Editor's Letter

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We open the Fall issue with Clarke, de Silva, and Thorley providing factor-based explanations to the question "When Does Capitalization Weighting Outperform?" Currently the active returns of mutual funds are positively associated with the performance of the momentum and profitability factors and are negatively associated with the performance of the value and low beta factors. These effects are particularly strong in mutual funds with a stated growth objective. Thus, capitalization-weighted indexes outperform active managers most of the time, but especially when the value and low beta factors have high returns and the momentum and profitability factors have low returns.

Hsu, Liu, Shen, Viswanathan, and Zhao evaluate the performance of environmental, social, and governance (ESG) firms. They replicate results that find returns among ESG firms that are similar to those among non-ESG firms. In addition, they find that sorting stocks based on cost of equity capital generates significant positive returns for both ESG and non-ESG firms. Investing in an ESG in need index, which contains only high-ESG companies and tilts toward firms with high cost of capital, thus generates both higher social value and better return than investing in traditional capitalization-weighted ESG indexes.

Next, Pennington proposes a way to systemically eliminate the primary source of uncompensated risk from trading in one of the largest sectors of the global financial markets. He explores the market infrastructure enhancements that will be achieved in the foreign exchange forward contract market by integrating distributed ledger technology into the creation of collateral-linked contracts for currency forwards (CLCF). The essential benefits of the over-the-counter market structure are preserved because CLCF contracts remain bilateral agreements subject to International Swaps and Derivatives Association and Credit Support Annex constraints while they continue to allow for customized terms and conditions between market participants.

Alighanbari and Doole discuss different ways of controlling investment capacity in designing a factor index. Six practical ways are investigated that allow investors to modify their strategies to be capacity-sensitive while still capturing the desired factor exposure: controlling the maximum benchmark multiple, trade size, and turnover and rebalance frequency, alongside the use of staggered and spread rebalancing.

Hao, Soe, and Tang propose a stylized framework to integrate traditional style factors with carbon efficient portfolios for both U.S. and developed Europe markets. The results show that although carbon-efficient factor portfolios do achieve the objective of lowering carbon intensity, they generally have lower risk-adjusted returns than the pure factor portfolios.

The issue concludes with a factor analyses of major market indexes by Madhavan, Sobczyk, and Ang.

As always, we welcome your submissions. Please encourage those you know who have good papers or have made good presentations on indexing, ETFs, mutual funds, or related subjects to submit them for consideration. We value your comments and suggestions, so please email us at journals@investmentresearch.org.

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