Discussion:

Peer-reviewed theory does not help predict the cross-section of stock returns

Andrew Y. Chen, Alejandro Lopez-Lira, and Tom Zimmermann

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Summary

- A meta research on one of the most classical questions in finance: the cross-section of expected stock returns
  - Name of the game:
    explain the cross-sectional variation in expected stock returns
    with observable firm characteristic
  - Flourished field, many papers, many predictors
  - Theoretical foundation: characteristics related to risk exposure
    (but empirically, what risk?)

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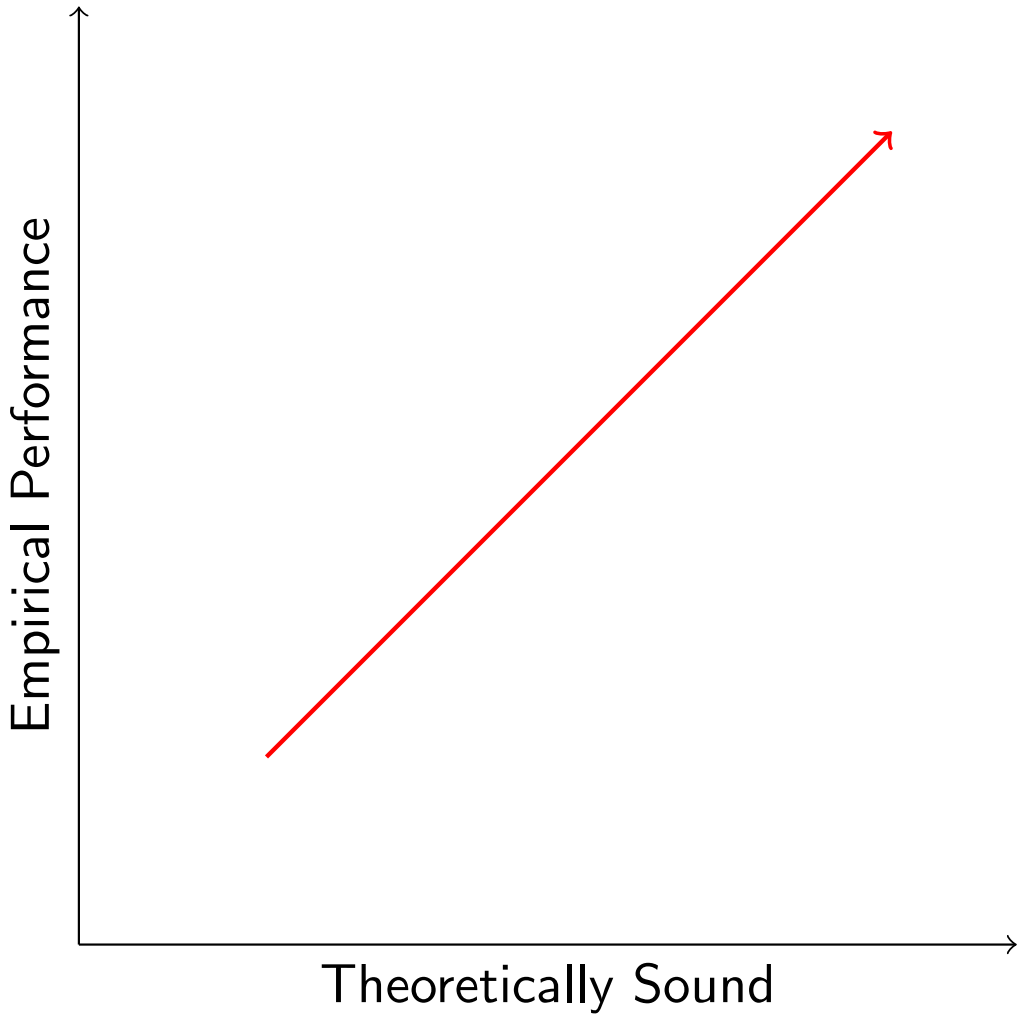
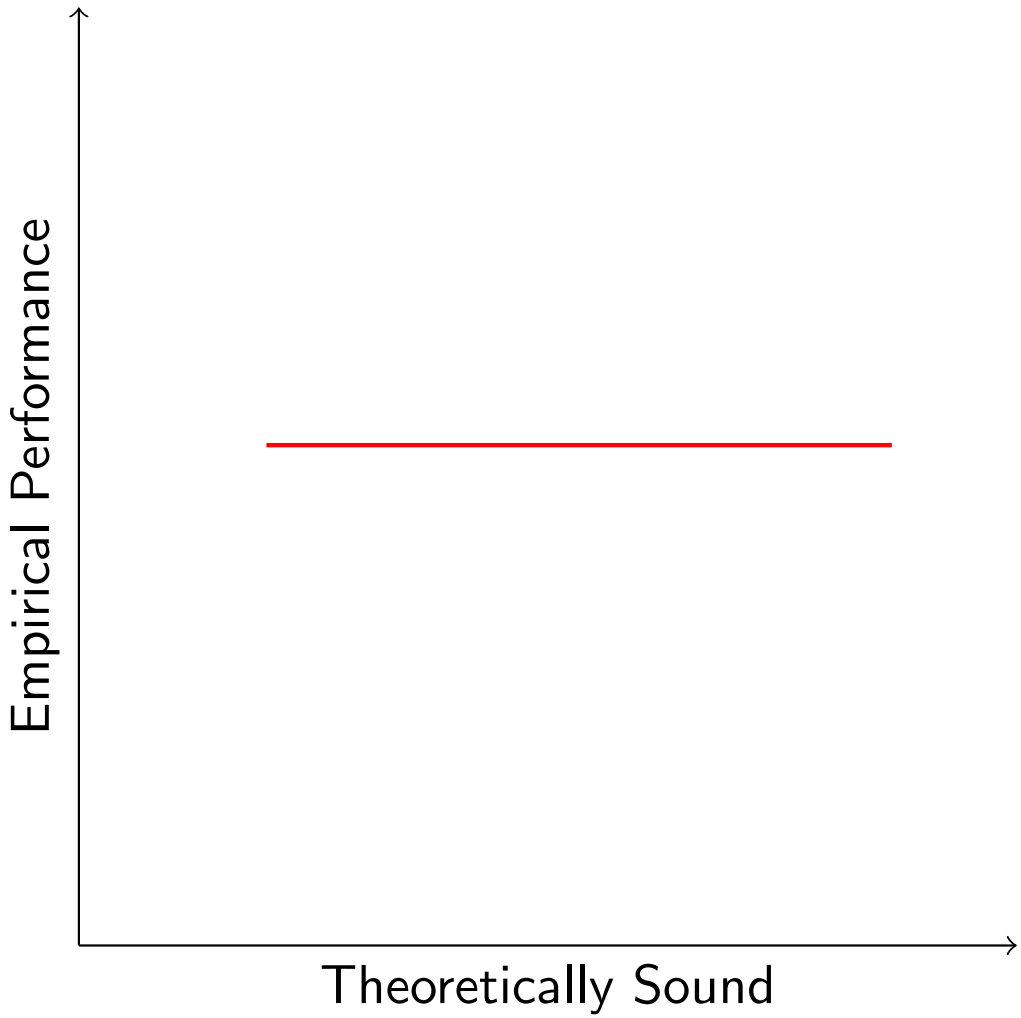
    (but empirically, what risk?)
- This paper: evaluate the empirical performances of data-mined vs theory-based predictors
  - Differentiation relies on textual analysis of the papers
    (innovative and makes sense!)
- The significance of this question and the findings:
  (next pages)

