

4 - Factors

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Table of contents

1	Construction of Factors	1
1.1	Factor Model	2
2	Factors in Portfolio Evaluation	2
3	Historical Context	3
4	Coding Challenges:	3
4.1	Tentative answer to Challenge 2:	4
4.2	Tentative answer to Challenge 2:	4

Factors are portfolios constructed based on specific characteristics of assets. For example, Fama and French proposed factors based on company valuation (over- or under-valuation) and company size.

1 Construction of Factors

A standard, simplified method for constructing a factor portfolio involves creating a long position in the third of assets with the strongest characteristic (e.g., the most undervalued) and a short position in the third with the weakest. For instance, the **HML** (High Minus Low) factor by Fama and French takes a long position in the top third of companies with the highest market-to-book value and shorts the bottom third with the lowest.

This results in a portfolio with zero net cost because the long and short positions offset each other. Hence, there's no need to subtract the risk-free rate when

calculating returns for factor portfolios.

In Titlon, there are four factors: **SMB**, **HML**, **LIQ**, and **MOM**, alongside the market factor (the market index).

- **SMB (Small Minus Big)**: The return of small companies minus the return of large companies.
- **HML (High Minus Low)**: The return of companies with high market-to-book ratios compared to those with low ratios.
- **LIQ (Liquidity)**: The return of the most liquid companies minus that of the least liquid.
- **MOM (Momentum)**: The return of companies with high momentum minus those with high reversal tendencies.

1.1 Factor Model

The main purpose of factors is to be used in regression analysis, like the following:

$$\begin{aligned} x - r_f = & \alpha + \beta_M(r_M - r_f) \\ & + \beta_{SMB} \cdot SMB \\ & + \beta_{HML} \cdot HML + \beta_{LIQ} \cdot LIQ \\ & + \beta_{MOM} \cdot MOM + \epsilon \end{aligned}$$

This is a multifactor model. If we only include the market factor, the model reduces to the well-known **CAPM** (Capital Asset Pricing Model). Adding the additional factors results in a more comprehensive **factor model**.

2 Factors in Portfolio Evaluation

Numerous factors have been proposed in the literature. However, many are believed to be the result of data mining, so it's common practice to use only the most established ones, like those mentioned above, when evaluating portfolio performance.

The estimated α from the factor model is the most widely recognized measure of risk-adjusted return. A positive α indicates that a portion of the excess return of $x - r_f$ cannot be explained by exposure to any of the factors, including the market factor. This implies that the portfolio has delivered some form of risk-free excess return.

As in any regression, you can compute the standard error and p-value of the estimated α . This is crucial because, if the α is not statistically significant, we cannot confidently conclude that it is different from zero. Therefore, to claim that an asset or portfolio has truly outperformed the market, its multifactor α should be both positive and statistically significant.

3 Historical Context

This framework is the standard method for determining whether a portfolio manager has genuinely been skilled or simply benefited from luck or factor exposures.

The field of finance has, in many ways, been driven by the need to explain portfolio managers' overperformance. In the early 20th century, some managers appeared to consistently outperform the market. The development of **CAPM** revealed that this was often due to selecting stocks with high market risk rather than genuine skill. Most of these managers did not generate CAPM alpha.

For investors seeking higher returns by taking on more market risk, simply buying more shares (increasing exposure to the market) is typically more cost-effective than picking the riskiest stocks. The development of CAPM helped investors make more informed choices.

Similarly, the introduction of factor models showed that some managers were merely betting on small-cap stocks or undervalued companies to generate excess returns. When accounting for these factors, much of the supposed excess return often disappears.

4 Coding Challenges:

- **Challenge 1:** - Download stock data from Titlon for a single stock. - Perform a multifactor regression model using the downloaded data. - Analyze the significance of the alpha: check whether it is statistically significant, and interpret its direction (positive or negative). - Provide commentary on what the result implies in terms of the stock's performance relative to the factors.
- **Challenge 2:** - Download factor data from Titlon and plot the performance of these factors alongside the optimal portfolio from the previous chapter. - Add each factor as a data point on the chart, allowing comparison between the factors and the optimal portfolio as well as the portfolio frontier. - Use the following SQL query in the Titlon script to retrieve the factor data: `sql`

```
SELECT [SMB], [HML], [LIQ], [MOM] FROM
[OSE].[dbo].[factors] WHERE YEAR([Date])
>= 2016 - Plot the performance and visually assess how each factor
performs relative to the optimal portfolio.
```

