Stock Market Dispersions: European Example

Here is an analysis of the dispersion of returns in the various sectors of the European equity markets as defined by the Stoxx sub sector indices.

Dispersion here has been defined as the standard deviation of returns across the constituent stocks in a Stoxx sector index. I looked at 2 year daily data as well as 10 year weekly data.

The higher the dispersion, the more the variation of returns is explained by idiosyncratic risk and company specifics. This lends the sector to stock selection and fundamental analysis.

The lower the dispersion, the more the variation of returns is explained by systemic risk and sector specific themes. This lends the sector to thematic directional trading.

Up until 3Q 2008, Banks had low dispersion and traded as a bloc. Resource stocks have always traded with high dispersion across the time period. Oil and Energy has also displayed chronically high dispersion. Utilities, healthcare, food and beverage have all had chronic low dispersion and continue to do so.

During the crisis period of the last 12 months, dispersion was highest in Banks, Insurers, Resources and Oil. Dispersion in these sectors has most recently fallen back to a more normal range and within normal spreads to the other sectors.

The stability and moderate levels of dispersions in Industrials, Autos, Consumer goods lend these sectors to fundamental research and relative value investing.

Daily dispersions Last 2 years:

Looking more generally across the various sectors in the longer term chart, we see that dispersions were clearly higher in the years 2000 to 2004. Since 2003, as equity markets recovered from the recession and terrorist attacks of the years before, equity market dispersion was low as markets came to be driven by excess liquidity and low interest rates. For stock pickers and fundamental equity long short strategies, this was not a conducive environment. This observation confirms my assertion that the years 2004 – 2007 were the most difficult times to make money from fundamental stock selection and equity long short or relative value strategies. It was more productive to be outright long through the period and trade tactically.

Weekly dispersions Last 10 years:

The picture has certainly changed. While monetary policy has fueled a liquidity driven rally in global equities and dispersion has fallen substantially from the crisis months of late 2008 and early 2009, dispersions have not compressed to the levels seen in 2005 and the opportunity set for fundamental equity long short remains attractive.

There are of course more interesting and sophisticated strategies that can be used to capture the themes of dispersion such as outright correlation strategies involving long and short vega positions in index and constituent options but the alternative investment industry is having a difficult enough time explaining simple things to investors.