used to assume for US government bonds) is, apparently, greatly valued by many but is in reality valueless. The day interest rates go up, individual bonds fall in value just like the bond fund. By holding the bonds to maturity, you will indeed get your principal back, but in an environment with higher interest rates and inflation, those same nominal dollars will be worth less. The excitement about getting your nominal dollars back eludes me.

But getting your dollars back at maturity isn't even the real issue. Individual bond prices are published in the same newspapers that publish bond fund prices, although many don't seem to know that. If you own the bond fund that fell in value, you can sell it right after the fall and still buy the portfolio of individual bonds some say you should have owned to begin with (which, again, also fell in value!). Then, if you really want, you can still hold these individual bonds to maturity and get your irrelevant nominal dollars back. It's just the same thing.

Those believing in the subject fallacy often also assert that another negative feature of bond funds is that "they never mature" whereas individual bonds do. That's true. I'm not sure why anyone would care, but it's true. But the real irony is that it's only true for individual bonds—not the actual individual bond portfolio these same investors usually own. Investors in individual bonds typically reinvest the proceeds of maturing bonds in new long-term bonds (often through the use of a "laddered portfolio"). In other words, their portfolio of individual bonds,

each of which individually has the wonderful property of eventually maturing, never itself matures. Again, this is precisely like the bond funds that they believe they must avoid at all costs.

I'm sorry if I've destroyed the peace of mind of individual bondholders everywhere by informing them that owning only individual bonds does not solve the problem that bonds are risky. I'm also sorry if the irrelevant idea that you'll eventually get your nominal money back on a bond was comforting to many. It is actually quite possible that I have made some readers worse off by destroying these illusions. It's possible that the false belief that individual bonds don't change in price each day like a bond fund's net asset value does led to better, more patient investor behavior. I admit that listening to me is not always a pleasant or even wealth-enhancing experience.

## Conclusion

I am not so arrogant that I dismiss the idea that I also have some crazy notions that might make another's list of peeves and that I could benefit from reading it. Also, although I will admit to nothing, at times, I have certainly made some of the mistakes I have discussed, and whatever lessons I've learned have often come from experience—not before-the-fact superior reasoning.

Finally, I certainly have some peeves I haven't shared, but I must stop here lest anyone think I'm a curmudgeon.

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*This article qualifies for 0.5 CE credit.*

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## Notes

1. This really is the very simplest framework. Although this section is, to a large extent, a defense of the concept and use of volatility, simple well-behaved symmetric volatility measures are not the only weapon in the quantitative risk management toolkit by a long shot. For instance, another common criticism of measuring volatility is that it treats the upside and the downside similarly, but there are quantitative measures that deal with this distinction. For instance, volatility would be particularly inappropriate for option-like securities with by-design asymmetric payoffs.
2. See Shleifer and Vishny (1997) for the situation where you are metaphysically certain you are right but you can still be practically wrong if you are forced out of a position, if you panic, if your client panics, and so on.
3. Studying this issue further is definitely worthwhile because many other issues arise when examining it more deeply, including the following: (1) risk being about individual investments versus being about portfolios (preview: although it can still be expressed with expected return, I have more sympathy for obsessing over the left tail of each security in a very concentrated portfolio versus a very diverse one); (2) rebalancing (preview: unless things jump to zero, how you act along the way determines much of how harmful a particular left tail can be); (3) the idea that some risk may be very short term and mean reverting, which inflates "return volatility," but perhaps can be traded against (by quants or non-quants); (4) geometric versus arithmetic returns; and (5) dynamic versus static portfolio choice.
4. For a related editorial, see Sullivan (2010).
5. Some argue that debt bubbles are more dangerous than equity bubbles or that the tech bubble was a smaller segment of the economy, but these are some of the counterpoints I mentioned in the beginning that I'm leaving for another day!