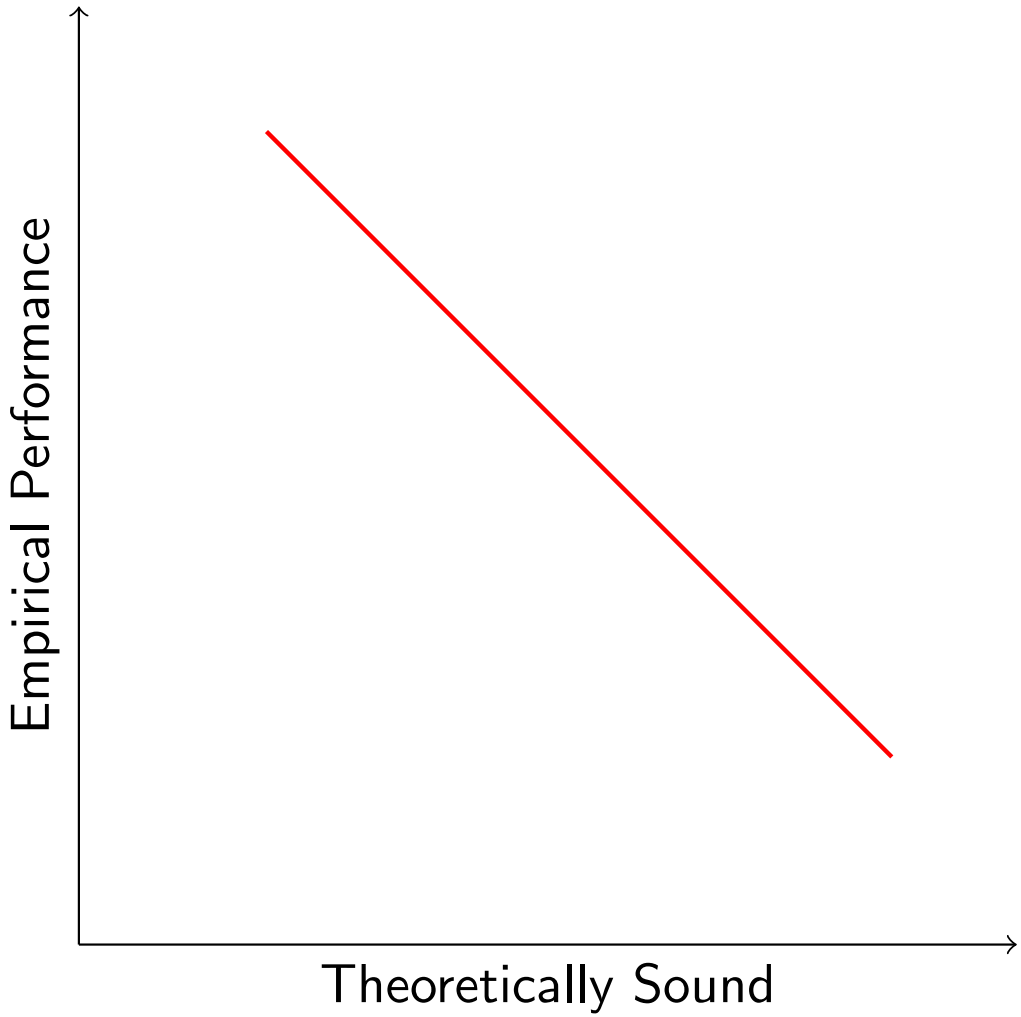
Traditional view: theory guards against fishing



Finding: "...Theory Does Not Help Predict ..."



(more like making things worse)



