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Academic Research Digest

February Update

- **What's New in Academic Research** — In this issue of Academic Research Digest, we highlight four articles on stock selection strategies and one article on market timing. We also cite five additional working papers that we believe are of interest.
- **Earnings Magnitude and Sign** — A new earnings based stock selection strategy.
- **When the Prophets are Wrong** — Using short interest information to trade against analysts' recommendations.
- **Illiquidity** — A new theory-based factor for stock selection and risk management.
- **Is Meeting or Beating Earnings Forecasts Always Good/Bad?** — Learning how to predict the market reaction to firms' meeting or beating or missing forecasts.
- **Forward-Looking Market Timing** — Using option pricing to determine cash/equity timing.

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See Appendix A-1 for Analyst Certification and important disclosures.

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Contents

Introduction	3
Articles	5
1. Post loss/profit announcement drift	5
2. Trading Against the Prophets: Using Short Interest to Profit from Analyst Recommendations	7
3. Theory-Based Illiquidity and Asset Pricing	9
4. 'Other Information' as an Explanatory Factor for the Market Reactions to Firms' Meeting or Beating Analyst Forecasts	11
5. Asset Allocation with Option-Implied Distributions: A Forward-Looking Approach	13
Short Coverage	15
Previously published Academic Research Digest Reports	16
Global Quantitative Research Team	17
Appendix A-1	21

Introduction

For our 15th edition of the Academic Research Digest (ARD) we examine some interesting papers on well known research topics. We continue to be surprised that there are still new, original and sometimes simple ideas that can potentially lead to successful portfolio strategies. In this month's report we highlight four stock selection strategies and one market timing model. While we generally like to provide a range of papers covering stock selection, portfolio construction and asset allocation, for this month we have looked at four fairly diverse and unique stock selection papers that are particularly relevant to today's market conditions. In the last paper, we examine a particularly interesting piece that explores the information content of option implicit information in the context of market timing – market timing being a topic that we have experienced a lot of client interest on lately.

Karthik Balakrishnan, Eli Bartov, and Lucile Faurel in the first paper of this month's issue touch upon an unexplored question related to earnings. Rather than looking at earnings surprises or earnings quality they focus on earnings magnitude and sign. They propose a trading strategy that is based on the magnitude of profit/loss, i.e. a portfolio that is long stocks with extreme profits and short stocks with extreme losses. The return on the hedge portfolio is an impressive 21% per year. Moreover the authors show that the mispricing associated with the loss/profit strategy is distinct from, and incremental to three previously documented accounting-based anomalies: the post-earnings-announcement drift, the value-glamour anomaly, and the accruals anomaly.

The second paper, authored by Michael S. Drake, Lynn Rees, and Edward P. Swanson, studies the interaction between short interest and analysts' recommendations. The analysis concludes that short interest is a useful signal for when to trade against analysts' recommendations. In particular the authors show that a hedge portfolio that invests long in firms with the worst recommendations (sell signal) but the lowest short interest levels (buy signal), and invests short in firms with the best recommendations (buy signal) but the highest short interest levels (sell signal) earns a six-month abnormal return of 9.6%. Lastly, the analysis finds empirical evidence that short sellers are more efficient relative to financial analysts in using information captured by a number of quant variables.

In the third paper Tarun Chordia, Sahn-Wook Huh, and Avanidhar Subrahmanyam study the impact of (il)liquidity on stock returns. To this end they introduce a new, theory-based measure which can be estimated at low cost through plausible empirical proxies for its input variables. In their empirical analysis they study the return on portfolios sorted on the value of the proposed measure and size. They show that High-Low illiquidity portfolios generate monthly returns that range from 0.5% (largest-cap stocks) to 1.9% (smallest-cap stocks). The conjecture that illiquidity is a priced factor in equity returns is also confirmed through appropriate cross-sectional regressions.

