

Scientific Beta study highlights the risks of deviating from academically validated factors and the limitations of many popular factor-investing solutions

A new study from Scientific Beta entitled “[The Risks of Deviating from Academically Validated Factors](#)” highlights the dangers of not adhering to academic consensus when it comes to factor investing. Among the key points of the study:

- Factors used in investment practice show a stark mismatch with factors that have been documented by financial economists.
- Commercial factors are based on complex composite definitions that offer maximum flexibility. Providers use this flexibility to seek out the factors with the highest performance in a given dataset.
- Such practice allows spurious factors to be found. Spurious factors work well in a small dataset but will be useless in reality. Therefore, many factors that appear in popular investment products and analytic tools are likely false.

This type of practice leads to the presentation of in-sample performances that have very little chance of being reproduced out of sample. This in turn calls the usefulness of factor investing into question, even though factor investing is a serious and robust source of superior long-term risk-adjusted performance when it respects the academic research that justifies its existence and that many factor providers continue to ignore.

Indeed, and unfortunately, even though many providers claim their factors are grounded in academic research, two important conditions to support this claim are often not fulfilled:

- The factor definitions should have been used and validated across different independent studies and
- A risk-based explanation should support the existence of the factor.

Without these assurances, there is no reason to assume the persistence of the factor.

Commenting on the study, Professor Noël Amenc, CEO of Scientific Beta, said, “*Understanding the factor drivers of returns increases transparency and allows investors to formulate more explicit investment choices. However, being aware of exposures to useless factors, which have no reliable link with long-term returns, is pointless. For a meaningful contribution to the ability of investors to make explicit investment choices, factor investing should focus on persistent and externally validated factors. It is time to recall the good idea of factor investing.*”

The white paper can be accessed through the link below:

[The Risks of Deviating from Academically Validated Factors, Scientific Beta White Paper, February 2019](#)



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About Scientific Beta

Scientific Beta aims to be the first provider of a smart beta indices platform to help investors understand and invest in advanced beta equity strategies.

Established by EDHEC-Risk Institute, one of the top academic institutions in the field of fundamental and applied research for the investment industry, Scientific Beta shares the same concern for scientific rigour and veracity, which it applies to all the services that it offers investors and asset managers.

The Scientific Beta offering covers three major services:

- **Scientific Beta Indices**

Scientific Beta Indices are smart beta indices that aim to be the reference for the investment and analysis of alternative beta strategies. Scientific Beta Indices reflect the state-of-the-art in the construction of different alternative beta strategies and allow for a flexible choice among a wide range of options at each stage of their construction process. This choice enables users of the platform to construct their own benchmark, thus controlling the risks of investing in this new type of beta (Smart Beta 2.0).

Within the framework of Smart Beta 2.0 offerings, Scientific Beta provides access to smart factor indices, which give exposure to risk factors that are well rewarded over the long term while at the same time diversifying away unrewarded specific risks. By combining these smart factor indices, one can design very high performance passive investment solutions.

- **Scientific Beta Analytics**

Scientific Beta Analytics are detailed analytics and exhaustive information on its smart beta indices to allow investors to evaluate the advanced beta strategies in terms of risk and performance. The analytics capabilities include risk and performance assessments, factor and sector attribution, and relative risk assessment. Scientific Beta Analytics also allow the liquidity, turnover and diversification quality of the indices offered to be analysed. In the same way, analytics provide an evaluation of the probability of out-of-sample outperformance of the various strategies present on the platform.

- **Scientific Beta Fully-Customised Benchmarks and Smart Beta Solutions** is a service proposed by Scientific Beta, and its partners, in the context of an advisory relationship for the construction and implementation of benchmarks specially designed to meet the specific objectives and constraints of investors and asset managers. This service notably offers the possibility of determining specific combinations of factors, considering optimal combinations of smart beta strategies, defining a stock universe specific to the investor, and taking account of specific risk constraints during the benchmark construction process.

With a concern to provide worldwide client servicing, Scientific Beta is present in Boston, London, Nice, Singapore and Tokyo. As of December 31, 2018, the Scientific Beta indices corresponded to USD 43bn in assets under replication. Scientific Beta has a dedicated team of 52 people who cover not only client support from Nice, Singapore and Boston, but also the development, production and promotion of its index offering. Scientific Beta signed the United Nations-supported Principles for Responsible Investment (PRI) on September 27, 2016. On November 27, 2018, Scientific Beta was presented with the Risk Award for Indexing Firm of the Year 2019 by the prestigious professional publication Risk Magazine.

Risk
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Scientific Beta
Indexing firm
of the year