Overall comment

- Innovative methods, extremely valuable data collection/cleaning work
- Stunning finding: "theory does not help"!
  how surprising depends on your background,
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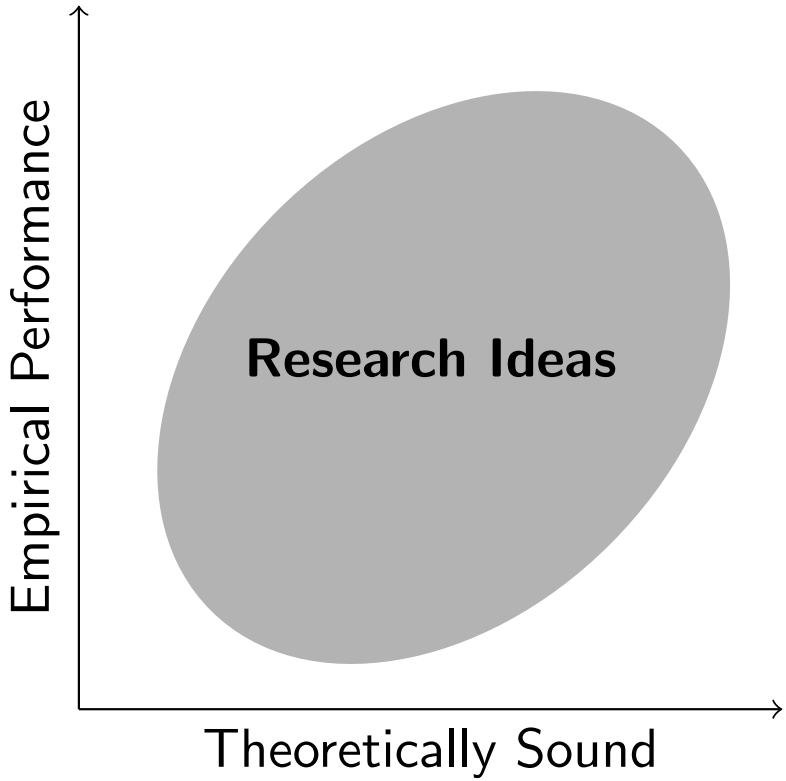
- Disclaimer: my job is "meta squared"!
  by commenting on this paper, I am commenting on my field

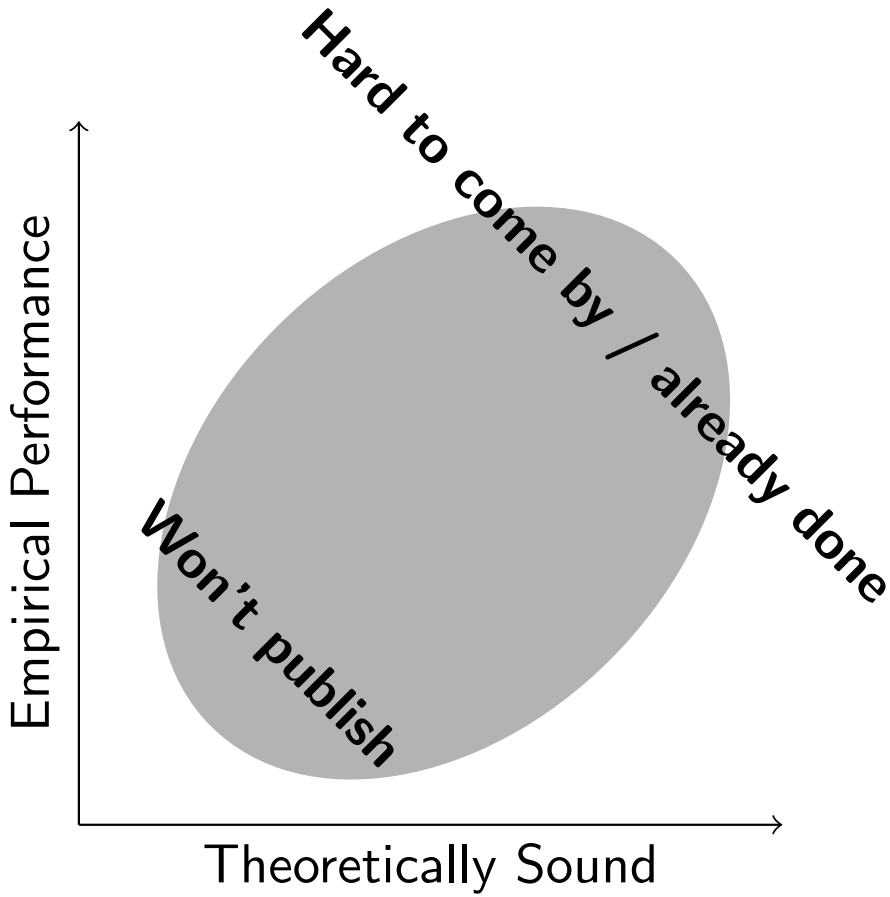
Main comment

I propose a explanation of the finding:
"negative relationship between theory foundation and empirical performance"