The fourth paper studies market reactions to firms' meeting or beating analysts' expectations. The authors, Vincent Y.S. Chen and Samuel L. Tiras, posit that seemingly counterintuitive market reactions, i.e. negative market reactions for firms that meet or beat analyst forecasts and positive market reaction for firms that miss analyst forecasts, may be attributable to the market reacting to information not captured in the accounting process (as well as the transitory nature of earnings). Using analysts' forecasts to quantify 'other information' incremental to earnings they show that the market evaluates 'other information' too when assessing firms' meeting or beating analysts expectations. And they show how a profitable trading strategy can be formulated on the basis of this observation.

The last paper of this issue addresses market timing within a novel framework where estimates about future return moments/distributions are derived from forward-looking option price cross-sections. Alexandros Kostakis, Nikolaos Panigirtzoglou, and George Skiadopoulos show that timing portfolios constructed on the basis of moments/distribution estimates obtained from option prices can be more profitable than portfolios formulated on the basis of the historical moments/distribution estimates. Their strategy outperforms the backward-looking approach under all performance criteria (Sharpe ratio, the opportunity cost, and portfolio turnover and transaction costs).

We hope that you find the ideas presented in these papers interesting and thought provoking. Please feel free to call us if you want to discuss any of these research papers in more detail or you need any further information.

Articles

1. Post loss/profit announcement drift

Karthik Balakrishnan, Eli Bartov, and Lucile Faurel¹, October 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

Key Points:

- Earnings signs and magnitude contain significant information
- Hedge portfolios based on profit/loss can yield up to 21% per year
- The 'profit/loss' factor is distinct from and incremental to standard earnings and value related quant factors

Earnings magnitude and sign contain useful information for future returns

This article proposes an event-driven portfolio strategy that is based on earnings signs, a loss versus a profit, and their magnitudes. Balakrishnan, Bartov and Faurel show that over the 120-trading-day window following the earnings announcement day, firms in an extreme loss quintile portfolio exhibit a negative drift of nearly 7%, whereas firms in an extreme profit quintile portfolio exhibit a positive drift of over 3%. The return on the hedge portfolio is approximately 21% per year. The authors conclude that the return on profit/loss sorted portfolios is more substantial than, and incremental to the returns generated by portfolios formed on the basis of earning surprises, book-to-market, and the accruals.

A simple buy profit, sell loss announcing firms' strategy, generates 13% per annum

Data for this study are sourced from COMPUSTAT and CRSP and cover the period 1976 to 2005 (some of the tests are from 1988 onwards though). In the first set of tests the authors examine if stock prices fully react to loss/profit announcements. To this end they formulate two portfolios: a loss portfolio containing all firms with negative earnings and a profit portfolio containing all firms with positive earnings. The results in the window [1, 120] indicate that the loss firms exhibit a significantly negative return of -5.07% and the profit firms exhibit a significantly positive return of 1.46%. The return on the hedge portfolio is 6.52% or about 13% annualised

A finer earnings partition enhances portfolio performance significantly up to about 21% per annum

A finer earnings partition of loss (profit) into five loss (profit) quintiles is consistent with substantial profit potential. For tests carried out both for [1, 60] and [1, 120] it appears that buy-and-hold returns can be on average 5.87% and 10.13% respectively for the period 1976-2005. Additional analysis indicates that the return on the hedge portfolio is consistently profitable both when adjusted for size and when adjusted for standard risk factors, i.e. market, size, value, momentum. Also it is robust with respect to three partitions of the sample, i.e. 1976-1985, 1986-1995, and 1996-2005.

The loss/profit effect is incremental to, and more pronounced than a number of accounting-based anomalies

The authors then turn to examine the relation between post loss/profit announcement drift and other accounting-based strategies that it might be linked with. Balakrishnan, Bartov and Faurel posit that the post loss/profit announcement may be another manifestation of the earnings surprise, earnings quality, or book-to-market anomalies and test against these hypotheses. Based on the analysis of portfolio returns formulated with two-way sorts, i.e. earnings surprise, book-to-market, and accruals, and loss/profit quintiles, the authors show that the loss/profit effect is incremental to, and more pronounced than any of the accounting-based anomalies examined.

¹ Karthik Balakrishnan and Eli Bartov are at New York University, and Lucile Faurel is at University of California, Irvine.

