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Measuring Factor Exposures: Uses and Abuses

July 15, 2017

The Journal of Alternative Investments

A growing number of investors have come to view their portfolios (especially equity portfolios) as a collection of exposures to risk factors. The most prevalent and widely harvested of these risk factors is the market (equity risk premium); but there are also others, such as value and momentum (style premia).

Measuring exposures to these factors can be a challenge. Investors need to understand how factors are constructed and implemented in their portfolios. They also need to know how statistical analysis may be best applied. Without the proper model, rewards for factor exposures may be misconstrued as alpha, and investors may be misinformed about the risks their portfolios truly face.

This paper seeks to serve as a practical guide for investors looking to measure portfolio factor exposures. The authors discuss some of the pitfalls associated with regression analysis, and how factor design can matter a lot more than expected. Ultimately, investors with a clear understanding of the risk sources in an existing portfolio, as well as the risk exposures of other portfolios under consideration, may have an edge in building better diversified portfolios.

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