Academic Finance as a Check on Pretensions

By Tadas Viskanta

Categories: Economics, Philosophy, Portfolio Management

“Essentially, all models are wrong, but some are useful.” — George E.P. Box

Investment professionals recognize that the markets are messy places, filled with less than rational participants. From their perspective, this can obviate any further discussion about the value of academic finance and its models.

But this puts too high a threshold on the measure of academia. Box’s quote illustrates a much more realistic approach to measuring the value of models. We look to them to be useful, to highlight the phenomena that we need to focus on. But models need not, in the strictest sense of the word, be true.

It is easy to forget that Security Analysis, by Benjamin Graham and David Dodd, was published in 1934, and the classic Theory of Investment Value, by John Burr Williams, in 1938. We are still in the early stages of academic finance. As Ben Carlson, CFA, writes:
“My first thought when reading [Peter] Bernstein’s take here is just how young investment theory really is in the grand scheme of things. Investors were basically in the Dark Ages until four to five decades ago and as he says — things are still evolving.

“I don’t think enough investment professionals today appreciate the contributions made by academics in the investment management profession. Far too many investors spend their time criticizing these theories because they don’t provide a perfect roadmap or explanation of the inner workings of the financial markets.”

Criticism of academic finance comes from those who view its prescriptions as at odds with their chosen business model. In *Pragmatic Capitalism*, Cullen Roche writes:

“In fairness, most of the criticism of modern finance comes from the high fee active investing community who sells the hope of ‘market beating’ returns in exchange for the guarantee of high fees. They criticize things like the Efficient Market Hypothesis (EMH) because they need to sell the idea that they can beat the market and still charge high fees. I obviously reject that whole notion of trying to ‘beat the market’ and emphasize the importance of low fees.”

The reluctance to embrace academic finance helps to explain why it takes so long for its insights to become practical applications. For example, Burton G. Malkiel, author of *A Random Walk Down Wall Street*, was calling for retail-oriented equity index funds for four years before their launch by the Vanguard Group. Fischer Black noted the low beta anomaly back in the 1993. Only recently, however, have low-volatility exchange-traded funds (ETFs) become popular, although some may say too popular.

Writing about the late Jack L. Treynor for *Enterprising Investor*, Mark Harrison, CFA, noted that it takes time for academic ideas to filter their way down to the mainstream. Harrison writes:

“In the end, the greatest barrier to the acceptance of novel concepts or techniques, especially those involving mathematical language that many find tedious, is human prejudice. In any organization, people with irrational prejudices will surround themselves with like-minded acolytes. Educational frameworks, professional customs, and institutional and regulatory structures will always lag behind new intellectual insights. So the gradual incorporation of innovations, such as quantitative techniques into the investment profession, even if now it appears a linear triumph, was hindered by many obstacles that Jack Treynor did much to overcome.”

It’s hard to ignore the shift of funds from active to passive management. This trend reflects the “Arithmetic of Active Management,” discussed by Nobel Prize winner Bill Sharpe in his 1991
**Financial Analysts Journal article.** In short, simple math works against the prospect of widespread manager alpha. However, passive funds still manage only 30% of global equities.

This has not prevented some from criticizing the trend toward indexing. There are a number of arguments against passive management that don’t hold much water, including the prospect of increased market volatility. Passive management only looks troubling from the perspective of an industry facing falling profit margins. *The Economist* recently celebrated the rise of “tracker funds”:

“For the foreseeable future any risks from tracker funds are far outweighed by their ability to offer cheap, diversified funds to retail investors. The real problem is not the rise of Vanguard and the other tracker funds; it is the rotten deal that retail investors have received from the fund-management industry for far too long.”

One of the reasons why we have seen many academics establish investment management firms is because their ideas were not being reflected in the work of more established institutions. *Dimensional Fund Advisors, AQR Capital Management, and LSV Asset Management*, are just a few examples of those companies translating academic research into investment management products.

That is not to say that academic finance is without flaws. One of its primary problems is the question of publication bias. This refers to publishing only the research that shows significant results or, in the parlance of academics, an anomaly. Another problem is the continued mining of our limited history of financial data. Campbell R. Harvey and Yan Liu in the *Journal of Portfolio Management* write:

“Researchers in finance, whether practitioners or academics, need to realize that they will find seemingly successful trading strategies by chance. We can no longer use the traditional tools of statistical analysis that assume that no one has looked at the data before and there is only a single strategy tried. A multiple-testing framework offers help in reducing the number of false strategies adapted by firms. Two sigma is no longer an appropriate benchmark for evaluating trading strategies.”

This issue is most relevant to “smart beta” funds. These funds aim to generate alpha by providing investors with exposure to various individual and, more recently, multiple factors. The arguments in favor of these funds often rest on research demonstrating the strategy’s attractiveness. The challenge for investors is to wade through the competing claims. Indeed, the success (or failure) of these strategies will only play out over time, and will rely on the use of investor funds to prove their theses.
It is difficult to imagine the investment management industry without academic influence. A grounding in both academia and practice is necessary to keep the focus on clients, where it belongs.

“Academics play a vital role; they are a generally unbiased check on the pretensions of financial practitioners, with enough technical knowledge to cut through the jargon with which Wall Street can confuse the investing public. Academic views will change over time; of course they will. But we should be glad they are around.”

The lines between academia and investment management have become blurred over time. Indeed, some investment management firms are formalizing their relationships with academic institutions with the hope of gaining a practical edge. That should give us some pause, but on the whole, we should be grateful there are academics continuing to publish research and keeping a wary eye on financial practitioners.

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David Pfaff said:
Excellent article Tadas!! The very first sentence in the body of your article rings far too true historically and ever more present in the current economic climate. The very last sentence offers “pause” as you so eloquently write, and sketchy hope.

19 July 2016 at 01:44

Sukanya said:
I too believe that the lines between academia and investment management have become blurred over time..I loved this article..It is very interesting and I really enjoyed reading it..Thank you for sharing your knowledge..

19 July 2016 at 06:20

Brad Case said:
Excellent piece—thanks for publishing.
On my office door is a quotation from Harvard professor Henry Rosovsky: “Never underestimate the difficulty of changing false beliefs by facts.”

19 July 2016 at 08:12

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ECB keeps rates on hold but flags rising risks
The European Central Bank was unsparing as it noted developing downside risks to the eurozone's economy, but it kept rates steady at its meeting Thursday. President Mario Draghi noted Brexit's risk and slowing growth in emerging markets, and he signaled that the ECB will use stimulus if needed. Reuters (21 Jul.)

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