Ilmanen, Antti – Expected Returns

John Wiley & Sons, 2011, [Finance] Grade ★★★★★

This is a magnificent book. It's also absolutely massive, 500+ pages totally stuffed with information. The recent recruit to AQR, Antti Ilmanen, with a long experience from the Finish central bank, Salomon Brothers FX-department and the hedge fund Brevan Howard is a sponge concerning financial knowledge. There is enough knowledge content in this book to get the highest grade twice. I'm not surprised that Norges Bank Investment Management uses him as an advisor. With this book we can all get that advice for a more modest fee than NBIM probably pays.

The bulk of the text consists of chapters that present three different ways to analyse expected returns. As AQR luminary Cliff Asness points out in his foreword, there are two ways to earn returns and that is either to get paid to bearing a risk or to use someone else's systematic mistakes. The chapters cover; 4 asset classes - stocks, credits, government bonds and alternative investments; 4 strategy styles – value, trend, carry and volatility; and 4 underlying risk factors – growth, illiquidity, inflation and tail risks. The different viewpoints give the reader a quite nuanced view of risk factors and a good understanding of sources of returns.

I find a pair of the key points that Ilmanen constantly keeps pounding in especially important and/or novel. They are firstly the time varying nature of expected returns, i.e. how expected returns the next few years depends on starting valuation, on the amount of overcrowding and the on the environment. The author even tries to present the reader with a systematic method to estimate returns over different asset classes. Secondly, the author often comes back to the notion of tail risk premium meaning that there is over time a payment to be had from owning assets that perform the worst at exactly the wrong time – when the stock market declines.

The ending advice are amongst other to pursue several strategies in parallel to harvest diverse sources of expected returns as long as they are not overvalued, that investors should diversify more than they do and use leverage to leverage up low volatility assets and the low volatility parts within different assets. Further, try to find sources of return that show low correlation such as value and momentum and don't buy lottery ticket types of securities within assets.

The book took quite a while to read. It is hard work and it's certainly primarily suited for professional investors. The reader will be taken up to speed on practically everything that has happened within academic finance and quantative asset management during the last 30 years. It would almost be a pity if too many read the book. Asness jokingly says that he briefly considered having Ilmanen killed instead of writing the foreword but decided that he would instead have to work another 20 years so Illmanen would have something to write about in the next book.

The author combines a broad knowledge of academic research, number crunching – even though the book doesn't contain much math – and an understanding that history does not tell the entire story. It's an inspiring book that will arm the reader with knowledge not only to understand best practice in the asset management business but also to shape future best practice. The book glows with a passion to understand the world and the author even includes his email for anyone that wants to comment on the book and take his learning process further.

This is a tough read but those who take the time will be greatly rewarded. If you don't take the time? Well, it's you're funeral.

Mats Larsson, November 27, 2011