



7 February 2011

QCD Model

QCD model update

Research summary

Every month, we provide our readers with a review of broad quant factor performance, our QCD model recommendations, and our model performance. Please contact us to be added to our spreadsheet distribution list.

February 2011 update

Broad quantitative alpha factor performance

After a very challenging month in December, most quant factors improved steadily and added value in January. All six factor groups – value, growth, momentum, sentiment, quality, and technicals – had positive performance. Value factors and technical factors performed best.

Model recommendations

For February 2011, our model suggests allocating more weight to quality, revision, and technical factors, and less weight to value, momentum/reversal, and growth factors.

In the large cap space, i.e., Russell 1000 index, our model suggests overweighting the energy and info tech sectors; and underweighting the financials and consumer discretionary sectors.

Within small-cap universe, i.e., Russell 2000 index, our model suggests the info tech and energy are likely to outperform, while the financials and consumer discretionary sectors are likely to underperform.

The QCD model performance

Our QCD model outperformed in January, with a sector-neutral rank information coefficient (IC) of 6.72%.

Our five model portfolio performance

Last month, the five model portfolios (large-cap core, large-cap value, large-cap growth, small-cap, and market neutral) produced after-cost active returns of 0.67%, 0.00%, 0.69%, 3.96%, and 2.41%, respectively.

An in-depth description of our model methodology can be found in our *DB Quant Handbook*, July 22, 2010. QCD model scores for all stocks in our universe and the exact holdings in our five model portfolios are available in two separate spreadsheets. Please contact us to be added to the spreadsheet distribution list.

Please note that all our research is distributed from DBEQS.Americas@db.com. A list of our recent publications can be found in the Appendix.

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Factor performance review

Every month, we review the performance of about 80 factors from our factor library (Figure 1). Please note that this is only a small fraction of our factor library, which includes over 1,200 factors for the US market. We choose these 80 factors to provide a balanced view for each broad factor category – they are not necessarily the best 80 factors or the factors in our QCD model.

We measure factor performance in five standard analyses: long/short hedged portfolio, Pearson information coefficient, Spearman rank IC, sector-neutral IC, and risk-adjusted IC. For simplicity, we present only Spearman rank IC in this report.

Due to space limitation, we will present the results for only the broad investable universe, i.e., the union of Russell 3000, S&P 1500, and MSCI USA indices. We perform standard factor backtesting for more sub-universes on a daily basis, e.g., all major Russell and S&P index families, GICS sectors/industry groups, etc. Please contact us for customized factor backtesting.

After a very challenging month in December, most quant factors improved steadily and added value in January. All six factor groups – value, growth, momentum, sentiment, quality, and technicals – had positive performance. Value factors and technical factors performed best.

