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Editorial for the Special Issue of the Journal of Banking & Finance on Asset Pricing and Factor Investing

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This special issue on Asset Pricing and Factor Investing is edited jointly with the 2021 conference of the French Finance Association. Following the measures taken by the French government to limit the spread of COVID-19, the original event planned for 25-27 May, 2020 was postponed to 26-28 May 2021. For the same reason, the conference was the first one to be fully virtual for AFFI and had 515 participants with 489 papers from 37 countries and 320 institutions including Chicago Booth, Yale, Emory, HEC, Cambridge, Oxford, Durham, Zurich, Leuven, Bocconi, Esade, Renmin, Peking, Deakin, NAU, Tokyo, etc. and 6 keynote speakers, two of which linked to the main conference, in alphabetical order: Mariassunta Giannetti and Roni Michaely. The conference was supported by LABEX Louis Bachelier Institute and Amundi Asset Management. After about two years of intensive selection and reviews a small number of quality papers has made it to publication in this special issue of the Journal of Banking & Finance.

The special issue was aimed at state-of-the-art high-quality articles on topics related to asset pricing and factor investing. The asset pricing literature has identified hundreds of factors capable of capturing sizeable risk premia. The range of ‘successful’ styles that impact asset returns has become so wide that investors are likely to be somewhat bewildered by the possibilities. The final goal was to help academics and practitioners alike in their search for risk premia and in their asset allocation decisions within and across asset classes. The topics of interest included but were not limited to: theoretical asset pricing models; estimating and evaluating asset pricing models; factor identification, timing and forecasting; factor optimization; factor zoo; fading anomalies; return predictability big data and machine learning; asset allocation; style integration; risk management; performance evaluation; implementation and transaction costs.

Lim, Sotes-Paladino, Wang, and Yao (2024) contribute novel insights and evidence on the cross-sectional relationship between firm profitability, scale, and stock returns. They are

motivated by the fact that the literature has examined extensively the relation between returns and profitability levels but not so much profitability growth. They examine the impact of the latter and firm size on asset returns both theoretically and empirically. Using a simple two-stage dividend growth model on NYSE AMEX and NASDAQ common stocks, they confirm their theoretical predictions. More specifically, they empirically verify that profitability growth is strongly short-term persistent, and that this persistence is inversely related to firm size. Using these as proxies they support the predictions of their framework, first using portfolio sorts, then using Fama–MacBeth cross-sectional regressions. Indeed, high profitability growth firms earn higher subsequent returns, and this effect is reduced for larger firms (only if their profitability growth is sufficiently high, with the effect reversing otherwise). Their results are robust to various considerations and are not sensitive to different measures of firm scale, the inclusion of small firms, or industry effects.

In the article entitled “Chasing the ESG factor” **Abraham Lioui and Andrea Tarelli (2022)** look in to the relation between ESG ratings and stock returns. They are motivated by the fact that the literature offers mixed results rendering positive, negative, or nonsignificant relations as being equally plausible. They argue that the plethora of heterogenous methods used to identify the ESG premium contributes to this, and they analytically compare two dominant methodologies for the construction of an ESG factor: the time-series (ratings used to sort stocks) and cross-sectional (ratings used to weight stocks) approaches. They propose a method for constructing the ESG factor that controls for ESG ratings and other firm characteristics that makes it possible to build pure ESG factors directly comparable across data vendors, as well as different pillars of ESG ratings. In other words, the authors make every effort to account for the intrinsic differences between the methods and datasets in order to make comparisons between the two differently built ESG factors meaningful. That is why, they use ESG data for American common stocks from Refinitiv Asset4, MSCI KLD, and

MSCI IVA to construct a cross-sectional factor (i) featuring a targeted rating, thus allowing comparability with other factors, (ii) neutralizing exposure to other firm characteristics, and (iii) not harming diversification through stock screening. Using ratings from several data vendors, they document strong variations of the factor alpha in the time series and across vendors. The conditional alpha is negatively related to the level of media attention for ESG and positively related to variations in media attention.