A simple strategy based on the sign and magnitude of earnings provides robust and persistent performance...

...incremental to the post-earnings-announcement drift, the value-glamour anomaly, and the accruals anomaly

Collectively this paper introduces a new quant factor, i.e. earnings sign and magnitude. The authors show that portfolio strategies based on this factor yield significant returns that can be as high as 21% per year. Moreover they show that the mispricing associated with the loss/profit strategy is distinct from, and incremental to three previously documented accounting-based anomalies: the post-earnings-announcement drift, the value-glamour anomaly, and the accruals anomaly. And finally that the loss/profit anomaly is robust to alternative risk adjustments, distress risk, short sales constraints, transaction costs, and time periods.

GQR comments and investment implications

Although we have discussed several papers on earnings-based strategies in the ARD – last month for example we discussed the investor distraction hypothesis – we are surprised that there are still new, original, sometimes simple ideas that can lead to very successful portfolio strategies. This paper is one of them. The authors, motivated by the premise that investors make decisions based on normatively inappropriate simplifications, hypothesise that after a positive (negative) earnings announcement, a strategy of buying the stock will yield abnormal positive (negative) returns. Interestingly, this hypothesis is not rejected and the equity long/short strategy that builds upon this idea generates a robust 21% per annum. Not only is the average performance substantial but also size-adjusted returns as well as four factor alphas have been consistently positive over the study period (with only three exceptions for the four factor alphas). From the point of view of an equity portfolio manager implementation issues such as transaction costs and short-sale constraints are shown not to be critical for the profitability of the strategy. In addition the strategy is shown to work both when small-caps are included and excluded suggesting that managers with more constrained mandates may also play this factor.

2. Trading Against the Prophets: Using Short Interest to Profit from Analyst Recommendations

Michael S. Drake, Lynn Rees, and Edward P. Swanson², October 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

Key Points:

- Analysts' recommendations and short interest
- Short interest is a profitable signal for when to trade against analyst recommendations
- Hedge portfolios based on the interaction of short interest and analysts recommendations yield a six-month abnormal return of 9.6%

The value added by analysts' recommendations increases significantly when viewed together with short interest information

The short interest almost doubles post 2000 while analysts' recommendations are on average close to 'buy'

Analysts' recommendations seem to be less effective – if at all effective – when considered in isolation compared with short interest

This article studies the investment implications of the interaction of analysts' recommendations with short interest information. Drake, Rees and Swanson study both recommendations levels and changes and show that the most profitable strategy is to use short interest as a signal for when to trade against analyst recommendations. In particular they show that a zero-investment strategy that (1) invests long in firms with the worst recommendations (sell signal) but the lowest short interest levels (buy signal), and (2) invests short in firms with the best recommendations (buy signal) but the highest short interest levels (sell signal), earns a six-month abnormal return of 9.6%. When short interest is combined with changes in recommendations the obtained average six-month abnormal return is 7.9%.

The study covers the period 1994 to 2006. It uses a number of sources including CRSP, IBES, and COMPUSTAT and stock exchanges to obtain data for stocks trading on NYMEX, AMEX, and NASDAQ. Short interest data are in particular sourced from COMPUSTAT from January 2005 onwards and the respective exchanges for the rest of the study period. A description of the dataset highlights that the average analyst recommendation is very close to 'buy' from 1994 to 2001. However, the average recommendation declines (becomes more sell oriented) during 2002 and 2003 and remains at low levels thereafter. Low levels of short interest on average are observed up to 2000 while the level of short interest more than doubles post 2000.

The first set of experiments focuses on the effectiveness of each factor individually. The authors show that following analysts' recommendation levels does not generate positive abnormal returns over the full sample period or for any of the three sub-periods examined (1994-1998, 1999-2003, 2004-2006). Recommendation revisions on the other hand are shown to be a profitable factor but with quite modest profitability, i.e. 2.3% for a six-month period for the full sample period, not more than 3% in the three sub-periods. The short interest factor seems to be more effective. Buying (selling) firms that are in the lowest (highest) short interest quintile yields a six-month abnormal return of 4.3%.