4.1 Tentative answer to Challenge 2:

```
df = pd.read_pickle('output/stocks.df')
```

4.2 Tentative answer to Challenge 2:

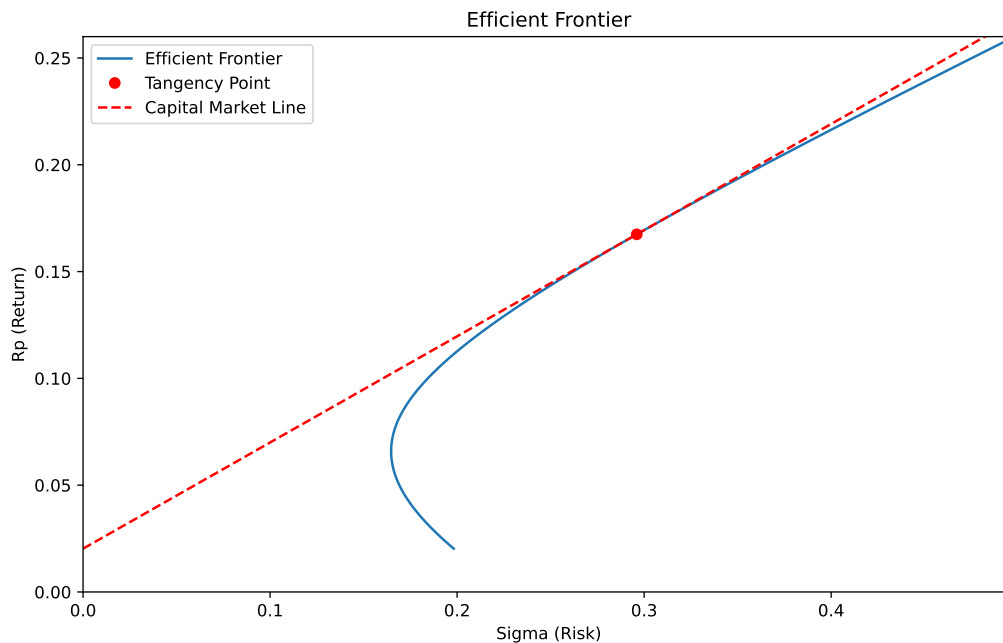
First, let us

First, let us just rerun the last few cells of the previous chapter, in order to have the previous graph in the memory. That can be done with a custom function `calc_notebook` in the module `functions.py` in this directory. `d` contains the variable from those calculations.

Alternatively you can just copy the cells from lecture 3 here, after the download from titlon, and run them before next cell.

```
import functions
d = functions.calc_notebook("3-lecture_optport.ipynb",
                           ["read_pickle", "get_matrix", "cov_matrix", "A =",
                            "portfolio_front", "ax.plot"])
locals().update(d)
```

Hence the optimal portfolio in this case is



When you have run the above cell (or your pasted cells), we can add the factors to the chart.

For that we need to calculate the means and standard errors, after reducing the frequency from daily to weekly:

```
import pandas as pd

df = pd.read_pickle('output/factors.df')
df['Date'] = pd.to_datetime(df['Date'])
df = df.set_index('Date')
df_weekly = df.resample('W').sum()
df_weekly = df_weekly[['SMB', 'HML', 'LIQ', 'MOM']].dropna()
df = df[['SMB', 'HML', 'LIQ', 'MOM']].dropna()
means = df_weekly.mean()*52
std = df_weekly.std()*52**0.5
print(std)
print(means)
df_weekly
```

```
SMB    0.145195
HML    0.193652
```

```

LIQ      0.160615
MOM      0.216708
dtype: float64
SMB      0.074676
HML      0.145056
LIQ      0.019353
MOM      0.164041
dtype: float64

```

	SMB	HML	LIQ	MOM
Date				
2016-01-10	0.040139	-0.038205	0.063480	0.039485
2016-01-17	-0.004794	-0.053537	0.045607	0.013392
2016-01-24	0.016701	0.025072	-0.004320	-0.014409
2016-01-31	0.002747	-0.001928	-0.016214	-0.024070
2016-02-07	-0.008014	-0.029920	-0.002909	-0.008874
...
2024-03-10	0.032518	0.037676	0.017710	-0.005075
2024-03-17	0.014078	0.007018	-0.025601	0.023273
2024-03-24	0.013395	-0.008679	-0.003795	0.036296
2024-03-31	0.000000	0.000000	0.000000	0.000000
2024-04-07	0.000000	0.000000	0.000000	0.000000

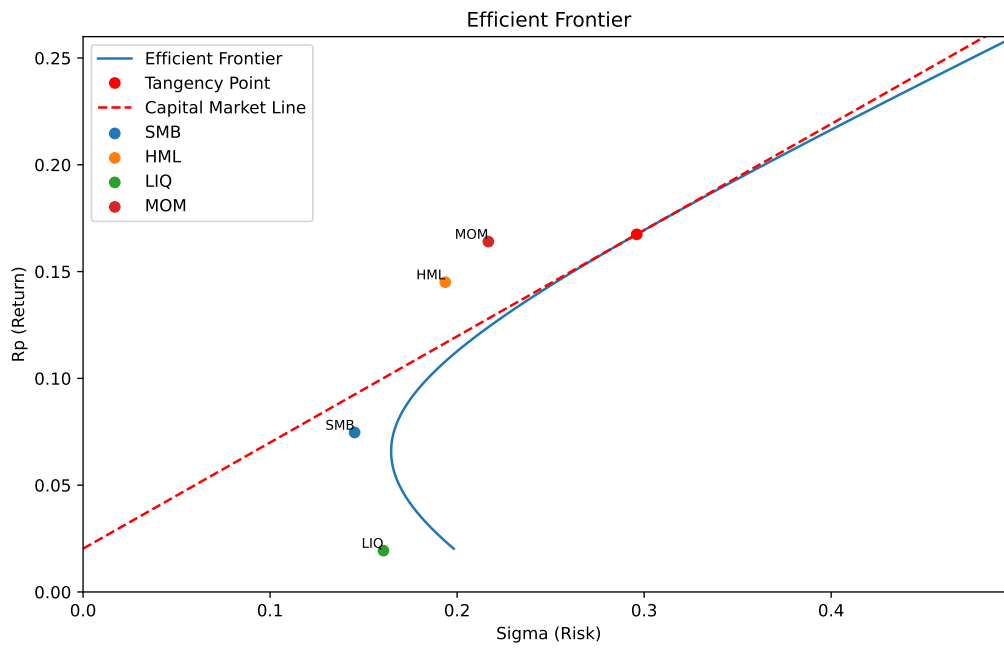
We can then plot the factors in the existing portfolio frontier

```

for series in means.index:
    ax.scatter(std[series], means[series], label=series)
    ax.text(std[series], means[series], series, fontsize=8, ha='right')
ax.legend()

fig

```



Can you construct the optimal portfolio of the stocks and the factors?