Profitability of Index-based Size and Style Rotation Strategies in the UK Equity Market

Natasha Todorovic[1]

Bhavesh Gokani

EXTENDED ABSTRACT

The objective of this paper is to examine whether short-term directional variation in the size and style spreads of indices in the UK equity market is predictable and exploitable by means of active style rotation strategies.

Using a set of market related, macroeconomic and fundamental variables chosen by the Principal Component Analysis (PCA) method, we employ a recursive dynamic modelling approach (logit model) to predict the direction of the style index return spreads. Our style rotation strategies are based on small-capitalisation, large-capitalisation, value and growth segments of the market, using the appropriate style benchmark indices as proxies for styles, namely: FTSE 350 Value, FTSE 350 Growth, FTSE Small Cap and FTSE 100. The period analysed is January 1987 to May 2005.

The results indicate that the optimal long only and long/short style rotation strategies are profitable for UK investors and that both the size of transaction costs and the strength of the forecasting signal play an important role in determining the profitability of the rotation strategy. Finally, we believe that there are two comparatively simple and cheap ways in which the suggested rotation strategies can be applied by a real-world investor: through ETFs and stock index futures.

[1] Bhavesh Gokani, ABN AMRO
Dr. Natasha Todorovic, Cass Business School
Please send all correspondence to Natasha Todorovic: n.todorovic@city.ac.uk