

Principal Equities

The importance of idiosyncratic risk and return

JUNE 2025

In an investment landscape increasingly shaped by passive strategies and factor-based investing, distinguishing genuine active skill from systematic market exposure has become more important than ever. This paper explores the concept of idiosyncratic risk and return, why it has become a defining characteristic of successful active management, and how a robust research and portfolio construction process can consistently generate differentiated, stock-specific alpha.

What is idiosyncratic risk and return and why does it matter?

The notion of Idiosyncratic risk and return has its foundation in the Capital Asset Pricing Model (CAPM) and the extensions of this through Fama-French, who began to use systematic factors (such as size and value) other than simple market risk to try to explain investment returns. It is defined as the portion of overall returns that cannot be explained by the systematic factors used in the models.

Over the past several decades, both academics and quantitative practitioners have built on these simple models to incorporate hundreds of supplementary explanatory factors in a multitude of combinations. Famously, Harvey, Liu and Zhu identified 316 distinct factors in their paper “...and the cross section of expected returns”. Despite this proliferation, which has given rise to a whole industry of “smart beta” strategies, the unexplained (idiosyncratic) variable persists as necessary to complete each and all these models.

In portfolio terms, idiosyncratic return thus represents the portion of performance that stems from a manager's specific skills, research, or analysis, as opposed to market exposure, factor biases (whether intended or otherwise) and timing. **In essence, idiosyncratic alpha is the alpha that active managers genuinely generate through their own insights and investment strategies and, as such cannot be passively captured nor replicated.**

In their paper “In Defence of Active Management”, Bernstein represented this as follows:

Portfolio return = stock selection return + market exposure + factor/theme exposure + timing ability,

Where stock selection is the true idiosyncratic variable and the timing ability term is broadly defined as the skill in seeking out market, factor, or thematic opportunities. They argue that, given market and factor/thematic (read smart beta) exposure is now available at passive rates, active fees should be paid only for the delivery of idiosyncratic alpha and not systematic exposure and/or timing in disguise.

AUTHORS



George P. Maris, CFA

Executive Managing Director, CIO, Global Head of Equities, and Portfolio Manager



Matt Peron

Deputy CIO and Portfolio Manager



Jonathan Price

Managing Director, Client Portfolio Manager

How valuable is it?

The last 15 years have been exceptional for equity returns with market-wide beta high, factor-based returns directionally persistent and volatility low. In terms of the above equation it has meant that portfolio returns have, for the most part, been dominated by market and factor/theme exposure and, correspondingly, asset flows to passive and static factor-biased approaches have ballooned.

