

Lecture discussing

**Does Academic Research Destroy Stock Return
Predictability?**

by Mclean and Pontiff (2015) (forthcoming *Journal of Finance*)

Mclean and Pontiff [2015].

Interesting way of asking to what degree results are due to data mining:

Consider an academic paper that identifies a new variable that seem to predict stock returns.

What are the alternatives?

- ▶ The effect is in reality not there, there is actually no predictability
 - ▶ The effect is due to data mining
- ▶ The effect is there, one can predict stock returns.

So, what should happen if one returns to a predictive variable *after* the publication of the academic paper that first identifies it.

One can here have several hypotheses;

- ▶ The effect is due to data mining
 - ▶ → The effect should disappear
- ▶ The effect is due to risk differences, or other rational reasons.
 - ▶ If the predictability is because one identifies the high risk stocks - those *should* have a higher return.
 - ▶ Similarly with non-risk, but rational, such as transaction costs
 - ▶ → The predictability should remain
- ▶ The effect is due to mispricing
 - ▶ Investors not realizing that the predictive variable should be used in their trading decisions.
 - ▶ → The effect should disappear
 - ▶ → Alternatively, if there are impediments to trading allowing mispricing to persist, the predictability should be less.

Specifics

Of interest: Cross-sectional predictability (ability to rank returns on same date/time period)

Findings

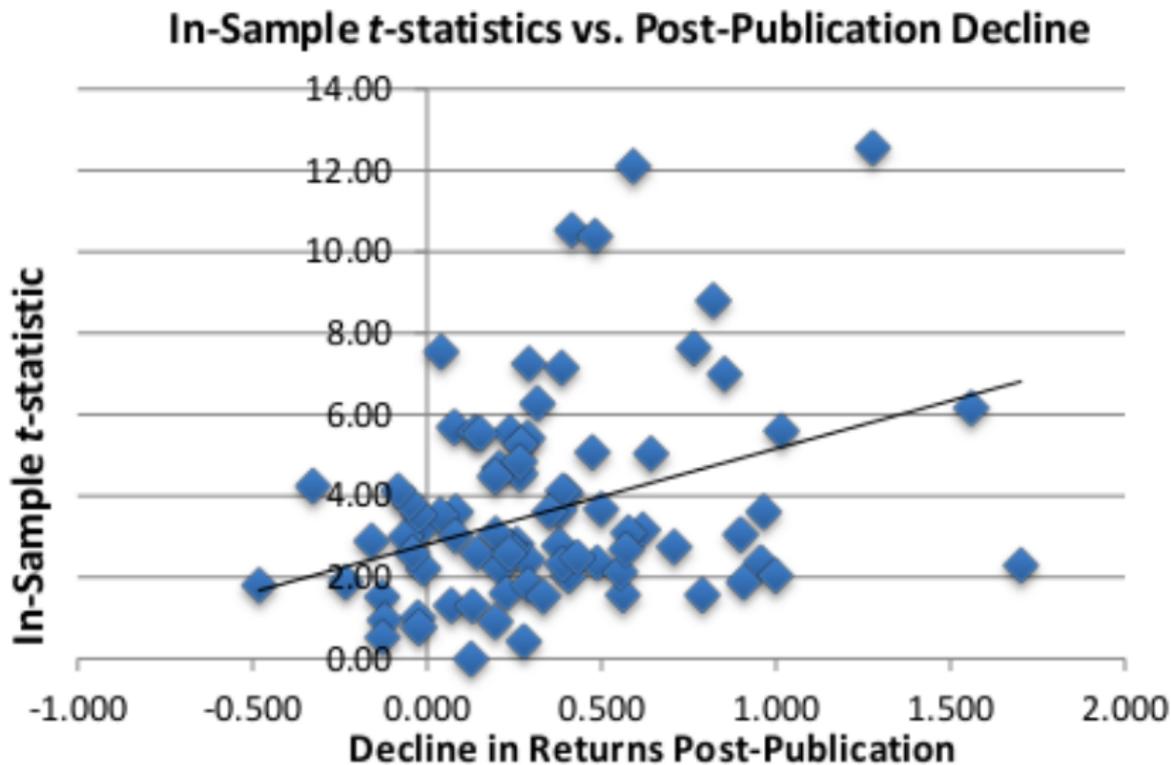
Measuring returns of long-short portfolios sorted on the predictive characteristic.

- ▶ Declines by 26% out of sample
- ▶ Declines by 58% post-publication.

Hypotheses

- ▶ Stock return predictability disappears entirely – Rejected
- ▶ Stock return predictability remains unchanged – Rejected
- ▶ Findings consistent with mispricing accounting for some or all of the original return predictability, and investors learning about this mispricing.

Cute picture



R David Mclean and Jeffrey Pontiff. Does academic research destroy stock return predictability? *Journal of Finance*, 2015. Forthcoming.