
PRACTITIONER'S DIGEST

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LEANING WITH THE WIND: LONG-TERM ASSET OWNERS AND PROCYCLICAL INVESTING

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Bradley A. Jones

With their long duration liability profile, little need for liquidity and relatively stable risk preferences, it seems reasonable to expect that long-term institutional asset owners would have a natural edge in countercyclical investing designed to harvest the multi-year mean reverting properties of asset returns. But is this how long term asset owners—official sector institutions, pension funds, insurers and endowments funds among them—actually invest in practice?

Curiously, the findings of this study suggest the answer is likely no. More precisely, little evidence is found to support the notion that asset owners lean against the wind. Rather, procyclicality in two forms—contemporaneous drift (where annual rebalancing is eschewed in favor of allowing portfolio weights to inherit relative annual performance) and more active multi-year performance chasing—appears to better characterize the asset allocation shifts of large institutional asset owners. That momentum patterns in asset returns tend to breakdown and eventually reverse sign at multi-year horizons might not be an issue per-se, were it not for the tendency of long-term asset owners to reallocate portfolios procyclically at this very horizon. In other words, it seems asset owners are inclined to pursue a momentum-like strategy at the reversal frequency, and thus cede an important source of their competitive edge. Analysis of the role that institutional-based frictions (limits-to-arbitrage) might play in explaining behavior of this type, and the identification of possible remedial measures, would therefore seem fertile grounds for future research.

HORIZON EFFECTS THAT ARE LARGER THAN YOU THINK: DYNAMIC ALLOCATION WITH A REPRESENTATIVE INVESTOR

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Thomas J. O'Brien

Should investors and investment managers make higher allocations in stocks for longer horizons, as is sometimes suggested in the popular press? For an investor who periodically rebalances allocations and

who has a typical degree of risk aversion, the scholarly literature's answer to this dynamic allocation question is "yes", provided that the horizon is long enough to reflect the mean reversion that has been found in empirical stock returns.

This article revisits the question using a traditional two-fund capital market model with a representative investor. The answer is generally the same as found in previous models, but the analysis here yields useful new insights: (1) The optimal stock allocation for a given horizon is *substantially higher* than suggested in the previous literature for investors holding a traditional positive mix of stocks and fixed income securities. (2) For investors who hold 100 percent in stocks or have levered stock portfolios, the optimal allocation is relatively close to that suggested in the previous literature.

A PITFALL IN ETHICAL INVESTING: ESG DISCLOSURES REFLECT VULNERABILITIES, NOT VIRTUES

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Gerald T. Garvey, Joshua Kazdin, Ryan LaFond, Joanna Nash and Hussein Safa

Does Environment, Social, Governance (ESG) investing work? In this paper, we focus directly on ethical and social performance rather than returns. Our measure of performance is the publication of business ethics controversies or regulatory actions against the firm. We choose these outcomes because they are objective, widely applicable, and as we show are also associated with negative stock market reactions.

Like most observers, we expected an ESG-friendly profile would be associated with better social performance. We were wrong. Firms that disclose the widest range of socially responsible policies such as signing the UN Global Compact, disclosing "family friendly" employment policies, and monitoring suppliers' labor practices, are more likely to experience ethics controversies and adverse regulatory actions in the future.

Our results clearly show that screening firms based on popular ESG metrics will not reduce exposure to ethical and social risks. To our knowledge no one has advocated such a crude screening, and ESG practitioners also consider the "E" and "G" components. However, our last section presents evidence that prominent ESG index providers favor firms with more policies, and as a consequence show more rather than less exposure to subsequent controversies.

THE IMPACT OF DIFFERENT DEFAULT TRIGGERS ON CMBS RISK EVALUATION

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Andreas D. Christopoulos

This paper presents a structural generalization for pricing commercial mortgage backed securities (CMBS) and their derivatives, CMBX. I compare results for the structural generalization with a reduced-form approach using identical data sets and analyses. My comparisons are made at both the loan and bond levels and cover the period November 2007 through June 2015 using \$389 billion of loans serving as the underlying collateral for CMBX Series 1 through 8.

The sole difference between the two modelling approaches is found in the set of conditions and methods for simulating the default event which together comprise the “default trigger” that differ for each model. I statistically validate the default estimations and then construct an automated long/short trading strategy using the risk measure Theta to compare the impact of default estimates on investment and risk management decision making.

The strategies exhibit anomalous excess returns in the automated trading strategies for the reduced form using Theta and the risk tenor adjustment. Additionally, from a portfolio management perspective, the reduced-form exhibits a lower proportion of negative automated returns and a slower steepening of positive returns than the structural generalization, indicating a greater ability to realize larger returns than with the structural generalization. These portfolio findings, taken together with the underlying statistics and positive returns, suggest the reduced form provides greater precision than my structural generalization in estimating CRE default events and in assessing trading opportunities in the CMBS sector.

RETHINKING THE FUNDAMENTAL LAW OF ACTIVE MANAGEMENT

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Jose Menchero

The fundamental law of active management provides a powerful framework for making investment decisions and analyzing portfolio risk-adjusted performance. As developed by Grinold and Kahn, the fundamental law expresses the portfolio Information Ratio as a product of skill and the square root of Breadth. Grinold and Kahn measure skill by the Information Coefficient, which represents the time-series correlation between the forecasts and the realized returns. Breadth is defined as the number of independent bets in the portfolio.

The Grinold–Kahn formulation assumes that the manager has equal forecasting skill across every asset, which is unlikely to be the case in practice. Furthermore, whereas Breadth is simply equal to the number of assets in the portfolio for the case of uncorrelated assets, it is not clear how to compute Breadth under more realistic scenarios. These two limitations make the fundamental law of active management difficult to apply in practice.

In this paper, we present a new formulation of the fundamental law. By recognizing that manager skill is independent of asset correlations, we derive a new measure of skill, which we denote as the *Signal Quality*. We then provide an analytic expression for a new quantity, termed the *Diversification Coefficient*, which measures the Breadth of a portfolio. Our new formulation requires only a set of alpha forecasts and an asset covariance matrix, hence is easy to apply in practice. We complete our formulation of the fundamental law with several illustrative examples and a discussion of the Transfer Coefficient, which measures the impact of constraints on risk-adjusted performance.