Figure 1: Broad factor performance review, Spearman rank IC

Factor Name	Direction ¹	Current # of Stocks	Average (%)			Since Inception										Avg in Up Mkt (%)	Avg in Dn Mkt (%)	Serial Corr (%) ²
			Last M	12M Avg	3Y Avg	Avg	Std Dev	Max	Min	p-value ³	Months	# of Stocks	%Positive					
1. Value																		
1 Dividend yield, trailing 12M	Ascending	2,941	0.87	(0.71)	(0.17)	2.67	14.83	42.72	(32.91)	0.00	277	2,811	54.15	(2.53)	11.86	99.30		
2 Expected dividend yield	Ascending	2,941	1.19	(0.51)	(0.00)	2.90	15.19	43.91	(33.27)	0.00	277	2,811	53.79	(2.50)	12.46	99.31		
3 Price-to-operating EPS, trailing 12M, Basic	Descending	2,286	2.31	(0.37)	1.56	2.99	10.88	30.72	(31.08)	0.00	192	2,362	58.33	0.92	6.69	95.05		
4 Operating earnings yield, trailing 12M, Basic	Ascending	2,912	7.63	1.12	2.08	4.67	13.65	45.99	(33.55)	0.00	192	2,886	60.42	(0.36)	13.63	96.12		
5 Earnings yield, forecast FY1 mean	Ascending	2,748	8.80	1.92	1.37	4.39	12.63	47.67	(34.40)	0.00	277	2,524	62.82	0.92	10.53	94.98		
6 Earnings yield, forecast FY2 mean	Ascending	2,741	8.81	3.59	2.15	4.08	12.12	45.69	(33.86)	0.00	277	2,418	64.62	1.76	8.17	94.20		
7 Earnings yield x IBES 5Y growth	Ascending	1,795	4.23	1.60	1.27	1.97	10.26	41.13	(27.52)	0.01	192	1,957	62.50	4.21	(2.03)	93.42		
8 Sector-rel Operating earnings yield, trailing 12M, Basic	Ascending	2,912	10.66	1.49	2.20	3.97	8.62	28.25	(15.78)	0.00	192	2,886	66.67	1.10	9.09	95.60		
9 Hist-rel Operating earnings yield, trailing 12M, Basic	Ascending	2,553	2.61	(0.25)	0.85	1.04	7.25	18.44	(17.04)	0.07	157	2,389	54.78	0.65	1.64	93.31		
10 Operating cash flow yield (income stmt def)	Ascending	2,913	9.11	2.08	1.94	4.09	11.43	45.93	(32.98)	0.00	277	2,765	63.90	0.99	9.58	95.68		
11 Cash flow yield, FY1 mean	Ascending	1,651	11.70	1.80	1.64	1.71	13.79	35.41	(47.95)	0.08	199	846	55.78	0.98	3.04	96.32		
12 Free cash flow yield	Ascending	2,891	4.48	1.31	2.01	4.87	8.24	32.69	(19.45)	0.00	240	2,515	73.33	2.50	9.19	94.45		
13 Price-to-sales, trailing 12M	Descending	2,882	(0.57)	1.97	2.12	2.09	11.14	40.19	(29.58)	0.00	277	2,742	57.40	1.72	2.73	99.06		
14 Price-to-book	Descending	2,842	(0.75)	(0.20)	0.68	1.17	11.00	34.60	(25.69)	0.08	277	2,727	50.54	(0.01)	3.27	97.47		
15 EBITDA/EV	Ascending	2,606	8.43	1.83	1.91	4.15	10.52	40.01	(27.73)	0.00	277	2,429	64.98	1.23	9.31	95.16		
16 Price-to-book adj for ROE, sector adj	Descending	2,670	(1.01)	0.62	1.58	0.78	8.84	32.59	(21.87)	0.14	277	2,452	50.90	1.12	0.19	95.27		
2. Growth																		
17 Hist 5Y operating EPS growth	Descending	2,819	(0.27)	(0.84)	0.07	0.43	7.38	19.32	(20.81)	0.43	185	2,648	52.43	(1.30)	3.33	97.10		
18 Hist 5Y operating EPS acceleration	Ascending	2,819	(0.29)	(1.76)	(0.60)	1.10	6.32	14.01	(17.03)	0.02	185	2,648	59.46	0.28	2.47	94.30		
19 IBES 5Y EPS growth	Ascending	1,923	6.22	(0.37)	0.09	0.54	8.89	23.07	(30.78)	0.31	277	1,886	53.43	1.91	(1.87)	98.21		
20 IBES 5Y EPS growth/stability	Ascending	1,923	4.66	(0.68)	0.08	1.02	8.13	21.69	(21.27)	0.04	277	1,886	55.96	0.88	1.25	98.58		
21 IBES LTG EPS mean	Descending	2,123	0.34	(2.96)	(1.03)	1.83	16.37	52.16	(37.25)	0.06	277	2,159	48.74	(3.80)	11.80	98.04		
22 IBES FY2 mean DPS growth	Ascending	2,006	1.23	(1.36)	0.19	0.58	8.69	23.84	(20.94)	0.50	104	1,364	50.00	(3.13)	7.30	87.95		
23 IBES FY1 mean EPS growth	Ascending	2,076	3.26	1.34	(1.23)	0.82	8.43	20.49	(29.10)	0.11	277	2,142	59.93	2.22	(1.66)	88.83		
24 Year-over-year quarterly EPS growth	Ascending	2,925	10.75	2.48	0.36	2.22	7.15	24.30	(21.11)	0.00	192	2,895	67.19	2.15	2.34	80.84		
25 IBES FY1 mean CFFS growth	Descending	1,268	(8.24)	(1.96)	0.81	0.08	10.92	41.83	(26.82)	0.93	149	525	51.01	(0.38)	0.93	92.76		
26 IBES SUE, amortized	Ascending	2,607	3.46	1.32	(0.13)	1.71	6.32	19.04	(15.12)	0.00	237	2,195	61.60	2.55	0.20	73.80		
3. Price momentum and reversal																		
27 Total return, 1D	Descending	2,937	(6.28)	2.81	3.20	5.11	7.12	34.03	(15.29)	0.00	277	2,767	79.06	5.09	5.16	1.64		
28 Total return, 21D (1M)	Descending	2,937	1.13	3.48	1.82	2.28	10.75	41.78	(27.50)	0.00	277	2,765	60.29	3.89	(0.57)	(0.02)		
29 Maximum daily return in last 1M (lottery factor)	Descending	2,936	10.53	(0.20)	2.26	4.90	15.02	55.44	(38.43)	0.00	277	2,645	63.54	(1.12)	15.57	52.04		
30 21D volatility of volume/price	Descending	2,936	10.34	1.35	0.68	0.32	6.97	17.85	(24.87)	0.44	277	2,645	50.18	1.20	(1.24)	55.95		
31 Total return, 252D (12M)	Ascending	2,702	4.60	2.16	(1.54)	2.81	14.03	39.94	(53.84)	0.00	277	2,665	60.29	1.28	5.51	89.39		
32 12M-1M total return	Ascending	2,702	4.72	2.95	(0.63)	3.73	13.18	38.42	(46.64)	0.00	277	2,665	64.26	2.71	5.53	87.79		
