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Weak beta, strong beta: factor proliferation and rank restrictions

INTERVIENE

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ABSTRACT

A plethora of competing factors appear to explain the cross-section of expected returns, as recent methodological works in asset pricing call for raising statistical standards. This paper contributes to this literature via an identification-robust methodology to assess factor pricing, regardless of whether factor betas are jointly informative or not, or heterogenous enough to identify risk premiums. We provide a formal definition of non-informative factors in this regard, and document the extent to which inferences on Fama-French-Carhart factors are affected by taking into account such source of uncertainty. Confidence sets are proposed that invert popular asset pricing tests, and analytical and tractable solutions are derived. An extensive simulation study is reported in addition to our empirical assessment of the standard as well as the recent profitability and investment factors. Results suggest that the standard three factors are not statistically insignificant, yet resulting betas are not convincingly priced. Evidence of pricing weakens post 1970s, as the three factor model more broadly does not perform well. We do not find evidence favouring size or book-to-market risk over the market risk. The Carhart and recent Fama-French factors are not utterly redundant, yet heterogeneity of betas is not sufficient to distinguish a priced momentum anomaly from profitability or investment risk. All models struggle when tested with all portfolios jointly and identification of risk premium worsens globally post 2000s.

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