² Michael S. Drake, Lynn Rees, and Edward P. Swanson are at Texas A&M University.

A strategy that is contrary to analysts' recommendations but in line with short interest signals yields a one-year abnormal return of 18.5%

When the authors combine the signals, the profitability of the hedge strategies improves significantly. More specifically the authors distinguish between two hypotheses: one that requires that short sellers and analysts agree on their predictions and one where they disagree. The results indicate that the most profitable investment strategy is to trade against analysts' recommendation levels. Specifically, investing long in firms classified in the worst recommendation quintile but the lowest short interest quintile, while investing an equal amount short in firms classified in both the best recommendation quintile and highest short interest quintile, yields a six-month abnormal return of 9.6%. This is obviously a significant improvement to the strategy that is based on either of the factors alone.

Short sellers are more efficient relative to financial analysts in processing publicly available information

Drake, Rees, and Swanson next examine the relation between short sellers' signals and other investment signals. They show that short sellers appear to be much more efficient relative to financial analysts in using information captured by variables such as firm size, price momentum, forecast revision, earnings surprise, earnings-to-price ratio, book-to-market ratio, average daily stock turnover, forecasted long-term growth, realised sales growth, total accruals, and capital expenditures. Detailed analysis shows that the value of analysts' recommendations to investors is not incrementally positive to short interest and other publicly available information. Various checks confirm the robustness of the analysis.

Short interest helps identify profitable trades particularly when it is in contrast with analysts' recommendations

In summary this paper studies the interaction of two well-known quant factors: analysts' recommendations and short interest. The analysis indicates that short interest helps identify stocks particularly in cases where analysts' recommendations are in contrast with short interest. This idea can be implemented through a long/short equity strategy that buys stocks with low short interest and the worst recommendation and sells stocks with high short interest and the best recommendation. This strategy yields a robust six-month abnormal return of 9.6%.

GQR comments and investment implications

The use of short interest as a quant factor has been the subject of extensive research especially in recent years. Our October 2007 ARD issue discusses a paper (see 'The good news in short interest') which shows how short interest can be used in an equity long/short portfolio context. This paper uses the short interest factor not in a standalone fashion but as a means of identifying candidate stocks that receive contrarian (relative to short interest) analyst recommendations. The return of the proposed zero-investment strategy is really impressive, i.e. a six-month abnormal return of 9.6%. Another interesting finding of this paper is that the information contained in short interest data is incremental to that contained in standard quant factors. Some additional attributes of the constructed hedge portfolios that we consider worth highlighting include a bias towards large firms as well as the persistence in returns (the one-year abnormal return is 18.5%).

3. Theory-Based Illiquidity and Asset Pricing

Tarun Chordia, Sahn-Wook Huh, and Avanidhar Subrahmanyam³, August 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

Key Points:

- A theory-based measure of (il)liquidity
- Portfolios based on this measure generate returns up to about 2% monthly
- The impact of illiquidity is higher in small-cap firms

Liquidity is priced in the cross-section of stock returns

This paper studies the relationship between liquidity and (expected) stock returns. Chordia, Huh and Subrahmanyam introduce a new framework which expresses illiquidity in terms of plausible empirical factors and stronger economic underpinnings relative to those in the current literature. The authors present evidence which suggests that illiquidity is priced in the cross section after controlling for known characteristics such as firm size, book-to-market equity, and momentum as well as for known sources of risk such as the Fama and French (1993) factors. They also show that the proposed illiquidity measures are priced even after accounting for the effects of other competing (il)liquidity measures.

A theory-based liquidity factor can be estimated through empirically plausible proxies

The authors estimate two variants of closed-form expressions, one of which assumes perfect information signals, while the other postulates noisy signals. The variables that are required to estimate the new illiquidity measures include the number of analysts following a firm in each month, the standard deviation of daily returns within the previous month, and the average of daily dollar volume within the previous month when there is perfect information; and the stock price at the previous month's end, the squared value of earnings volatility, the squared value of the earnings surprise, and the squared value of the average of daily dollar volume within the previous month when information signals are noisy. The analysis is carried out for stocks listed on NYSE/AMEX/NASDAQ for the period 1976 (1983 for NASDAQ stocks) to 2002.