33 Price-to-52 week high	Ascending	2,832	9.78	(2.67)	(2.31)	2.93	16.52	48.56	(58.21)	0.00	277	2,708	61.73	(2.48)	12.51	82.90		
34 Total return, 1260D (60M)	Ascending	2,129	4.81	(0.11)	(1.52)	0.66	10.81	23.51	(33.83)	0.32	265	2,039	54.72	0.05	1.72	97.25		
4. Sentiment																		
35 IBES LTG Mean EPS Revision, 3M	Ascending	1,981	1.09	0.99	(0.69)	0.84	3.94	11.50	(12.23)	0.00	277	2,072	61.37	0.61	1.24	59.30		
36 IBES FY1 Mean EPS Revision, 3M	Ascending	2,708	3.77	0.77	(0.45)	2.81	8.68	24.93	(32.88)	0.00	277	2,464	64.62	2.52	3.33	76.20		
37 IBES FY1 EPS up/down ratio, 3M	Ascending	2,693	1.73	0.27	(0.18)	3.03	7.99	22.66	(24.55)	0.00	277	2,320	65.70	3.36	2.44	79.76		
38 Expectation gap, short-term - long-term	Ascending	2,076	3.48	0.46	(1.25)	1.28	5.20	15.67	(23.03)	0.00	277	2,142	65.70	1.33	1.18	87.41		
39 IBES FY1 Mean CFFS Revision, 3M	Ascending	1,400	1.17	0.76	(0.40)	0.79	10.40	29.68	(36.74)	0.30	190	783	61.58	(0.20)	2.58	65.29		
40 IBES FY1 Mean SAL Revision, 3M	Ascending	2,680	(0.12)	1.63	(0.23)	0.96	7.99	27.76	(24.36)	0.11	175	2,120	59.43	0.49	1.71	71.29		
42 IBES FY1 Mean DPS Revision, 3M	Ascending	1,084	1.51	(0.14)	0.12	0.31	5.42	15.16	(16.81)	0.56	101	963	52.48	0.19	0.54	61.34		
43 IBES FY1 Mean ROE Revision, 3M	Ascending	2,051	1.06	0.54	0.60	0.54	6.90	20.29	(21.42)	0.43	101	1,671	56.44	(0.14)	1.83	66.24		
44 Recommendation, mean	Descending	2,122	0.54	1.37	0.69	0.76	8.46	21.93	(23.43)	0.20	206	2,281	55.83	2.54	(2.41)	94.22		
45 Mean recommendation revision, 3M	Descending	1,989	1.02	0.90	0.68	1.33	4.32	12.17	(19.86)	0.00	203	2,190	63.05	1.14	1.67	60.12		
46 Target price implied return	Ascending	2,108	0.60	4.36	3.50	1.10	16.63	61.66	(38.20)	0.43	142	2,093	54.93	8.82	(10.08)	78.36		
47 Mean target price revision, 3M	Ascending	1,973	5.38	(1.52)	(1.05)	1.87	13.82	31.22	(43.76)	0.11	139	1,991	61.87	(0.73)	5.60	75.67		
5. Quality																		
48 ROE, trailing 12M	Ascending	2,821	7.78	1.22	1.65	4.04	11.27	35.81	(31.87)	0.00	192	2,816	63.02	0.19	10.91	97.77		
49 Return on invested capital (ROIC)	Ascending	2,901	6.70	1.28	2.15	3.89	10.23	31.87	(29.73)	0.00	192	2,878	63.54	0.45	10.01	97.97		
50 Sales to total assets (asset turnover)	Ascending	2,912	(0.92)	3.01	3.49	1.54	8.95	22.61	(22.13)	0.00	277	2,765	57.40	2.40	0.02	93.43		
51 Operating profit margin	Ascending	2,869	(2.52)	0.57	0.92	1.03	5.40	16.06	(14.29)	0.00	277	2,597	59.21	0.66	1.67	98.41		
52 Current ratio	Descending	2,339	7.65	(0.19)	(0.45)	1.95	10.62	38.60	(31.28)	0.00	277	2,230	54.51	(0.96)	7.10	97.85		
53 Long-term debt/equity	Ascending	2,815	11.20	0.71	(0.82)	0.65	9.81	35.11	(27.77)	0.27	277	2,706	48.38	(1.23)	4.00	98.49		
54 Altman's z-score	Descending	2,303	5.67	0.30	(0.06)	0.08	9.41	30.42	(31.80)	0.89	277	2,158	51.62	(0.67)	1.41	98.20		
55 Merton's distance to default	Ascending	2,132	5.22	(0.65)	1.20	2.89	11.51	30.14	(42.66)	0.00	277	2,127	64.98	(0.89)	9.57	94.73		
56 Ohlson default model	Descending	2,292	4.43	1.14	1.30	2.02	6.29	18.43	(15.77)	0.00	240	2,106	63.75	1.51	2.95	98.09		
57 Campbell, Hilscher, and Szilagyi model	Descending	2,704	7.63	0.95	1.62	2.45	11.72	25.28	(37.26)	0.00	193	2,602	55.96	(1.10)	8.83	96.77		
58 Accruals (Sloan 1996 def)	Descending	1,723	1.08	0.51	0.46	0.64	4.42	14.21	(11.50)	0.02	277	1,400	56.32	0.70	0.54	89.09		
59 Firm-specific discretionary accruals	Descending	1,554	0.99	1.14	1.14	0.49	4.20	14.36	(11.65)	0.11	184	1,297	52.17	0.15	1.07	98.69		
60 Hist 5Y operating EPS stability, coef of determination	Ascending	2,819	(3.18)	(1.86)	(0.80)	0.45	4.99	13.18	(12.23)	0.22	185	2,648	52.43	0.29	0.71	96.62		
62 IBES FY1 EPS dispersion	Descending	2,524	1.64	1.02	0.56	2.12	10.35	25.79	(35.84)	0.00	277	2,302	60.65	(0.73)	7.15	84.81		
63 Payout on trailing operating EPS	Ascending	2,220	(3.86)	(2.04)	(0.91)	0.66	13.80	39.21	(30.70)	0.42	277	2,196	49.82	(4.13)	9.16	99.21		
64 YoY change in # of shares outstanding	Descending	2,859	0.78	0.45	1.39	2.49	9.07	45.70	(18.76)	0.00	277	2,714	59.21	(0.94)	8.55	93.86		
65 YoY change in debt outstanding	Descending	2,197	(8.30)	(0.84)	(0.03)	0.34	4.12	10.36	(12.52)	0.17	277	2,175	56.68	1.07	(0.96)	89.69		
66 Net external financing/net operating assets	Ascending	2,874	5.00	1.40	1.33	2.82	10.31	47.81	(27.49)	0.00	277	2,455	58.12	(0.32)	8.37	94.73		
67 Piotroski's F-score	Ascending	2,188	7.68	0.60	(0.45)	3.03	11.08	36.03	(30.78)	0.00	192	2,165	58.85	(1.19)	10.57	90.32		
68 Mohanram's G-score	Ascending	576	1.88	(1.08)	1.14	2.02	8.82	23.26	(28.97)	0.00	192	445	57.81	0.02	5.61	94.82		
6. Technicals																		
69 # of days to cover short	Descending	2,937	22.01	1.25	2.20	2.67	9.73	25.39	(33.58)	0.01	94	2,890	58.51	3.45	1.07	93.00		