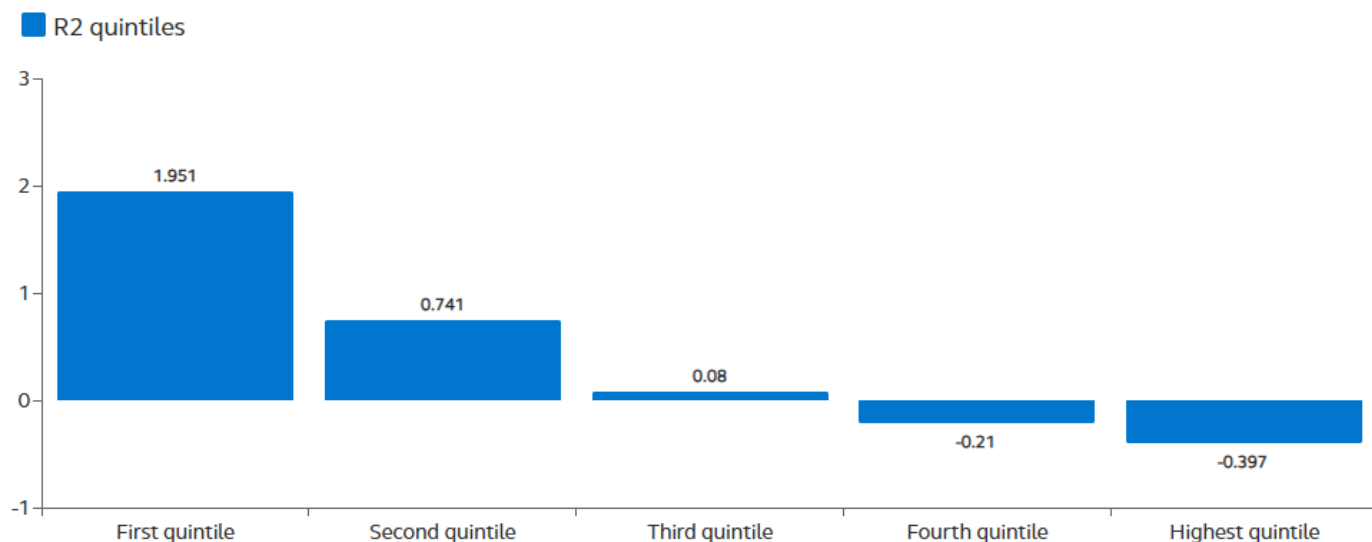
Within this exceptionalism however, 2022 saw all three of these characteristics reverse and, despite returns being dominated by market (negative) and factor (style rotation) components, was a sharp reminder of the value of the “idiosyncratic” element which should be largely immune to these market leadership swings. There are very few instances of managers delivering excess returns through 2022 by timing the change in factor leadership.

The next 10 years are likely to see more moderate beta, more frequent rotations in factor leadership, and an increase in volatility, all of which support a focus on those generating idiosyncratic returns both from a perspective of materiality – idiosyncratic drivers are likely to be a great proportion of overall returns; and persistency – as evidence has shown that idiosyncratic returns are not dependent on specific market backdrops, leadership styles or other factor driven considerations.

Moreover, Amihud and Goyenko in their paper “Mutual Fund’s R Squared as a predictor of future success” found that those managers that have in the past delivered alpha with a high level of idiosyncraticity are far more likely to continue to do so in the future than those managers whose alpha is more dependent on factor exposure and timing. This work was further refined by Harmswoth and Mand from Alliance Bernstein, in their paper “A cut above: Why idiosyncratic alpha is better than beating the benchmark”, who further isolated stock selection effects from factor timing.

Fund portfolio alpha, based on sorting by lagged R2 and alpha

Portfolio alpha, annualized, using monthly returns from January 1990 to December 2010



Portfolio alpha, annualized, monthly returns from January 1990 to December 2010. Source: Mutual Fund’s R2 as Predictor of Performance by Yakov Amihud and Ruslan Goyenko. <http://rfs.oxfordjournals.org>. Past performance does not guarantee future results.

Generating idiosyncratic insights

The two biggest challenges with idiosyncratic risk and return are, firstly, having an investment philosophy and research approach that can repeatedly generate idiosyncratic insight and, secondly, a portfolio construction approach that can combine these so as to maintain overall high idiosyncratic levels of risk. The first of these depends on having broad enough coverage to ensure enough rocks are turned whilst the second necessitates an understanding of how the systematic risks associated with any stock are related to those of others.