- An equilibrium outcome
- Driven by the demand (the publication process),
  Rather than the supply of research ideas

Under this view: the result has no implication on whether theory hurts or helps empirics


Empirical Performance
Research Ideas
Theoretically Sound


Hard to come by / already done
Won't publish
Empirical Performance
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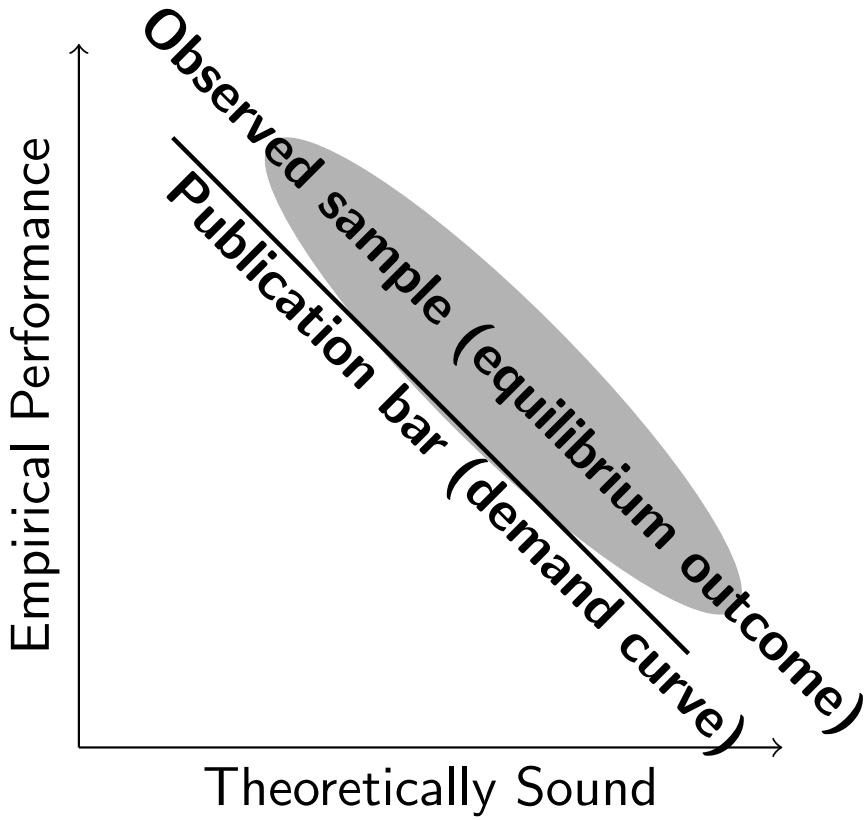
Observed sample (equilibrium outcome)
Publication bar (demand curve)
Empirical Performance
Theoretically Sound

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- Similar to the "association but not causation" critic in applied micro (have to say, paper is reserved in any making causal claim)

Admittedly, I have no empirical evidence. I am relying on theoretical reasoning. But I feel it is a realistic description of our field.

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Under this view, additional testable implications:

- *conditional on publication*, papers written by authors in under-represented groups $\rightarrow$ stronger empirical performances

Additional comment, about the empirical horse race

About this empirical horse race: predicting return with characteristics

1. It has been a good game
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   - E.g., combining many plausible characteristics (theoretical analysis often fruitful here)

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   - new proposals: total R^2 for factor models, Sharpe ratio for trading strategies

Final few words, about my belief in theory

Think about aviation...

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Credit: I thank my colleague Vadim Elenev for inspiring some of the comments.