A long/short equity strategy that is based on the theory-based liquidity factor yields as much as 1.8% monthly abnormal return

To get perspective on the impact of illiquidity on returns the authors create portfolios by sorting stocks into quintiles by illiquidity and size. The results indicate that within a given size group the value-weighted average return increases with illiquidity, except for the largest size group. In particular, the average High-Low returns are positive and significantly different from zero in four out of the five cases, i.e. 1.9%, 1.3%, 0.9% and 0.5% monthly. This finding suggests that illiquidity pricing is stronger in smaller firms, though as claimed by the authors not solely driven by a few small firms. Three-factor alphas for the High-Low portfolio are also positive and significant although this time only for the three groups with the smallest stocks, i.e. 1.8%, 1.1% and 0.7%.

³ Tarun Chordia is at Emory University, Sahn-Wook Huh is at Brock University, and Avanidhar Subrahmanyam is at University of California at Los Angeles.

**The new measure provides information
beyond illiquidity measures used so far**

The impact of illiquidity on returns is then examined in terms of cross-sectional regressions. Under the various specifications considered it is shown that the proposed illiquidity measures are associated with positive and significant coefficients suggesting that stocks with higher illiquidity are expected to have higher (excess) returns. Supplementary analysis provides support for the robustness of these results. In addition the authors show that the proposed illiquidity measures are a priced attribute in the cross-section of expected returns, even after controlling for other illiquidity measures prevalent in the literature.

**Illiquidity is a priced attribute especially
in the small-cap space**

Collectively, this article introduces a new, theory-based measure for (il)liquidity. The authors show that the new factor can be estimated at low cost through plausible empirical proxies for its input variables. They also show that successful equity long/short strategies can be created by sorting stocks on the illiquidity factor which can yield up to about 2% per month. The authors highlight though the constructed portfolios have a size bias.

GQR comments and investment implications

This article proposes a new measure of illiquidity, a theory-based measure, as an alternative to empirical proxies that we have thus far considered in the literature. The new measure can be computed with a straightforward algorithm and is very effective in predicting stock returns. In particular, zero-investment portfolios formulated on the basis of stocks sorted on this measure can generate up to about 2% gross or 1.8 abnormal monthly return. Although the return on hedge portfolios with smaller-cap stocks is higher than the return of High-Low illiquidity portfolios with larger-cap stocks, each portfolio is quite well diversified. The average number of component stocks used in each of the 25 (5 size x 5 illiquidity quintiles) portfolios in each month is 68.61. Notably, the authors find that the correlation between the book-to-market ratio and the illiquidity measure is positive which indicates that value stocks are likely to be more illiquid. Illiquidity on the other hand is negatively correlated with the momentum suggesting that good past price performance of a stock tends to contribute to the improvement in the liquidity of that stock.

4. 'Other Information' as an Explanatory Factor for the Market Reactions to Firms' Meeting or Beating Analyst Forecasts

Vincent Y.S. Chen and Samuel L. Tiras⁴, September 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

Key Points:

- Market reaction to firms' meeting or beating, or missing of earnings targets is not independent of other information
- 'Other information' can be measured through the incremental to earnings related information implicit in analysts' forecast
- Trading on the basis of 'other information' can generate abnormal returns not subsumed by total accruals, firm size, beta and book-to-market ratio

The market does not react to meeting or beating earnings targets unconditionally

This paper investigates market reaction to firms' meeting or beating analyst forecasts in the context of a factor capturing 'other information', i.e. information captured by analyst forecasts incrementally to the information reflected in the accounting process. Chen and Tiras show that markets overreact to 'other information' and conclude that whether market prices earnings information rationally, partly depends on whether 'other information' is priced rationally.

'Other information' can be decisive...

The analysis is carried out with data sourced from CRSP, IBES and COMPUSTAT for the period 1990 to 2005. The authors measure 'other information' as the residual of a regression of consensus analyst forecasts of next period's earnings on the accounting earnings and book value. In this context a higher 'other information' value indicates more favourable non-earnings information.

