Editorial

The theme of this special issue is the mismeasurement of tracking error. In recent years, standard risk models have seriously underestimated the tracking error experiences by equity investors; *ex ante* tracking error has been typically 50 per cent of *ex post* tracking error.

A number of theories have been put forward to explain this phenomenon, which I list below. First, there is the idea that there is a serial correlation and/or trend in prices/returns; this can be shown to cause an underestimation of risk if its presence is not taken into account.

Secondly, there are explanations that are based on the presence/absence of common factors and the changing nature of factors. Most models have only recently added a technology factor to explain equity returns; they may now be thinking of taking it out.

Thirdly, there are explanations to do with the large documented increases in

cross-sectional volatility. As a consequence, investors have been taking large bets on sectors and/or styles over short time-horizons. This has led to large changes in holdings; the risk models have been unable to take account of these.

This last explanation leads to theories that try and explain the *ex ante/ex post* discrepancy by randomness in the portfolio weights; a number of the papers in this special issue take such an approach.

I hope that readers find this topic interesting. I am sure that much more will be written about it, since it has implications for both asset and risk management. That said, there are further thought-provoking papers on other subjects to be read once the readers' appetites have been whetted.

*Dr Stephen Satchell, Editor
Journal of Asset Management
December 2001*