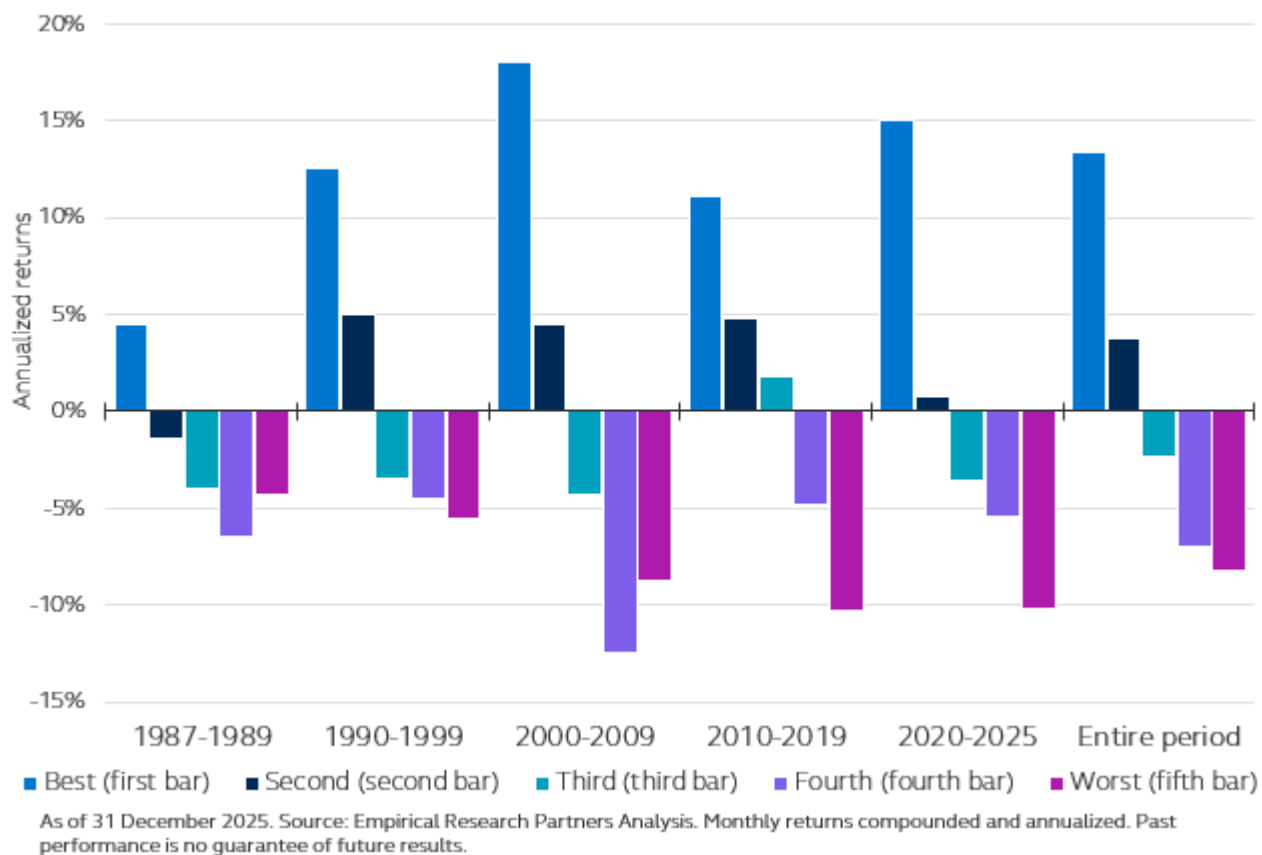
At Principal, our investment philosophy is centred on investing in companies where future free cash flow growth is underestimated by the market. Research by Empirical Partners have shown that forward free cash flow yield is a powerful determinant of future return (insert Empirical Partners research), is idiosyncratic, has efficacy across different style market environments and cannot be passively replicated.

This philosophy requires deep fundamental scrutiny of growth opportunities to assess free cash flow generation. It also demands an understanding of valuation by identifying mis-pricing opportunities arising from differences in growth expectations. Opportunities arise by focusing on essential value drivers for each company and identifying material dislocations relative to market expectations.

A fundamental forward free cash flow growth focused discipline allows for open-minded assessment of opportunities ranging from aggressive growth to deep value. By explicitly rejecting thematic approaches to investing, the strategy attempts to anticipate shifts in market sentiment by focusing on where and why dislocations exist.

