
CHENGGUO WENG, University of Waterloo

When Does The $1/N$ Rule Work?

The $1/N$ rule provides a simple way to obtain a diversified portfolio. Studies have shown it often outperforms more sophisticated approaches. We show that the $1/N$ rule only outperforms an optimal portfolio in two out of seven major equity markets: the USA and Japan. We develop a market-specific measure that indicates when the $1/N$ rule will dominate. Our measure is based on the distance between the $1/N$ portfolio and the maximum Sharpe ratio portfolio. We label it the $1/N$ favorability index. The $1/N$ rule also does well when the market as a whole performs well and we analyze the joint contribution of this factor and the favorability index. This is a joint work with Danqiao Guo, Phelim Boyle, and Tony Wirjanto.