The number of common factors affecting various asset classes directly impacts the diversification benefits resulting from holding a multi-asset diversified portfolio. Understanding the behavior of these common factors during various economic regimes will help portfolio managers control their investments' risk profiles through time.

ASSET ALLOCATION

In "Determining the Maximum Number of Uncorrelated Strategies in a Global Portfolio," Ling–Ni Boon and Florian Ielpo examine this issue and search for the optimal number of factors in a multifactor model, where the most common approach in solving the problem is to use a Principal Component Analysis framework. Using a refined information criterion, the authors estimate the number of factors for a set of asset classes. They examine U.S. Treasury Bonds, corporate bonds, commodities, and currencies; identify five common factors affecting their behavior; and investigate their stability over time. During recessions, fewer common factors affect these asset classes. This could be interpreted as an increase in systemic risk. Interestingly, for commodities the common factors do not show increased correlation, providing evidence that their diversifications benefits remain relatively strong during economic downturns.

Jorge A. Chan-Lau asks whether frontier markets are the next emerging markets—and if so, should global equity investors include them in their portfolios?" In "Frontier Equity Markets: Risk Parity Lessons for Asset Allocation," the author shows that from a risk parity perspective, investors could benefit from a frontier markets allocation well in excess of the market weight of the asset class. Historical data shows that a risk parity portfolio tends to outperform a market-cap-weighted portfolio during periods of positive equity returns, while delivering comparable returns during crisis periods. Even if portfolio managers cannot follow a risk parity asset allocation strategy due to benchmark tracking considerations, overweighting frontier markets could help them outperform their benchmarks during upside periods without increasing downside risks significantly.

There is undisputable evidence that market volatility changes randomly, and only part of the change can be predicted using available information. The question discussed in the next paper is whether unexpected changes in volatility have lasting impacts on future returns. Previous studies have shown that market volatility increases when returns are negative. In "Dynamic

Asset Allocation Strategies Based on Unexpected Volatil-ity," Valeriy Zakamulin shows that unexpected increases in current volatility affect future returns as well. In particular, the author shows that unexpected volatility is negatively related to expected future returns. The author demonstrates how the predictive ability of unexpected volatility can be utilized in dynamic asset allocation strategies that deliver a substantial improvement in risk-adjusted performance as compared to traditional buy-and-hold strategies. In addi-tion, active strategies based on unexpected volatility may outperform other market-timing strategies, such as those based on volatility targeting or moving averages.

HEDGE FUNDS AND CTAs

In "Hedge Fund Investments in Bankruptcy," Ben Branch and Min Xu investigate the role and impact of hedge fund investors on bankrupt firms. They find that hedge funds provide liquidity for the troubled firms and help enhance their profitability. Comparing the performances in post-bankruptcy to pre-bankruptcy levels, bankrupt firms with hedge fund involvement tend to be in better shape than those without any vulture investor involvement. On the other hand, firms having hedge funds among their inves-tors show comparable results to those with other vulture investors, such as private equity funds. In addition, the authors find, the above improvements only appear to take place in the short run. Overall, the involvement of hedge funds does not guarantee better stock performance. Hedge funds appear to be more financial than strategic players, as they rarely help the troubled firms go through a systematic restructuring to achieve sustainable improvements.

When investors consider allocating funds to a new manager, one underlying assumption is that money manag-ers tend to display performance persistence. In fact, if there is no such persistence, then due diligence is an activity with very little value added. Two factors that make tests of performance persistence problematic are the backfill and incubation biases that are present in all hedge fund and CTA databases. In "CTA Performance Persistence: 1994–2010," authors Marat Molyboga, Seungho Baek, and John F.O. Bilson test the performance persistence hypothesis in CTAs, considering the impact of incubation and backfill bias. Their empirical results show that ranking CTAs using the t-statistic of alpha with respect to a CTA benchmark is predictive of future returns. The authors provide evidence that the strong persistence of the best-performing funds is mostly due to incubation and backfill biases. They find that the worst-performing funds have a higher probability of liquidation than those of the other quintiles, and the top-performing funds have a higher conditional probability of staying top performers versus becoming worst performers than that of the worst performing funds.

STRUCTURED PRODUCTS

The market for structured products has grown dra-matically in the past decade. The diversity and complexity of these products has led to the development of many dif-ferent valuation approaches, and it is not always clear which approach to use to value a given product. In "Valuation of Structured Products," authors Geng Deng, Tim Hus-son, and Craig McCann discuss and apply four different approaches to valuing structured products: simulation of the linked financial instrument's future values, numerical integration, decomposition, and partial differential equation approaches. They apply the models to value a common type of structured product and then discuss the virtues and pitfalls of each.

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