Model recommendations

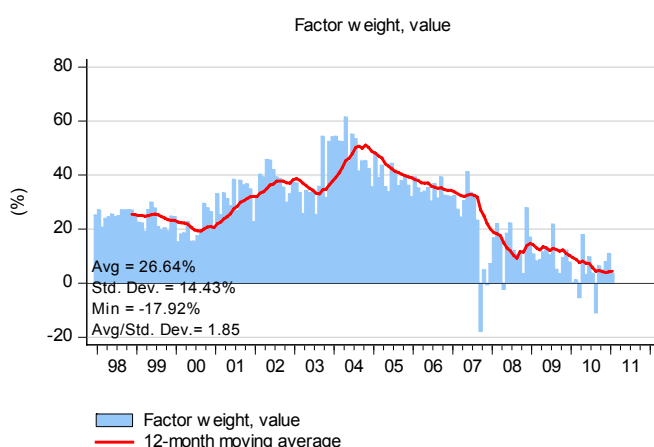
Our QCD model is primarily designed as a stock-selection tool. However, as a side benefit, it also gives us style and sector views.

Style outlook

Figure 2 to Figure 7 show the weightings of the six style factors in our QCD model. Please note that this is based on our style rotation model, i.e., our predicted factor performance for the six style factors.

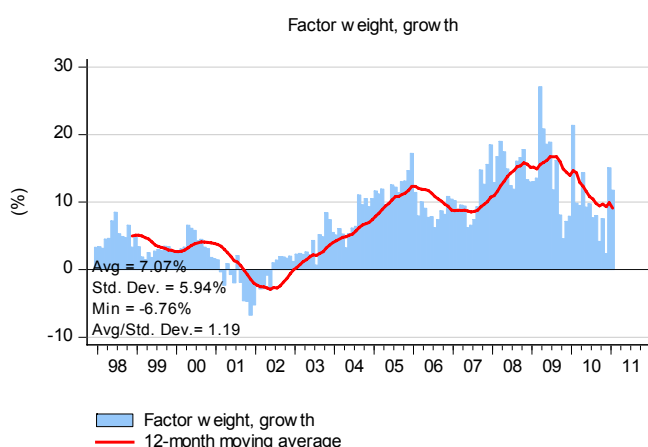
For February 2011, our model suggests allocating more weight to quality, revision, and technical factors, and less weight to value, momentum/reversal, and growth factors.

Figure 2: Factor weight, value



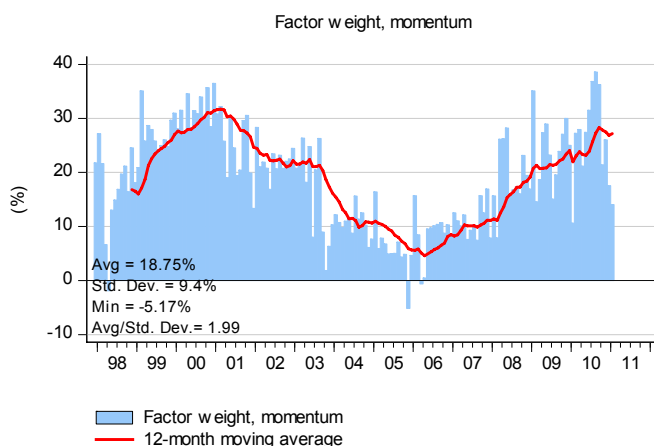
Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 3: Factor weight, growth



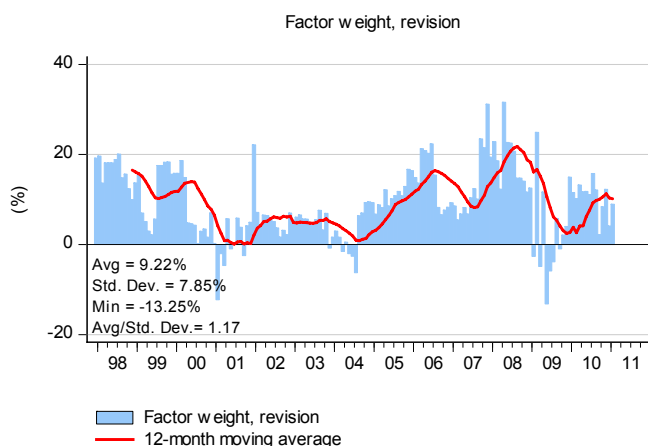
Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 4: Factor weight, momentum/reversal



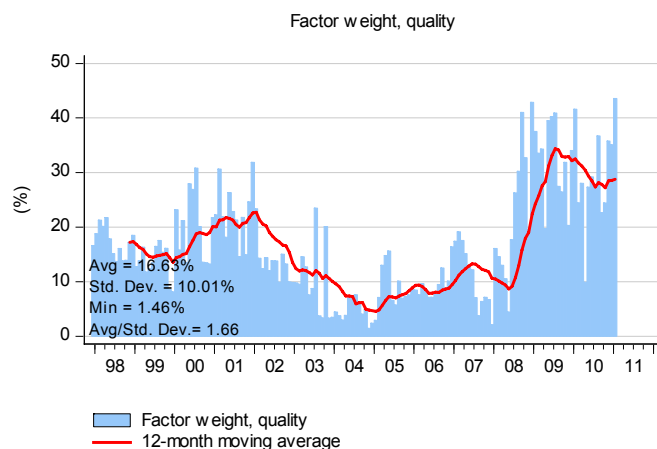
Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 5: Factor weight, sentiment



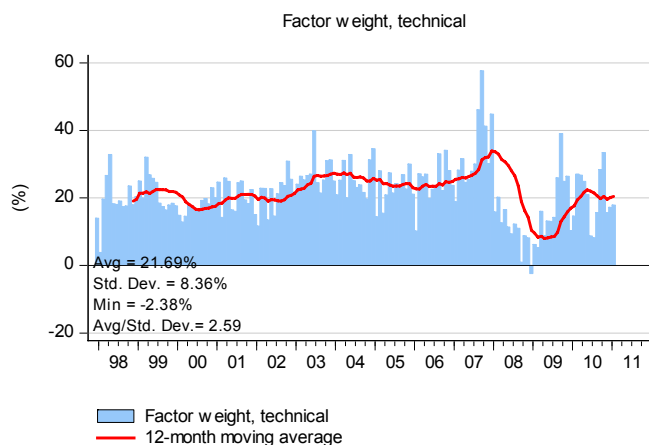
Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 6: Factor weight, quality



Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 7: Factor weight, technical

