

Research shows how to reduce the cost of modern investment strategies

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New research from the University of East Anglia (UEA) shows how investors can significantly reduce the cost of implementing portfolio strategies - in some cases by more than 90 per cent.

The study, published today in the journal *Financial Review*, shows that many modern [investment strategies](#) often lead to low returns or even lose money in practice, as they are prone to large trading costs. Such costs include bid-ask spreads, brokerage fees and capital gain taxes and can dramatically affect investment returns, turning an otherwise winning strategy into a losing one.

Many investors still adopt practices developed in 1952 by Nobel laureate

Prof Harry Markowitz, in the hope of achieving greater returns. Prof Markowitz introduced the idea of 'efficient portfolios', which offer the highest possible investment return for an acceptable level of risk.

An important obstacle in the application of efficient portfolios is that the parameters that define them are unknown to investors. To overcome this issue, investors typically estimate the unknown parameters using historical data. In recent decades, academic researchers have produced several portfolio strategies that improve this estimation.

The study recommends a modification to the original model of Prof Markowitz that improves the management of trading costs and leads to stable portfolios over time. The author of the study, Dr Apostolos Kourtis from UEA's Norwich Business School, found that investors can receive most of the benefits from their strategy by simply frequently rebalancing a small portion of their investment. This allows them to significantly reduce trading costs and improve their investment returns at the same time.

"Nowadays investors have dozens of excellent portfolio strategies at their disposal," said Dr Kourtis, a Senior Lecturer in Finance.

"However, they need to be careful when executing them as potential trading costs from portfolio rebalancing may consume all the benefits promised by a particular strategy.

"Indicatively, households, as well as professional investors around the world, pay over £60 billion each year in trading costs. By following our recommendations, investors can reduce such costs, with the reduction exceeding 90 per cent in some cases.

"Our methods are easy to apply to any existing portfolio strategy," added Dr Kourtis. "As such, they offer households and retail investors access to

sophisticated portfolio strategies that would be otherwise accessible only to institutional [investors](#) who could bear their high cost."

Dr Kourtis analysed the performance of the most efficient modern portfolio strategies from the recent academic literature in several investment settings. Based on this, he developed a new model that can reduce the cost of such strategies by making them more stable over time. He tested the new stable strategies in the same [investment](#) settings and found that they lead to significantly higher risk-adjusted returns and lower transaction costs than the original strategies.

More information: 'A stability approach to mean-variance optimization' by Dr Apostolos Kourtis is published by the *Financial Review* on July 17.

Provided by University of East Anglia

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