...and potentially captured in analysts' earnings forecasts

Chen and Tiras posit the hypothesis that 'other information' is negatively associated with the probability of a firm that meets or beats analyst forecasts and generates negative cumulative abnormal returns, and positively associated with the probability of a firm that misses analyst forecasts and generates positive cumulative abnormal returns. The empirical analysis suggests that indeed the market does not act blindly in reacting to firms that meet or beat, or miss analyst forecasts, and that the market considers the 'other information' aggregated in the proposed empirical proxy.

The market overprices 'other information', therefore trading this factor can be profitable

More relevant perhaps for an equity portfolio manager is the second hypothesis that is put forward, i.e. that the market overprices 'other information'. The empirical test of this hypothesis involves Fama and MacBeth (1973) tests for a hedge portfolio that assumes a long position for firms in the highest decile and a short position for firms in the lowest decile of 'other information'. The results indicate that the trading strategy based on 'other information' can generate abnormal returns which are statistically significant at 1% level and not subsumed by total accruals, firm size, beta and book-to-market ratio.

⁴ Vincent Y.S. Chen is at National University of Singapore and Samuel L. Tiras is at Louisiana State University.

The market does not fixate exclusively on the meeting or beating, or missing of earnings targets, but evaluates 'other information' too

All in all the paper focuses on the issue of market reactions to firms' meeting or beating analysts' expectations. The authors provide evidence suggesting that the market overreacts to 'other information', which in turn means that the market exhibits inefficiencies when information other than earnings news is disseminated in the market. The evidence provided by the authors suggests that the market does not fixate exclusively on the meeting or beating, or missing of earnings targets, but evaluates 'other information' too. For an equity portfolio manager integrating this information in an investment process, this can be a very profitable strategy.

GQR comments and investment implications

This is another paper that utilises analyst forecast information. While in one of the papers discussed above it appears that analyst recommendations are not in isolation very informative, this paper shows that analyst earnings forecasts can be used to identify information not captured in the accounting process. The authors term this information 'other information', show how to quantify it, and use it to predict market reaction to firms' meeting or beating analyst forecasts. The focus of the paper is not to study 'other information' in the context of portfolio strategies and lacks several tests that would shed light on various practical aspects. However, the authors provide sufficient empirical evidence for the predictive ability of this factor and motivate further research in this direction.

5. Asset Allocation with Option-Implied Distributions: A Forward-Looking Approach

Alexandros Kostakis, Nikolaos Panigirtzoglou, and George Skiadopoulos⁵,
December 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

Key Points:

- Option-implicit information may be superior to information obtained from historical data
- Timing cash/equity markets based on option prices cross-sections improves portfolio profitability
- Sharpe ratios can be as high as 0.75 per annum

Option-implicit information is useful for market timing strategies

The objective of this article is to develop a market-timing model that is based on option-implicit thus forward-looking information. Kostakis, Panigirtzoglou and Skiadopoulos develop an empirical procedure that uses stock index implied distributions as inputs to calculate the optimal portfolio in an asset universe that consists of a risky (the S&P 500) and a risk-less asset. The results presented in this paper suggest that the proposed approach serves as a better tool for market timing relative to an approach that is based on the historical distribution of returns.

Observed option prices and appropriate risk-adjustment are required for determining allocation inputs

The paper uses monthly data of S&P 500 futures options for the period February 1989 through May 2002. Data are sourced from the Chicago Mercantile Exchange, Bloomberg and Datastream. The proposed approach involves estimation of the forward-looking return distribution of S&P 500 returns from observed option prices, and then risk-adjusting them in order to construct the timing portfolio. Optimal portfolios are derived by direct maximisation as well as by maximising the second and fourth order Taylor series expansion of the expected utility of the individual investor.