6. For instance, the regulatory and rating agency blind spot in AAA securities probably contributed to the bubble's growth and the ensuing financial crisis, so I'm not saying some of the same explanations do not apply to both. But these two events were still separate, and many other much-argued-over potential explanations apply to only one or the other.
7. See Sharpe (1991, 2010) for similar points regarding this issue and investment outperformance.
8. There are weaker definitions of active versus passive than mine. For instance, one definition is that anyone who follows an index is passive (so any definable strategy, no matter what the fee or turnover, is passive as long as you can write it in the form of an index, which really amounts to calling any quantitative strategy passive, which I think is quite odd). Another is that passive just means low turnover. If people are using this definition, I partially withdraw my peeve. But I would replace this section with a peeve about weak straw-man definitions that don't mean much because I think low turnover is a very weak definition of passive. For instance, to me, possessing low turnover but maintaining a huge difference from cap weighting, such as owning a very concentrated portfolio, is a very active—not passive—strategy that simply doesn't call for changes very often. In other words, to me, passive is about being cap weighted or close to it, not about how many calories you burn while investing.
9. In the interest of full disclosure, my own firm runs investment products like some of these and occasionally uses these labels.
10. HML, originally from Fama and French (1993), stands for "high minus low" and refers to going long a diversified portfolio of high-book-to-price (low-price-to-book) stocks and shorting a diversified portfolio of the opposite. In other words, it's a diversified factor that represents the return spread of "cheap" or "risky" (depending on your views on market efficiency) value stocks over "expensive" or "low-risk" growth stocks.
11. Disclosure: Some indeed are mine or, more precisely, AQR Capital Management's.
12. Some who criticize "active management" are really criticizing those who pick individual stocks who often use nonsystematic means (traditional stock pickers). Without commenting on this criticism, I would call such a style a particular type of active management, with active still being a far more general category that, again, includes any nontrivial deviation from the cap-weighted market.
13. And, as a side point, if that bet does the same thing others have been doing for years, you don't get to call it "new" because you have a new name for it and it's in a new package.
14. Disclosure: Most of AQR's assets under management are not hedge funds, but the firm does run a significant amount of hedge fund assets.
15. Consider rolling seven-year versions of the betas of equity long-short hedge funds, as calculated in Asness et al. (2001), who accounted for both contemporaneous and lagged market exposure: The median seven-year period has a beta with the S&P 500 Index of 0.47, and the most recent seven-year period is at 0.44.
16. Of course, these things are connected because if hedge funds ran their portfolios fully hedged, the commentators would find it far easier to get it right!
17. See Harris (2013) for an article that, in my opinion, agrees with my view in general but that delves much deeper into, among other things, this set of activities I'm not vouching for (or condemning) here. Although I believe more discussion is needed, Harris examined some interesting possibilities regarding market design to mitigate what he sees as some of the negative aspects of HFT (while still agreeing that on net, HFT greatly lowers investors' costs). He also discussed the fact that many potential problems that are laid at the feet of HFT, such as order anticipation, are far from new even though they are often treated as problems unique to HFT.
18. This activity includes trying to avoid market making when on the wrong end of an "informed" trader; admittedly, this is sometimes hard to distinguish from an information-based trade by the high-frequency traders themselves.
19. See "Stock Options and the Lying Liars Who Don't Want to Expense Them" (Asness 2004).
20. One other potential purpose of a buyback is to raise the financial leverage of the common stock. If more aggressive common stock is desired and investors cannot, as simple theory often assumes, lever on their own, doing so may provide added value to investors. However, I believe I'm now creating reasonable explanations that are decidedly not the reasons being claimed in the real world.
21. Of course, there can be other reasons to choose between a portfolio of directly owned bonds and a bond fund that I don't address here. Taxes can be different. The commission and bid-ask costs of individual bonds can differ from the fee the fund charges and the trading costs incurred. If the fund is actively managed, you should invest largely on the basis of your belief in the net-of-fee skill of the manager. Diversification is generally greater in a fund—particularly, of course, for bonds with default risk. If the bonds are particularly illiquid, hard to mark, or expensive to trade, being in a fund might subject you to costs imposed by others getting in or out. Those can all matter. Someone recommending bonds over a bond fund or vice versa on these grounds is not subject to this peeve.

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"My Top 10 Peeves"

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