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Cross-sectional stock volatility lifts value factor

Dispersion in returns makes for ‘double alpha’

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In a year when mainstream markets tumbled, quants say scattered valuations across stocks have contributed to the success of one investment style in particular – value.

So-called 60/40 portfolios, a mixture of stocks and bonds, are facing the worst returns for a century, according to analysts at Bank of America Global Research.

Statistical arbitrage hedge fund QuantZ’s ValMo (value plus momentum) factor, though, has returned an eye-catching 64.5% year to date.

Founder Milind Sharma, a former prop trader at Deutsche Bank and RBC Capital Markets, says cross-sectional volatility, or dispersion, is partly the

reason.

The firm's ValMo signal is long cross-sectional volatility, he says. The model is choosing its longs well and outperforming on its short bets. But market conditions mean it's picking up some extra alpha, too.

In a market with elevated cross-sectional volatility, the model's longs and shorts are gaining and losing more value relative to each other. "In a bear market like this, when volatility goes up, you get double alpha," Sharma says. Inspired by a **paper** called 'Value and Momentum Everywhere', written by Cliff Asness – founder, managing principal and chief investment officer at AQR – the hedge fund operates a model that tracks more than 600 factors, which a machine learning program then **boils down** to a selection of 18 composite 'enhanced smart betas'.

The ValMo factor's long equity positions are up 11.8% while the S&P 500 is down 18% at time of writing. The stocks in the short side of the portfolio are contributing 41.7%.

Data from Glenmede Asset Management tells the same story.

Value has been the largest contributor to the outperformance of equity factors since September 2020, the data shows.

This year, the top quintile of value has beaten the average stock by 7.3% long-only and the bottom quintile 8.8% short only. That's when avoiding any big sector bets. A fund trading long/short value that was willing to run sector bets would have made even more – about 26%, according to Glenmede portfolio manager Alexander Atanasiu.

Glenmede's analysis found that most signals typically used in value factor investing are correlated with time series volatility (see table A below).

A. Value factors – 30-year average correlatio year volatility

Share

And some, such as price-to-book value, benefit also when dispersion is higher, as is the case at present (see figure 1).

1. Cross-sectional dispersion of returns for p Russell 300

Source: Glenmede
and Compustat s

Share

The top and bottom quintile of value stocks tend to be more volatile cross-sectionally and through time, Atanasiu says. "If you're long/short [value] right now, you have a dispersion bet on."

Dispersion in stock returns also makes it possible to generate greater returns with less turnover and leverage, he says, allowing factor investors to reduce

transaction costs.

Cross-sectional volatility between S&P 500 stocks has reached 36% this year, among the top 5% highest values since January 2007, according to data from Ossiam Asset Management.

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