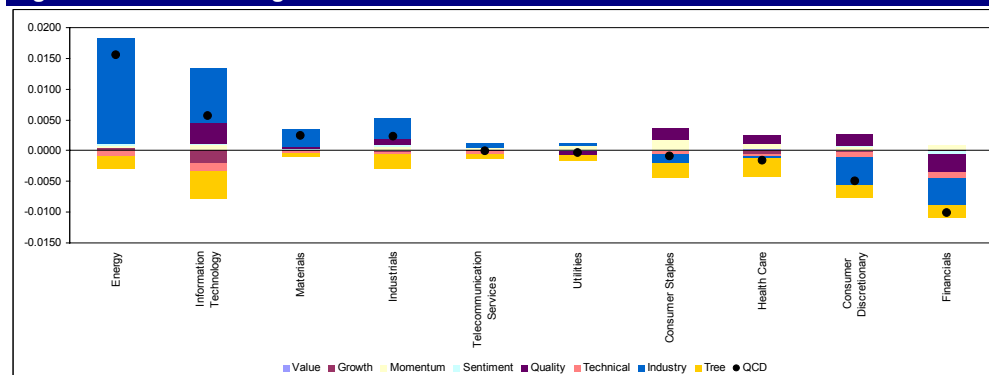


Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Sector outlook

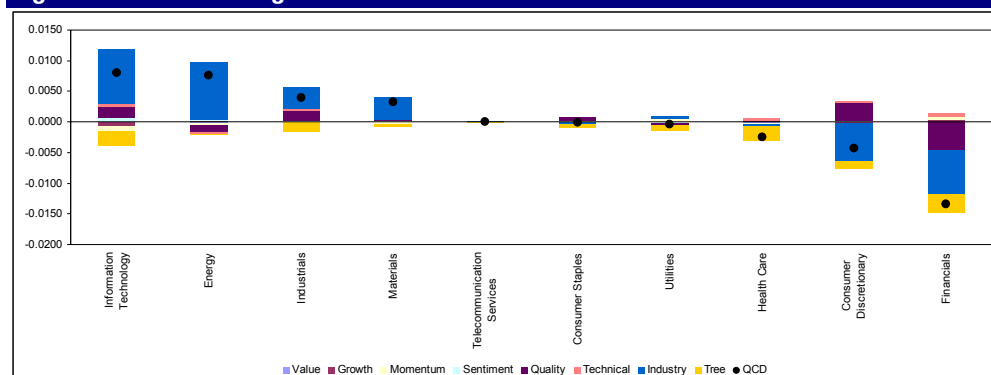
In the large cap space, i.e., Russell 1000 index, our model suggests overweighting the info tech and energy sectors; and underweighting the financials consumer discretionary sectors (Figure 8).

Figure 8: Sector ranking – Russell 1000 universe



Source: Compustat, IBES, Russell, S&P, Thomson Reuters, and Deutsche Bank

Within small-cap universe, i.e., Russell 2000 index, our model suggests info tech and energy are likely to outperform, while the financials and the consumer discretionary sectors are likely to underperform (Figure 9).

Figure 9: Sector ranking – Russell 2000 universe

Source: Compustat, IBES, Russell, S&P, Thomson Reuters, and Deutsche Bank

Stock recommendations

Due to space limitation, we do not present detailed stock rankings in the report. Detailed rankings are available in our monthly spreadsheet. Please contact us to be added to the spreadsheet distribution list.

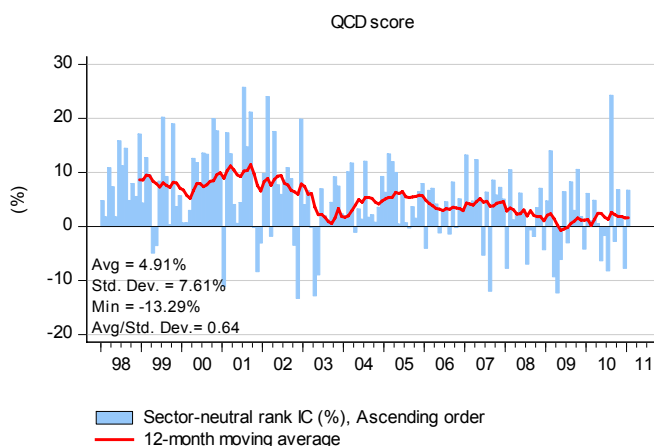
QCD model performance review

Since December 1997, the QCD model has performed very well. The most challenging periods for the QCD model were in late 2003/early 2004 and 2009/early 2010. We have seen some recovery in recent months (Figure 10). We recommend using the QCD model in a sector-neutral context, as the model has stronger skill in selecting stocks than ranking sectors (Figure 10 vs. Figure 11).

Most quant factors performed well in January, and our model also outperformed in January with a sector-neutral rank information coefficient (IC) of 6.72%.

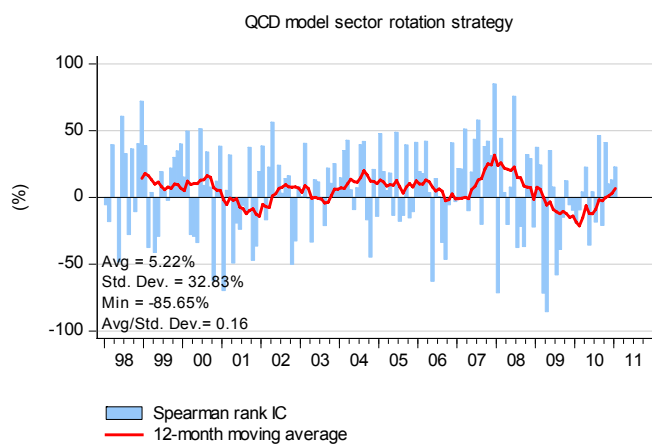
A more useful and realistic performance measurement is done at the portfolio level. We have five model portfolios: long-only large-cap core, long-only large-cap value, long-only large-cap growth, long-only small-cap, and long/short market neutral with typical institutional constraints and transaction costs. The IR/Sharpe ratio for the five model portfolios ranges from 1.5 to 3.2 and stays positive almost every year since 1998. Even in 2008 and 2009, two of the most challenging years for quantitative investing, our market-neutral strategy produces Sharpe ratio of 0.82 and 1.64, respectively.

Figure 10: Sector-neutral rank IC



Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Figure 11: Rank IC – industry rotation



Source: Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Model portfolios

On a monthly basis, we build five standard model portfolios: 1) a long-only large-cap core portfolio benchmarked to the Russell 1000 index; 2) a long-only large-cap value portfolio benchmarked to the Russell 1000 Value index; 3) a long-only large-cap growth portfolio benchmarked to the Russell 1000 Growth index; 4) a long-only small-cap portfolio benchmarked to the Russell 2000 index; and 5) a long/short market neutral portfolio. We can also create customized portfolios for clients, e.g., large-cap value portfolio, large-cap growth portfolio, 130/30 portfolios. Please contact us for details.

The IR/Sharpe ratio for the five model portfolios ranges from 1.5 to 3.2 and stays positive almost every year since 1998. Even in 2008 and 2009, two of the most challenging years for quantitative investing, our market-neutral strategy produces Sharpe ratio of 0.82 and 1.64, respectively.