Sharpe ratio, the opportunity cost, portfolio turnover and transaction costs are considered for comparison

The out-of-sample exercise compares the performance of timing portfolios based on the risk-adjusted distributions/moments and portfolios derived by distribution/moment estimates based on historical data. The evaluation of the out-of-sample performance of the various optimal strategies is done under various metrics (Sharpe ratio, the opportunity cost, and portfolio turnover and transaction costs). Further robustness checks are provided by using alternative standard and 'behavioural' utility functions to form the optimal portfolios of the individual investor.

⁵ Alexandros Kostakis is at University of Glasgow, Nikolaos Panigirtzoglou is at Queen Mary University, and George Skiadopoulos is at University of Piraeus.

Option price based allocation is superior to historical data based strategies

The authors show that timing strategies based on option-implicit information are more effective than traditional approaches using historical, backward-looking information. The superiority of their method is confirmed under all performance criteria. For instance, their approach yields a typical increase in the Sharpe ratio of the order of 0.2 per annum. In the case where transaction costs are included, the investor is still better off by 1%-3% per annum by following the forward-looking approach.

In summary this work explores the information content of option implicit information in the context of market timing. The authors show that portfolios constructed on the basis of moments/distribution estimates obtained from option prices can be more profitable than portfolios formulated on the basis of the historical moments/distribution estimates.

GQR comments and investment implications

This paper proposes a novel framework for market timing that is based on option implicit information. It addresses a question that has, in its general form, concerned academic and practitioners for a long time: that is, finding the best estimate of moments/distribution for optimal asset allocation decisions. The authors derive their estimates from option price cross-sections as opposed to estimates relying on historical data. The merits of this approach are twofold. First, estimations can be derived on the basis of just a few data points, i.e. option prices for different strikes and maturities, and second, perhaps more importantly the estimates are forward-looking in that they are based on the expectations of market participants, i.e. the option price setters. This approach can be viewed as a generalisation of the literature that suggests forecasting volatility by the implied volatility as well as part of the literature that suggests using information from option prices rather than historical data to estimate parameters like the beta and correlation coefficients that are crucial for risk management.

Short Coverage

This section cites five additional papers that we consider relevant and thought provoking.

'Sales Forecasting with Financial Indicators and Experts' Input' by Vishal Gaur, Nikolay Osadchiy, and Sridhar Seshadri, October 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com.

The paper proposes a model in which the total sales of a retailer is a function of sales forecasts generated by equity analysts, the term of the forecast, and the return on an aggregate financial market index over the term of the forecast.

'The Incremental Information Content of Tone Change in Management Discussion and Analysis' by Ronen Feldman, Suresh Govindaraj, Joshua Livnat, and Benjamin Segal April 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com.

This study shows that the Management Discussion and Analysis section of Form 10-Q and 10-K has incremental information content beyond financial measures such as earnings surprises, accruals and operating cash flows.

'Investor Attention and Stock Mispricing' by Justin Jin, January 2009

A copy of this article is available on the Social Science Research Network website – www.ssrn.com.

This study examines the relation between investor attention and stock mispricing of accruals in U.S. firms.

'Financial Distress, the Idiosyncratic Volatility Puzzle and Expected Returns' by Qingyi (Freda) Song, November 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com

This paper shows that the negative correlation between idiosyncratic volatility and return is a manifestation of financial distress.

'Accrual Quality and Expected Returns: The Importance of Controlling for Cash Flow Shocks' by Maria Ogneva, November 2008

A copy of this article is available on the Social Science Research Network website – www.ssrn.com.

This paper documents that poor accrual quality firms systematically experience more negative cash flow shocks compared to good accrual quality firms.

Previously Published Academic Research Digest Reports

January Update (19-Jan-09)

1. Driven to Distraction: Extraneous Events and Underreaction to Earnings News
2. Arbitrage Risk and Stock Mispricing
3. Distinguishing behavioral models of momentum
4. Macroeconomic Volatility and Stock Market Volatility, Worldwide
5. Portfolio Optimization with Mental Accounts

David Hirshleifer, Sonya Seongyeon Lim, and Siew Hong Teoh
John A. Doukas, Chansog (Francis) Kim, and Christos Pantzalis
Byoung-Hyoun Hwang
Francis X. Diebold and Kamil Yilmaz
Sanjiv Das, Harry Markowitz, and Jonathan Scheid

