Jacobs Levy Equity Management Center
for Quantitative Financial Research

Spring 2015 Forum:

"The Alpha and Beta of Factor Investing"

May 1, 2015

Welcoming Remarks
Bruce Jacobs, Ph.D., Advisory Board Chair, and Ken Levy, Advisory Board

BRUCE JACOBS:

Thank you, Chris. Under your leadership, the Jacobs Levy Center continues to thrive and fulfill its mission of advancing innovation in quantitative finance and fostering the application of quantitative methods and techniques.

All of us here today are engaged in the same mission. Ken and I have devoted over 25 years to quantitative research and portfolio management at Jacobs Levy Equity Management. Our firm focuses on active management of US equity portfolios. Much of our effort has been directed toward discovering and exploiting factors that have the potential to offer better-than-market returns. Our early research, published in the *Financial Analysts Journal* in 1988, disentangled the payoffs to stock market "anomalies"—stock price behaviors that were anomalous in the context of the prevailing efficient market hypothesis. Our findings revealed a much greater dimensionality to the stock market than suggested by the one-factor capital asset pricing model.

At the time, that one factor was beta; any returns in excess of those attributable to beta were considered alpha. A lot has happened to alpha and beta since then. Researchers have uncovered hundreds of potential alpha factors. Market neutral long-short portfolios were developed that can separate alpha from beta, and alpha can be transported to other asset types. Most recently, and notably, some alpha factors are now called beta factors and "smart beta" has been born. It is believed that these beta factors are persistent and can be harvested.

Estimates of smart beta assets under management range from 400 billion to 1 trillion dollars. There is little doubt that smart beta products are dramatically altering factor investing.

Our speakers will explore a variety of questions about factors. Which ones matter? How many are there? Why do they work? How to exploit them? Will they become crowded trades? Will they last?

Bryan Kelly proposes a risk factor—Common Idiosyncratic Volatility, or CIV beta that is correlated with household income risk and is priced in equity markets. Cam Harvey provides a cautionary note about the proliferation of factors. He introduces a new method to identify those factors that are not just due to chance. Our luncheon speaker, Cliff Asness, tells us how to make the size factor work. This afternoon, Vineer Bhansali shows us that trend and carry have predictive ability across a variety of markets. And our two panels, comprised of asset owners, consultants, and investment managers, will discuss the use of factors in investment practice.

Before we begin the program, I'll turn it over to Ken for the presentation of this year's Jacobs Levy Center Research Paper Prizes.

KEN LEVY:

In 2014, the Jacobs Levy Center established the Research Paper Prizes to recognize outstanding scholarship in quantitative financial research. Winners are chosen from recent submissions to the Center's working papers series. Outstanding papers are awarded cash prizes of $5,000, and the Best Paper receives a $10,000 prize.

We would like to announce the winning papers now. Afterwards, we will invite all of the prize recipients who are here to step forward and receive their awards.

An Outstanding Paper prize goes to Gill Segal, Ivan Shaliastovich, and Amir Yaron, all of The Wharton School. Their paper, "Good and Bad Uncertainty: Macroeconomic and Financial Market Implications," decomposes macroeconomic uncertainty into good and bad volatility, each of which contribute positively to risk premia, but in different ways.

Another Outstanding Paper prize goes to Peter Feldhutter and Christian Heyerdahl-Larsen of London Business School and Philipp Illeditsch of The Wharton School. Their paper, "Risk Premia, Volatilities, and Sharpe Ratios in a Nonlinear Term Structure Model," introduces a nonlinear

approach to modeling Treasury bonds, and shows that the yield curve can reveal more information than previously thought about expected excess returns.

The top prize for Best Paper is awarded to Lubos Pastor of the University of Chicago Booth School, and Rob Stambaugh and Luke Taylor of The Wharton School. Their paper, “Scale and Skill in Active Management,” finds strong evidence that as the size of the mutual fund industry increases, it becomes more difficult for individual funds to beat their benchmarks. They also find that the active management industry has become more skilled over time.

We now invite all of the prize recipients to join us at the podium to accept your awards. Congratulations!