A Data Scientific Approach to Equity Backtesting Research

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Abstract

Contemporary research into the cross-sectional variation in stock returns is fraught with replication challenges. This makes it difficult to validate important results and hampers the advance of knowledge in the field. This project addresses some of these challenges by fitting the backtesting research process to a data scientific workflow. By making extensive use of standard open source statistical programming languages the authors provide an environment in which total replication is trivial and common statistical errors are avoided by default.

Keywords

backtest, data workflow, overfitting, historical simulation, replication

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1 Motivating Argument

- There are major replicability issues surrounding academic research into the cross-sectional variation in stock returns. These issues can be largely mitigated by adhering to a data-scientific approach to data analysis.
- Robustness of results in the field of stock return research can be can be significantly improved by accounting for the risk of overfitting as the number of trials increases.
- The general availability of a *minimally sufficient analysis environment* should make the replication of results in the field more robust, easier to admit into the established knowledge base speed up iterative knowledge creation through significantly shortening the time required for downstream researchers to build on principal authors' work.

2 Discussion

Academic research into anomalies in the cross section of stock returns is beset by a replication crisis. A large proportion of the existing anomalies literature yields statistically insignificant findings when replicated (Hou, Xue, and Zhang (2017)). Failure to replicate results is an established thread of research in its own right.

This dissertation will survey the literature on anomalies research to map inadequacies in documentation, data cleaning and statistical modelling. A preliminary list of relevant papers in this area are provided below.

1. A survey of several well-known backtests and the documentation of their workflow

- E. F. Fama and MacBeth (1973)
- E. Fama and French (1992)
- Daniel and Titman (1997)
- Hou, Xue, and Zhang (2017)

2. Reproducibility in science in general and the field in particular

- Stodden et al. (2013)
- J. P. A. Ioannidis (2005)
- Brodeur et al. (2016)
- Harvey and Liu (2014)
- Munafò et al. (2017)

3. Statistical errors in backtests

- Lopez de Prado (2013)
- D. H. Bailey et al. (2014)
- Hou, Xue, and Zhang (2017)

Following

3 Aims and Objectives

This project is firmly rooted in the meta of finance research. The objective is not to validate whether particular anomalies in the cross-sectional variation of stock returns exists. Rather, it is to outline and implement a system wherein researchers can investigate these questions in a statistically rigorous manner.

1. Survey of current academic backtest methods (see the github dissertation repository)

- A critique of the challenges around replicability because of lack of documentation.

- A critique of the challenges around validity because of poor statistical methods (IS/OOS).
- Discussion on how these challenges can be mitigated using standard data science tools.

2. Documentation of an working demonstration system that mitigates these challenges (see the github code repository).

- Source code along with README documentation of every phase of the project will be released to a public repository under the AGPLv3 license.
- A strong copyleft license was chosen because a fundamental pronciple of this project is the facilitation of replication. Insofar that code sharing is necessary for replication, any researcher that uses this code should make their derivative work avaialable for replication.

3. An original replication case study which makes use of the demonstration system to replicate a widely cited academic paper in the field (see the github replication example).

4 Data Requirements Specification

All stages of the data collection and transformation will be transparently documented and source code will be made avaialble on a hosted repository.

All raw data wll be programmatically extracted from a Bloomberg Terminal using the Excel Add-In. Validation of this data will be conducted by randomly selecting ten financial reports from the universe and cross-checking the contents of those financials against the raw data.

All data cleaning and interpolation will be done using the dplyr and tidyr packages in the R statistical computing language.

5 Systems Requirements Specification

5.1 Hardware Requirements

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- A computer running an x86 processor
- 50gb of hard drive space
- At least 8gb or RAM
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5.2 Software Requirements and Packages Used

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- Access to a Bloomberg Terminal with Excel installed
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- A research machine running
  - Ubuntu 16.04 LTS
  - Jupyter Server
  - RStudio Server
  - Python 3.5
  - R 3.4.3
  - Nextcloud 12 for transferring data from the Bloomberg Terminal to the research machine

5.3 Software Development Framework, configuration control and version control

The primary objective of this dissertation is the creation of a script-based workflow that improves the equity backtesting research process. The complete codebase, as well as the dissertation and demonstration case will be made avaialble on a GitHub repository. The code will be released under an Apache 2.0 license.

The data will not be released due to data vendor licensing constraints. However, macro-enabled Excel workbooks that programmatically query the Bloomberg Excel Add-In for relevant data will be made available in the public repository.

Version control of all project deliverables will be managed using the Git version control system. Commits will be pushed regularly to the publically avaialable GiHub repository to ensure timeous backups of thw working paper and codebase.

6 Project Milestone Deliverables

Date	Milestone	Status
October 2017	Set up server with necessary dependencies	Complete
November 2017	Build Bloomberg Excel VBA Workbook to scrape data	Complete
December 2018	First Pass Literature Review	In Progess
January 2018	Scrape Bloomberg terminal for data	Complete
January 2018	Merge raw files into single csv files	Complete
February 2018	Document Codebase to Date	In Progress
February 2018	Write Project Proposal	In Progress
February 2018	Register for Academic Year	In Progress
February 2018	Clean, join and interpolate data	In Progress
February 2018	Transform raw data into Sqlite file	In Progress

Date	Milestone	Status
March 2018	Build out code to control for backtesting biases (look-ahead, survivorship etc)	Not Started
April 2018	Perform a case study backtest	Not Started
May 2018	Debug, refactor, refine	Not Started
May 2018	Re-document Codebase to Date	Not Started
June 2018	Add additional data sources: iNet, Datastream	Not Started
July 2018	Replicate case study backtest on alternative data and compare differential results	Not Started
August 2018	Create second backtest and document workflow steps and benchmark timing	Not Started
August 2018	Wrap Code Documentation, proposal and findings into dissertation	Not Started

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