Return of One-year forward free cash flow yield by quintile

Global ex-U.S. Markets (1 January 1987 – 31 December 2025)



A critical element of this stock-picking process is to incorporate independent and uncorrelated sources of alpha. This requires a collaborative approach between our experienced fundamental research analysts, portfolio managers and

our advanced R&D team. The task is to assess the best ideas across all sources, to arrive at those stocks where insights correspond with the strategy's investment philosophy. Rather than employing a filter approach where the strategy predetermines the ideas, the independent approach seeks an unbiased review of opportunities and is intentionally resourced deeply to ensure open minded and broad coverage across the investible universe.

So long as alpha sources are kept relatively independent and are not perfectly correlated, the intersection of these views should result in greater stock-selection efficacy than either resource in isolation. The results should be higher and yield more consistent hit rates than would otherwise be the case.

Delivering idiosyncratic returns

All stocks come with a mixture of idiosyncratic and systematic risk and so a principal element of our portfolio construction is risk decomposition and a monitoring of the levels and sources of risk in portfolios. This helps ensure there are no unintended systematic risks impacting the portfolio when we combine our security selections. The risk decomposition also helps identify behavioural biases that might otherwise go unnoticed. We further acknowledge that systematic risk models are often ineffective during periods of change as past relationships are no longer predictive and therefore a qualitative assessment based on our deep knowledge of company fundamentals is an additional guardrail to unintended systematic exposure.

We utilize our proprietary Portfolio Management Workbench to help inform portfolio construction and minimize behavioural errors. This proprietary tool enables us to conduct pro-forma trade scenario analysis and the impact to the portfolio profile, risk profile and overall factor exposures. The Portfolio Management Workbench also incorporates third party tools which provide enhanced insights and analysis of factor exposures, factor attribution and beta decomposition over time.

Within all of this, we use implied alpha analysis as the primary determinant of position size. Implied alpha is an unbiased and independent check on stock conviction levels which takes into account not only the underlying risk of a stock but the impact that stock has on the aggregate volatility of the overall portfolio. **Implied alpha analysis allows our Portfolio Managers to think among several dimensions around one stock: expected return, risk of the holding, confidence in expected return, exposure to a range of systemic risks, and correlation of these risks to other holdings in the portfolio.**

The results are portfolios with a high proportion of idiosyncratic risk and residual systematic exposures that are mitigated and understood to help ensure core, all weather performance outcomes by design.

Conclusion

As market conditions evolve, the ability to generate genuine idiosyncratic alpha is likely to become an increasingly important. Achieving this requires a philosophy and research process centred around generating differentiated, stock-specific insights, and a disciplined portfolio construction framework that identifies and controls unintended systematic exposures when these stock level insights are combined. Together, these elements provide the foundation for delivering resilient, repeatable active returns across a range of market environments.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is intent for use in: • **The United States** by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission. • **Europe** by Principal Global Investors (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGII, PGIE or PGII may delegate management authority to affiliates that are not authorised and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). • **United Kingdom** by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA"). • This document is marketing material and is issued in **Switzerland** by Principal Global Investors (Switzerland) GmbH. • **United Arab Emirates** by Principal Investor Management (DIFC) Limited, an entity registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as an Authorised Firm, in its capacity as distributor / promoter of the products and services of Principal Asset Management. This document is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation. • **Singapore** by Principal Global Investors (Singapore) Limited (ACRA Reg.No.199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. • **Australia** by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001. • **Hong Kong SAR** by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission. This document may only be distributed, circulated or issued to persons who are Professional Investors under the Securities and Futures Ordinance and any rules made under that Ordinance or as otherwise permitted by that Ordinance. • **Other APAC Countries/ Jurisdictions**. This material is issued for Institutional Investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

© 2026 Principal Financial Services, Inc., Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc. Principal Asset ManagementSM is a trade name of Principal Global Investors, LLC.

Principal Equities is an investment team within Principal Global Investors.

MM15049 | 07/2026 | 5727346-072027