“STYLE INVESTING” (Authors: N. Barberis, A. Shleifer)

The point of this note is to explain the ideas in the above research paper without using any mathematics or technical jargon (the original paper contains some of both). The intended reader is someone who is interested in economics and finance but who is not an academic researcher. I welcome your comments on the ideas below, whether you agree with them or not; and also on the write-up itself -- for example, please let me know if it is confusing, so that I can rework it.1

I’ll start with a short summary, and then give the longer version.

SHORT SUMMARY

We argue that investors often allocate funds at the level of asset categories, and investigate the implications that this might have for financial markets. We show, for example, that category-based investing can make stocks move together more than justified by economic fundamentals. We use our framework to make sense of some puzzling instances of comovement in the data.

LONGER SUMMARY

The investment problem we face when we allocate our money across individual stocks is dizzyingly complex: How should we split our wealth across the thousands of different stocks out there? In this paper, Andrei Shleifer and I argue that, to simplify this task, people often make decisions at the level of asset categories. In other words, they first put stocks into categories – small-cap, mid-cap, large-cap, value, growth, technology stocks, utility stocks, and so on – and then allocate their money across these different categories. Investment categories are sometimes called “styles”. Hence the title of the paper.

Even if you agree that many investors think in terms of categories, you might still ask: How do people choose which categories to invest in? Shleifer and I argue that investors tend to move money into categories that have recently done well and out of categories that have recently done poorly. So if small-cap stocks have recently done well relative to large-cap stocks, we assume that investors move into small-caps and out of large-caps. (This performance-chasing assumption can be motivated in a number of ways – for example, as a consequence of a psychological heuristic called “representativeness”. See the summary of “A Model of Investor Sentiment” for more details).

Shleifer and I find that our model has many predictions, but perhaps the most interesting thing that it leads to is a new theory of why stocks move together. The traditional explanation for why a group of stocks might move in tandem is that they have correlated earnings news (e.g. automobile stocks move together because their earnings are correlated). Our model leads to an alternative theory: a group of stocks may move in tandem because the stocks in the group are a salient category for many investors, and as

1 This is a preliminary draft. Please do not quote or cite.
these investors move money in and out of the category, the demand pressure makes the stocks in the category move together over and above what would be expected based on earnings correlation alone.

We use this theory to shed light on several puzzling instances of comovement. For example, small-cap stocks tend to move together, but there isn’t enough correlation in their earnings to fully justify this. The same is true for value stocks. Our model offers an explanation for this. The idea is that small-cap stocks are a salient category, or style, for many investors, so as these investors move money into small-cap stocks this month and out of small-cap stocks the next, they make small-cap stocks move together even if their earnings are largely uncorrelated. The same holds for value stocks.

**Postscript**

We published this paper in 2003. If anything, though, we think that style investing may be more important now, in 2010, than it was then. One reason for this is the huge growth in “exchange-traded funds” (ETFs). These funds make it much easier for investors to engage in style investing, simply because they provide a very convenient vehicle for investing in a style.

One piece of evidence that suggests that style investing is growing in importance is the rising correlation of stocks in the S&P 500, a phenomenon that is frequently discussed in the financial press. Given that there are now several ETFs that track the S&P 500, it is very easy for investors to treat the S&P 500 as a style, and to move money in and out of the index whenever they please. The demand pressure that results from these constant inflows and outflows may be the source of the rising correlation of S&P 500 stocks.