Resisting the Siren Song of Factor Timing

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It seems that now everyone wants to time factors. Indeed, we’d love to as well if we thought it was a very useful endeavor. But, although tempting, in an editorial piece for a special upcoming Journal of Portfolio Management issue focused on quantitative investing — written at the kind request of long-time editor, Frank Fabozzi — I argue that this tempting siren song should be resisted, even if I know some will be disappointed with this view.

In looking at the simple “value” of the factors themselves, I find such timing strategies to be quite weak historically (and whatever power they have is too highly correlated to the simple value factor itself). I also find some tests of their long-term power conducted by other researchers to be exaggerated and/or inapplicable. My suggestion to investors is to instead focus on identifying factors that they believe in over the very long haul, and aggressively diversify across them. Of course I agree the possibility exists that any factor could, in principle, become too crowded one day. To date I just see little evidence that this has occurred, and I outline what I’d look for to know when it’s time to worry. Finally, if you do decide to time factors, not something that I rule out entirely, and if timing is a “sin”, then you should “sin” only a little.

In future work we intend to explore a more in-depth timing system (remember I said “sin only a little” not be totally chaste!) that incorporates the factor-value signals like I do in this editorial, and in a way more akin to “carry” than valuation, and also uses factor trends (I muse upon these briefly in footnotes 10 and 14). Initial work shows some promise here, but I note that this approach becomes more like traditional Tactical Asset Allocation and less about pure factor “crowding.” Only the factor valuation signals investigated in the editorial can be clearly interpreted as being about crowding, which was the main concern I wanted to address.

Again, I believe this is a timely topic and hopefully my thoughts and ideas add to the ongoing dialogue on it.

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