Editorial

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The sensitivity of financial markets to macroeconomic announcements is well-known, and the chief economist in most financial companies is a macroeconomist. Most modellers want to use macroeconomic information in their portfolio construction methods and it therefore comes as a surprise to find that building regression models of individual stock returns based on macro factors invariably leads to dreadful results. The macro effects tend not to show up at the individual stock level as they seem to be swamped by noise.

Typical variables we might use are inflation, dividends, interest rates, short and long credit spreads and output measures. Some choices have been motivated by empirical work on arbitrage pricing models, so gold prices, commodity prices and industrial production also appear. Prices and rates are usually better to work with than quantities, which are often revised in mysterious ways by government statisticians. This adds great complexity to back-testing as one struggles to recreate exactly what investors knew at the time.

The profession's response to this has been to carry out the analysis at portfolio level, typically style portfolios, using as the portfolios of interest. These are usually value, growth, sometimes size and momentum. This issue of *JAM* contains

a number of articles that explore such linkages, and it is possible, without using highly complex mathematics, to build style-switching strategies based on forecasts of returns to particular styles.

One can also build highly sophisticated regime-switching models based on hidden Markov models, threshold autoregressions and a host of similar arcane specifications. We do not know whether the latter outperform the former; it would be humbling if they did not as the intellectual requirement of the former is an A in A-level maths, whereas the latter would require a PhD in econometrics from a good university.

This does point to a general need in building any piece of complex, quant technology; that is, one needs to make the case by comparing the output of the proposed model with a simple rule of thumb that does essentially similar things. So, for example, when advocating the use of autoregressive conditional heteroscedasticity models to a client who wanted to forecast volatility, we discovered that a simple 60-day moving average in squared returns did just as well most of the time.

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