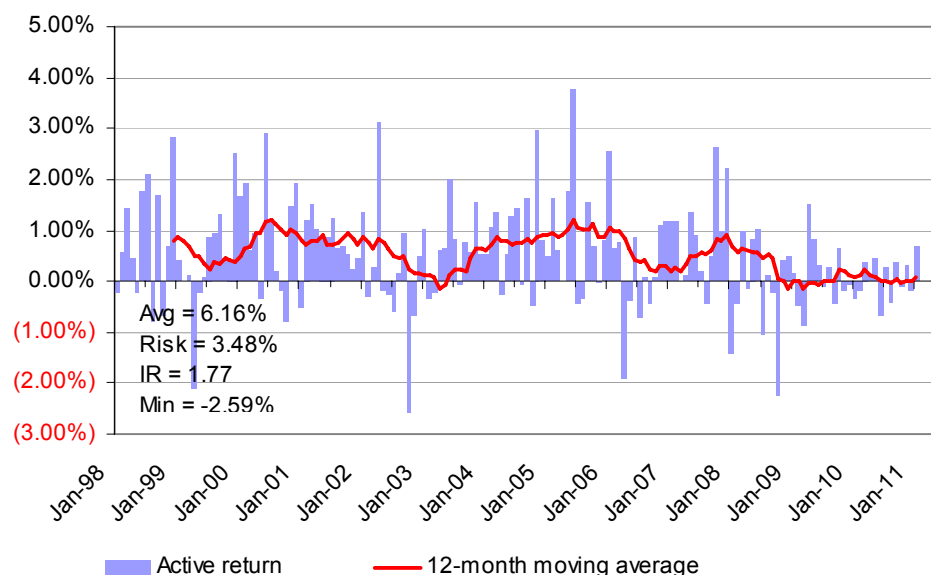
Last month, the five model portfolios produced active returns of 0.67%, 0.00%, 0.69%, 3.96%, and 2.41%, respectively.

Detailed holdings for the five model portfolios for next month are available in our monthly spreadsheet. Please contact us to be added to the spreadsheet distribution list.

Long-only large-cap core portfolio

For the long-only large-cap core portfolio, we try to maximize expected return with about 3.5% realized tracking error, using Russell 1000 as the benchmark. Figure 12 shows the portfolio performance vs. the benchmark.

Figure 12: Active return – long-only large-cap core portfolio

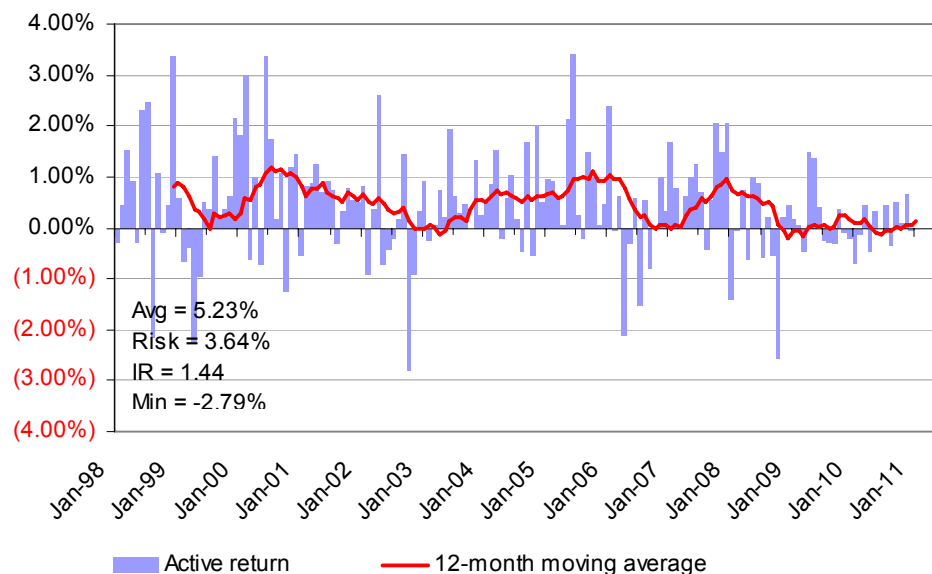


Source: Axioma, Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Long-only large-cap value portfolio

For the long-only large-cap value portfolio, we try to maximize expected return with less than 4% realized tracking error, using Russell 1000 Value as the benchmark. Figure 13 shows the portfolio performance vs. the benchmark.

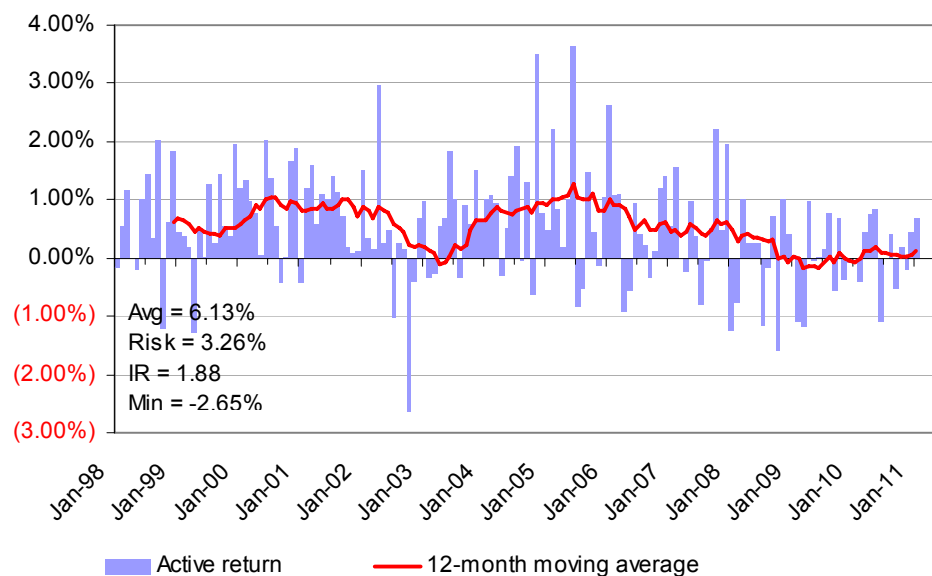
Figure 13: Active return – long-only large-cap value



