

10th Financial Risks International Forum
- Paris - March 28th 2017



Discussion on:

“Smart Alpha: a Post Factor Investing Paradigm”

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Main Results of the Article

- Proposed a new long-only active equity investment solution: Smart Alpha (SA) portfolio
 - **Stock alphas estimated using a “smart” PCA decomposition**, with the number of latent risk factors determined dynamically using one specific formulation of the information criteria of Bai and Ng (2002)
 - Optimal active portfolio obtained as the **solution of a long-only systematic variance minimization program under an alpha target**
- Empirical results / Stoxx 600 universe (1999-2016)
 - Show that the SA portfolio (un)conditionally outperforms both market cap index and traditional smart beta solutions such as EW, GMV and IV
 - Find that this outperformance cannot be attributed to the Fama-French factors (SMB, HML, RMW and CMA)

Comments, Remarks and Questions

- How could you justify **ex-ante** the existence of alpha **at the individual** stock level?
 - Reward for unknown risk factors/market anomalies? Means that your statistical factor is not well specified
 - Reward for specific risk/noise? How can it then be priced on the market?

- How can you justify the sharp increase of the number of latent risk factors during crisis periods (from 4/5 to **12/18!!!!**)
 - One would expect the reverse as individual stocks become more correlated during crisis period
 - Post-crisis number of latent factors is also at odds with what most researchers find on equity markets (6-10 vs 4-5, see Gagliardini et al. 17)
 - Is PCA really the « smartest » approach to extract the risk factors (statistical instability, non-scale invariance, non uniqueness and interpretation issues)?

Comments, Remarks and Questions

- Are your ex-post performance/risk results consistent and robust?
 - Why working with different VCV matrix estimates for the smart alpha (systematic PCA-based VCV estimate) and smart beta strategies (shrinkage towards identity/one factor model estimate of total VCV or total volatilities)?
 - There might be a problem with your Figure 2 (GMV seems to have a higher/similar beta than EW and IV portfolios for the period 08-14)

- What is your turnover constraint in your empirical application (missing important information)?

- Could be better to work with the returns in excess of the market cap index for your style analysis

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Thanks for your attention...

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