Zhang (2023) continues the conversation on the risk premium but this time looking in its relationship with product market competition, and in contrast to the existing literature, how the ability to adjust production capacity with product demand, i.e. investment reversibility, changes this relationship. Like the previous paper the motivation lies on the mixed evidence in the asset pricing literature that here is overcome by considering reversibility, and the development of a unified real-option framework involving corporate investment and disinvestment decisions in a continuous-time Cournot–Nash equilibrium. The central prediction of the model is that the competition-risk premium relation crucially depends on asset redeployability and if this is high, then the real option effect will dominate the leverage effect, and competition is more likely to decrease the firm’s systematic risk, and vice-versa if it is low. The theoretical prediction is applied to common USA stocks similar to the first paper by Lim, Sotes-Paladino, Wang, and Yao (2024), combined with Compustat data and the asset redeployability index of King and Kung (2017) to measure investment reversibility. The findings show a significant negative interaction effect between competition and investment reversibility on excess returns, consistent with the theoretical prediction. The results are robust to alternative measures of competition and investment reversibility.

Bernard and Cui (2023) present a theoretical framework based on Basak and Shapiro (2001), to study the impact of systemic risk management on financial institutions’ optimal wealth policies and asset prices in equilibrium. Specifically, they study in the context

of an economy with a finite horizon and a single consumption good the impact of scenario-dependent systemic risk regulation on an agent's optimal wealth choice within a utility maximization framework and on the market price dynamics of a production economy. Their motivation is derived from the ongoing debate on how an appropriate risk measure should be chosen to form the basis for regulating systemic risk and its potential impact on the investment behavior of financial institutions. They study the impact of the conditional VaR and systemic expected shortfall constraints and illustrate the potential adverse effects of conditional risk measures when the market is under stress. They find that a proper choice of the systemic expected shortfall constraint, especially based on option-implied information, may effectively reduce these impacts. Their contributions are two-fold. First, they show that regulating systemic risk using a forward-looking measure that has not been considered before in the context of systemic risk, has positive effects on financial markets. Second, they provide a warning against the adverse implications of specifying stress scenarios explicitly and of using conditional risk measures linked to these scenarios and computed under the physical probability measure to regulate market players.

Adrian Fernandez-Perez, Ivan Indriawan, Yiuman Tse, and Yahua Xu (2023) examine the profitability of a cross-asset time-series momentum strategy constructed using past changes in crude oil-implied volatility and stock market returns as joint predictors. The use of cross-asset time-series momentum strategy is motivated by Pitkäjärvi, Suominen, and Vaittinen (2020), who propose a cross-asset time-series momentum; but the paper here replaces past bond returns with an option-implied oil price volatility, that has been shown to be pertinent by the extant literature and by the authors who empirically motivate its pertinence. The paper contributes to the literature on the global impacts of oil uncertainty, as it examines this for a total of 59 countries in Europe, Asia, Africa and the Americas, as well as to the literature on cross-asset momentum spillovers and the impacts of crude oil

uncertainty on stock markets. The results show that: a) their cross-asset time-series momentum strategy outperforms the single-asset time-series momentum and buy & hold strategies with higher mean returns, lower standard deviations, and higher Sharpe ratios; and b) the cross-asset time-series momentum strategy can also forecast economic cycles, when focusing on key economic indicators, such as the industrial production index, the unemployment rate, and the inflation rate. The authors attribute the predictive power of oil price uncertainty for the stock markets to the funding constraints of financial intermediaries.

Fetherolf and Lovelace (2023), in an international study similar to the one above, explore whether five dimensions of national culture (individualism, long-term orientation, masculinity, power distance, and uncertainty avoidance) are related to stock price synchronicity, for 24 developed markets around the world. Their study is motivated by Bekaert, Hodrick, and Zhang (2009) who say that studying return comovements is central in finance, which in effect is linked to the diversification potential of investments. In addition, they consider that recognizing the interconnections of the global financial system, it is increasingly important to understand how culture affects financial decision-making. They study the link of these two dimensions using local currencies and thus restrict their sample period to the adoption of the euro in 2002, and up to 2020. Their study contributes to the literature on culture and finance, as well as the wider literature on R^2 , financial development, stock markets, and market efficiency. For example, it has broader implications for the influence of culture on market efficiency around the world as in a given country, a higher R^2 suggests that stocks move more synchronously with other stocks, while a lower R^2 could signal better incorporation of information into stock prices. According to the results, this study is the first to document a significant positive relationship between long-term orientation and stock price synchronicity. Uncertainty avoidance is also positively related to R^2 . On the

other hand, the study confirms individualism's negative relationship with R^2 . It also finds some similar evidence for masculinity, and power distance.

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