Source: Axioma, Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Long-only large-cap growth portfolio

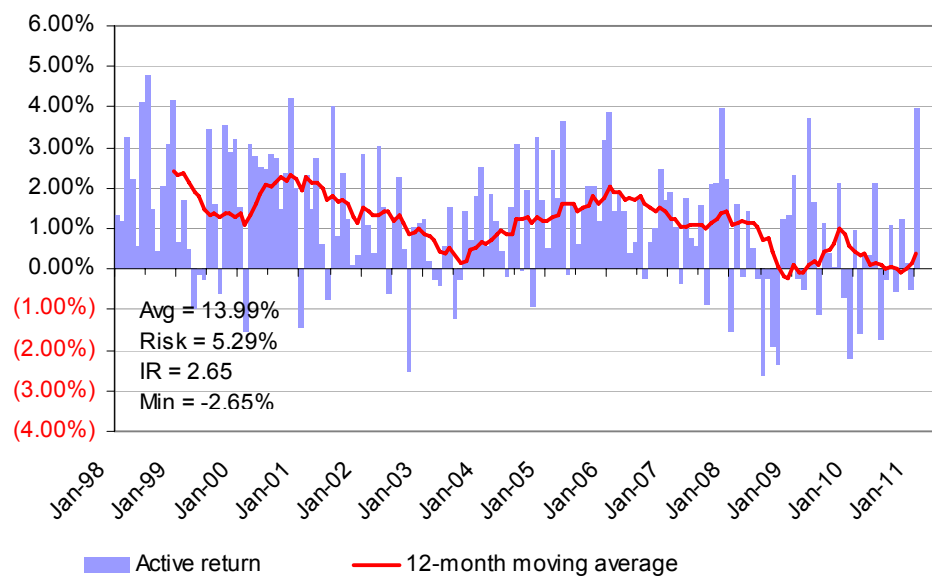
For the long-only large-cap growth portfolio, we try to maximize expected return with about 3% realized tracking error, using Russell 3000 Growth as the benchmark. Figure 14 shows the portfolio performance vs. the benchmark.

Figure 14: Active return – long-only large-cap growth portfolio

Source: Axioma, Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Long-only small-cap portfolio

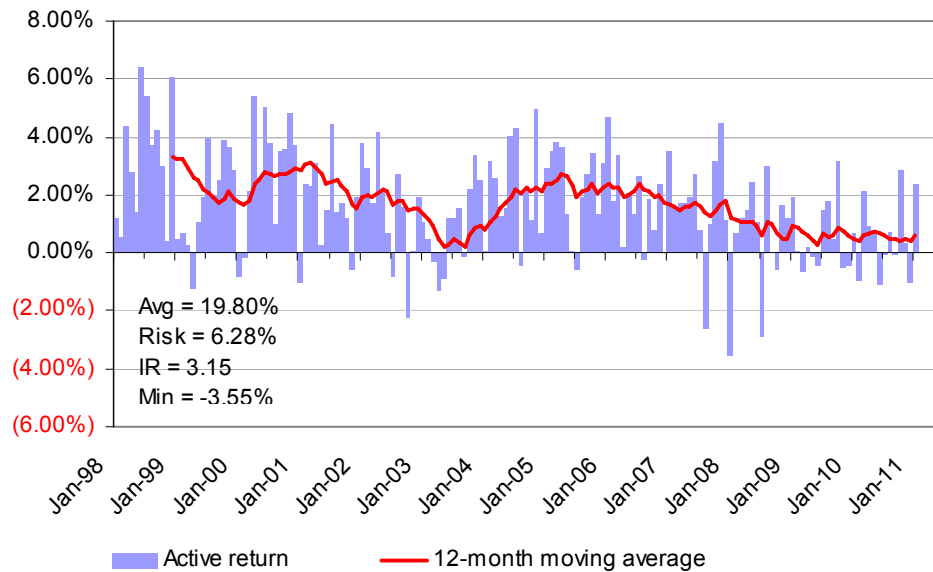
For the small-cap long-only portfolio, we try to maximize expected return with about 5% realized tracking error, using Russell 2000 as the benchmark. Figure 15 shows the portfolio performance vs. the benchmark.

Figure 15: Active return – long-only small-cap portfolio

Source: Axioma, Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Long/short market-neutral portfolio

For the long/short market neutral portfolio, we try to maximize expected return with about 6% realized volatility. Figure 16 shows the portfolio performance.

Figure 16: Active return – long/short marketing neutral portfolio

Source: Axioma, Compustat, IBES, Russell, S&P, Thomson Reuters, Deutsche Bank

Please note that with each of the model portfolios, past performance is no guarantee of future results. Calculations include transaction costs. Additional information is available on request.

Appendix – Deutsche Bank US/Global Quant Research Library

Deutsche Bank's US/Global quantitative strategy team produces one monthly newsletter, *Quantum*, and five monthly research series: 1) *Signal Processing* on alpha factors; 2) *QCD Model* on stock-selection models; 3) *Portfolios Under Construction* on risk and portfolio construction; 4) *Academic Insights* on academic research; and 5) *Canada Quant*.

All our research is distributed from DBEQS.Americas@db.com. Please contact us to be added to our research distribution list.

Quantum

Quantum is our monthly newsletter. The aim of *Quantum* is to make it easier for clients to keep track of all the research we publish, and to serve as a forum to highlight the latest news and thinking in the quant investing world. If you only read one email from us every month, make it *Quantum*.

- **Quantum** (January 27, 2011)
- **Quantum** (November 29, 2010)
- **Quantum** (October 28, 2010)
- **Quantum** (September 20, 2010)

Signal Processing

This is our flagship monthly alpha signal research series. We try to identify new data sources, build new and innovative factors, and investigate various style rotation models.

