



June 2019

HIGHLIGHTS FROM CFM'S NEW YORK SPRING SEMINAR

Introduction

Last month, CFM hosted its 2019 North America Spring Seminar in New York. Joined by more than 50 clients and investors, we heard from leading investors, academics and market experts on the subjects that spanned investment and portfolio construction to systemic global risks to neuroscience. For those who couldn't join us in-person, we are pleased to share with you a summary of the day's highlights.

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The agenda for the day included

The Rise of ESG Investing: Where to Next?

Fiona Reynolds, Chief Executive Officer, UN PRI
Philippe Jordan, President, CFM

Agnostic Risk Parity: Portfolio Allocation in an Uncertain World

Marc Potters, Chief Investment Officer, CFM

Agnostic Risk Parity in Action: Portfolio Construction Innovation

Philip Seager, Head of Alternative Beta Strategies, CFM

Is the Brain Really Meant to Make Rational Decisions?

Dr. Stéphanie Dubal, Brain & Spine Institute, Paris

Expectations Formation in Financial Markets

Professor David Thesmar, MIT Sloan School of Management

Impact, Co-Impact and Cross-Impact: Considerations for Optimal Portfolio Execution

Jean-Philippe Bouchaud, Chief Scientist, CFM

Incorporating Impact Costs in Trading Logic and Investing

Heath Windcliff, Head of Quant and Algorithmic Execution, Morgan Stanley

Systemic Global Risks

Professor Stephen Kotkin, Princeton University and Senior Fellow, Hoover Institution at Stanford

Highlights from the seminar

► Demand for Responsible Investing Continues to Grow.

On a panel led by Fiona Reynolds from the PRI and Philippe Jordan from CFM, we heard about the continued rise of responsible investing as more investors come to understand that ESG risks can be material, and how incorporating ESG factors into the investment process can enhance overall outcomes via performance and better risk management. And yet, not all hedge funds have truly embraced this – with only about 20% having an ESG policy in place, and 37% believing ESG will become more important in the next five years. Looking ahead, they examined the challenge of climate change that requires coordination on a global scale with the desire to avoid a scenario where the asset management industry falls into group think.

- **Constructing an Agnostic Risk Parity Portfolio.** CFM's Marc Potters and Philip Seager spoke to the group about agnostic risk parity portfolio construction and innovation. With an agnostic risk parity portfolio, CFM seeks to minimise exposure to unknown-unknowns generated by over-optimistic hedging of different bets. This allocation strategy has been shown to outperform Markowitz's allocation strategy in backtests when applied to historical CTA strategies. A presentation of the key ideas was followed by a Jupyter Notebook demonstration detailing the various layers in the portfolio construction methodology in an interactive session.
- **The Fallacy of Rationality.** Dr. Stéphanie Dubal from the Brain & Spine Institute in Paris warned the audience that we may not be as rational as we think, demonstrating how even in the well-known 'Invisible Gorilla' experiment on visual attention, something so evident as a gorilla walking among people is often missed due to selective attention. Dr. Dubal examined how brains process risk aversion or risk seeking options, as well as the concept of regret. Our takeaway? Humans are often irrational in reasoning and decision making, and in the investment world, supplementing our instincts with rigorous scientific and mathematical analysis will lead to better outcomes.
- **Forecasting Errors in Financial Markets.** MIT professor David Thesmar examined errors and bias in forecasting, including how backward-looking forecasts can lead to errors, and the roles of under and overreaction. In his conclusion as to why investors should understand forecast errors, he presented three compelling uses: to exploit forecasting mistakes of other investors, to improve forecasting and for future research.
- **A Short Review of Impact, Co-Impact and Cross-Impact.** CFM's Jean-Philippe Bouchaud presented the square-root impact law, impact decay, co-impact that occurs when others trade simultaneously, and cross-impact that looks at what happens to correlated assets when one of them is traded. He concluded his talk by stating the importance of cross-impact as a potential source of market instabilities.
- **Incorporating Impact Costs in Trading Logic and Investing.** Morgan Stanley's Heath Windcliff demonstrated to attendees why the impact model is a key component in trading decisions and should be used when determining the size and speed of an order. The impact model needs to be unbiased across many factors to be useful, and ideally you should isolate and separate market impact from in-trade alpha. The dynamic of market impact appears quite

stable across time and across a broad set of use cases, he concluded.

- ▶ **Systemic Global Risks.** Princeton University Professor Stephen Kotkin closed out the seminar with a compelling presentation on geopolitical risk, in which he focused on the rising tension between the US and China as China continues on its ascent as a global rival power – even under an authoritarian regime. The big picture? If China becomes a world power under its current regime it could overturn the world order. The US can try to halt or accommodate it, but if the communist regime implodes, China will still be a peer competitor. In order for the US to successfully compete, it must invest in human capital and infrastructure, champion open markets and good governance, and strengthen its allies.

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CFM has pioneered and applied an academic and scientific approach to financial markets, creating award winning strategies and a market leading investment management firm.



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