
Editorial

Building a behavioural quantitative model based on the substantial research that has occurred in academic finance remains a challenge. Broadly, the main approach seems to be to use measures of price momentum and other measures of under- and over-reaction to information. There may also be measures that try to encapsulate some notion of psychological delusion or limitation on the part of market participants. These have names like representativeness or conservatism.

A version of representativeness is the tendency of the sufferer to expect small samples of data to have the characteristics of the parent population; whilst conservatism is the tendency to underweight new information relative to information already contained. Now, a believer in behavioural finance would look for stock or fund information which would give evidence of the above failings, and build filters to create buy/sell lists based on them. Such a process would lead to stock selection rules which might lead to outperforming portfolios, and the process would seem

to be reasonably model-free, but it would suffer from one clear failing — no risk structure. One could take the active fund and its benchmark and use a standard commercial risk model to measure risk, but then the risk factors used may bear no relationship to the factors used in the fund construction.

And here we come to the moral of this story. Modern institutional finance builds its alpha and its risk essentially separately, without noting the fact that there is a necessary linkage between risk and return. These linkages can be seen very clearly in a mean variance frontier framework where along the efficient frontier, decreasing alpha decreases risk and where, off the frontier, one can move alpha and risk in any direction. This criticism is true for a much broader class of approaches than behavioural finance, but is especially true in that context.

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