- **The Long and the Short of It** (January 18, 2011). We use the DataExplorers securities lending database to develop new alpha signals based on stock lending and borrowing data. We show that we can combine these signals into a composite factor that works well in forecasting month-ahead stock returns. We also develop a way to adjust the factor scores for shorting costs, which helps steer the factor towards less costly names on the short side.
- **Frequency Arbitrage** (November 10, 2010). We try to bridge the gap between high and low frequency quant, and find that factors derived from high frequency data do have predictive power even for "traditional", lower-frequency quant investors.
- **Style Rotation** (September 7, 2010). We investigate three potential data sources to predict style factor performance: macroeconomic, capital market, and seasonal patterns. We find most academic research using economic variables in style timing suffers significant look-ahead bias. We test ten style prediction models, ranging from simple averages (assuming no style timing ability), linear regression, robust regression, Markov-switching, state-space, to nonlinear *TREE*, *FOREST*, and *PLANET* techniques. We find style rotation strategies can exhibit significant timing ability, which translates into better portfolio performance. Indeed, the multi-factor model built on style rotation strategies outperforms the naïve model (assuming no style rotation) by 54% in IR in the past 10 years. In the past three years, style rotation boosts IR by 1.30.

- **Beyond the Headlines** (July 19, 2010). In this research, we study text mining and natural language processing (NLP) in stock selection. We use three nonlinear model techniques (*TREE*, *FOREST*, and *PLANET*) to analyze news sentiment data and find signals can be used in both high and low frequency strategies.
- **Industry-Specific Factors** (June 7, 2010). Industry-specific data and factors like loan loss provision, same store sales growth, or break-even load factor have better predictive power than traditional/generic factors. We study 164 industry-specific factors in 12 industries. We found adding industry-specific factors to traditional multi-factor models can enhance model IC and portfolio IR.
- **The Options Issue** (May 12, 2010). We find options market tends to lead equity market. We find four signals from the options market have significant predictive power in forecasting month-ahead stock returns.
- **Launching US Quantitative Strategy** (April 12, 2010). We study three factors: 1) decomposing value factors – valuation ratios can be decomposed into a trend component (persistent) and cyclical component – both can be used to enhance value factor performance; 2) accruals and earnings quality – a small scaling adjustment can make a big difference; 3) market friction and price delay.

QCD Model

QCD is our flagship stock-selection model and illustrates our philosophy for picking stocks quantitatively. The model is updated every month, and is accompanied by an interactive spreadsheet.

- **DB Quant Handbook** (July 22, 2010). QCD is our main stock-selection model with a few unique features: factors are dynamically re-selected every month based on pre-determined algorithms; a nonlinear *TREE* model is combined with a linear panel data econometric model; and style rotation and industry timing models are incorporated in the bottom-up stock-selection model.
- **QCD Model Update** (January 6, 2010)
- **QCD Model Update** (December 6, 2010)
- **QCD Model Update** (November 2, 2010)
- **QCD Model Update** (October 6, 2010)
- **QCD Model Update** (September 8, 2010)
- **QCD Model Update** (August 6, 2010)

Portfolios Under Construction

In this series, we study various issues related to risk modeling and portfolio construction.

- **Robust Factor Models** (January 24, 2011). Traditionally, managers focus on selecting factors, while using the sample factor covariance matrix in constructing multifactor models. We compare the performance of the sample factor covariance matrix with 12 structured models (constant correlation, single index, four Bayesian shrinkage estimators, and six multivariate GARCH models). Our backtesting suggests that robust factor models incorporating structured covariance matrices improve portfolio IR significantly.
- **Correlation and Opportunity** (December 3, 2010). We find that stock return correlation has a long-term cyclical component that is linked to economic cycles. Negative economic sentiment is linked to increasing correlation.

- **Factor Neutralization and Beyond** (September 21, 2010). We expand our previous factor neutralization for the US market to Europe and find similar evidence. Many alpha factors have significant exposures to volatility. Neutralizing volatility exposure can improve factor consistency.
- **It's all in the Timing** (August 19, 2010). We examine, using "perfect foresight" simulations, whether style-timing actually adds value above and beyond the additional turnover costs incurred. We also use a real-world example, our QCD model, and find style timing is difficult, but not impossible.
- **Volatility = 1/N** (June 16, 2010). Many alpha factors have significant exposures to volatility. Neutralizing volatility exposure can improve factor consistency.
- **Quantiles versus Mean Variance** (April 23, 2010). Comparing quantile portfolios with mean-variance optimization. Two extreme cases of constructing a portfolio – quantiling or mean-variance optimization – can we learn something from both sides?

Academic Insights

On a monthly basis, we compile a list of practical academic papers related to investing. Every third month we also delve deeper into the most interesting ideas by carrying out our own backtesting and analysis.

- **Academic Insights** (January 20, 2011).
- **Academic Insights** (November 23, 2010).
- **Academic Insights** (October 27, 2010). *Backtesting edition* – We explore an interesting academic finding that momentum works better for high volatility stocks and reversal works better for low volatility stocks. We suggest four potential ways to exploit this relationship.
- **Academic Insights** (September 27, 2010)
- **Academic Insights** (August 23, 2010)
- **Academic Insights** (July 22, 2010). *Backtesting edition* – We confirm an academic finding that gross profitability over total assets is a better measure of profitability than traditional metrics like ROE and ROA. Furthermore, we show that this ratio is useful for conditioning value factors.
- **Academic Insights** (June 16, 2010)
- **Academic Insights** (May 20, 2010)
- **Academic Insights** (April 16, 2010). *Backtesting edition* – We show how a concept called the "capital gains overhang" can be used to exploit a behavioural bias and enhance the earnings surprise factor.
- **Academic Insights** (March 15, 2010)
- **Academic Insights** (February 12, 2010)

Canada Quant

On a monthly basis, we publish quant strategies unique to the Canadian equity market.

- **New Options in Canada** (November 23, 2010). In this research, we expand a previous US quant research and find factors based on options data (put/call ratio, options implied volatility, skew, relative volume, and put-call parity) are useful in predicting stock returns in Canada.

- **Introducing Canada Quantitative Strategy** (October 24, 2010). Quant investing in Canada used to be easy – all you needed was price momentum and earnings revision. In the past three years, however, as more and more quant investors outside of Canada start to diversify into less crowded markets like Canada, the performance of traditional factors has dropped severely. In this research, we suggest two potential ways to add alpha in Canada in this challenging environment – identifying new and less crowded factors; and style rotation.

Appendix 1

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