November Update (25-Nov-08)

1. The Sophisticated and the Simple: The Profitability of Contrarian Strategies
2. What Happened To The Quants In August 2007?: Evidence from Factors and Transactions Data
3. On the properties of equally-weighted risk contributions portfolios
4. Being Naive about Naive Diversification: Can Investment Theory Be Consistently Useful?
5. Return Predictability Revisited

Gishan Dissanaikie and Kim-Hwa Lim
Amir E. Khandani and Andrew W. Lo
Sébastien Maillard, Thierry Roncalli, and Jérôme Teiletchex
Jun Tu and Guofu Zhou

Ben Jacobsen, Ben Marshall, and Nuttawat Visaltanachoti

October Update (21-Oct-08)

1. Investor Sentiment, Post-Earnings Announcement Drift, and Accruals
2. Costly External Equity: Implications for Asset Pricing Anomalies
3. Value versus Growth: Time-Varying Expected Stock Returns
4. Style Investing, Comovement and Return Predictability
5. Forecasting Stock Market Returns: The Sum of the Parts is More than the Whole

Joshua Livnat and Christine Petrovits
Dongmei Li, Erica X. N. Li, and Lu Zhang
Huseyin Gulen, Yuhang Xing, and Lu Zhang
Sunil Wahal and M. Deniz Yavuz
Miguel A. Ferreira and Pedro Santa-Clara

September Update (23-Sep-08)

1. Not All Trading Volumes are Created Equal: Capital Gains Overhang and the Earnings Announcement Volume Premium
2. Momentum and Informed Trading
3. Stock Returns and Volatility: Pricing the Short-Run and Long-Run Components of Market Risk
4. Accruals and aggregate stock market returns
5. Technical Analysis: An Asset Allocation Perspective on the Use of Moving Averages

Wonseok Choi, Kenton Hoyem, and Jung-Wook Kim
Allaudeen Hameed, Dong Hong, and Mitch Warachka
Tobias Adrian and Joshua Rosenberg
David Hirshleifer, Kewei Hou, and Siew Hong Teoh
Yingzi Zhu and Guofu Zhou

July Update (21-July-08)

1. Mispricing Following Public News: Overreaction for Losers, Underreaction for Winners
2. Identifying Overvalued Equity
3. Leverage, Excess Leverage and Future Stock Returns
4. Analyst Forecast Biases and Stock Returns
5. Is the Distribution of Stock Returns Predictable?

Ferhat Akbas, Emre Kocatulum, and Sorin M. Sorescu
Messod Daniel Beneish and D. Craig Nichols
Judson Caskey, John Hughes, and Jing Liu
Zhi Da and Mitch Warachka
Tolga Cenesizoglu and Allan Timmermann

June Update (27-June-08)

Quantitative Conference 2008 Digest

May Update (20-May-08)

1. Sell on the News: Differences of Opinion, Short-sales Constraints, and Returns Around Earnings Announcements
2. Momentum Profits, Factor Pricing, and Macroeconomic Risk
3. Reversal Fear and Momentum
4. A Generalized Approach to Portfolio Optimization: Improving Performance by Constraining Portfolio Norms
5. Using Economic Theory to Build Optimal Portfolios

Henk Berkman, Valentin Dimitrov, Prem C. Jain, Paul D. Koch, and Sheri Tice
Laura Xiaolei Liu and Lu Zhang
Kevin Q. Wang
Victor DeMiguel, Lorenzo Garlappi, Francisco J. Nogales, and Raman Uppal
Thomas Chevrier and Robert E. McCulloch

April Update (18-Apr-08)

1. Real-Time Profitability of Published Anomalies: An Out-of-Sample Test
2. A New Measure of Analyst Earnings Forecast Dispersion
3. Portfolio Construction with Downside Risk
4. The Economic Value of Predicting Correlation for Asset Allocation
5. The Information Content of Analysts' Risk Ratings

Zhiijian (James) Huang
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Harald Lohre, Thorsten Neumann, and Thomas Winterfeldt
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Notes

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Appendix A-1

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