Buying Low and Selling High

Andrew Ang
Ann F. Professor of Business and Chair of the Finance and Economics Division
Columbia Business School

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Ain’t So Easy

- Buying low and selling high is how *any* investor, long or short horizon, makes money

- Being *counter-cyclical* goes against investors’ behavioral tendencies

- Most investors are pro-cyclical, and chase returns. They invest precisely at the wrong time: when prices are high, investors are drawn by *past* high returns, but *future* expected returns are low.
Investment Mistakes at CalPERS

CalPERS Total Equity Allocation

Rebalancing Buys Low and Sells High

- Rebalancing to fixed positions is the foundation of long-term investment strategies.

- Optimality of rebalancing was shown by Paul Samuelson and Robert Merton (who won Nobel Prizes in 1970 and 1997, respectively).

- Rebalancing buys low and sells high:
  - Cuts back on risk as prices rise
  - Increases exposure when prices fall
Rebalancing Buys Low and Sells High

- Long-term investing fallacies
  - A long-run investor never buys and holds
  - Long-term investing is first and foremost about being a good short-term investor

- Additional benefits of rebalancing
  - Ride out short-term fluctuations in risk premiums, and profit from periods of elevated risk aversions and mispricing
  - Acquire distressed assets when investors with over-stretched risk capacity or constraints have to sell
  - Most effective method of harvesting a liquidity premium
Rebalancing: Great Depression

1926 - 1940

- Pure bonds
- Pure stocks
- Rebalanced
Rebalancing: Lost Decade

1990 - Aug 2013

Pure bonds
Pure stocks
Rebalanced
Rebalance!

- Rebalancing rule = Buy low, sell high

- Superior weighting schemes incorporate *valuation* information, allowing investors to act even *more counter-cyclically*

- Buy even more when prices are low and sell even more when prices are high, but rebalancing is the baseline case

- Extend rebalancing to *dynamic factors*, similar to static equity-bond factors