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On Timing and Selectivity: Discussion

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DISCUSSION

ROBERT E. VERRECCHIA*: Throughout the portfolio performance evaluation literature, attempts are made to distinguish between market timing ability and forecasting ability (as it relates to the returns on individual assets). But these attempts have not been altogether satisfactory, in large part because the notions of "timing" and "selectivity" that have been introduced into the literature have usually been defined in terms of their regression characteristics, as opposed to primitive economic elements (see, for example, Grinblatt-Titman [1], which also provides an excellent synthesis of the relevant literature). To the extent that the paper on timing and selectivity by Admati, Bhattacharya, Pfleiderer, and Ross (ABPR henceforth) grapples with various interpretations of these phenomena, it fills an important void in the literature. The controversy is whether one should be encouraged or discouraged about the possibility of identifying timing information and detecting the existence of selectivity information on the basis of the evidence put forth in the ABPR analysis.

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ABPR suggest two interpretations of timing and selectivity: the portfolio approach and the factor approach. Under the portfolio approach, timing information is restricted to be information about the returns on a pre-specified set of timing portfolios. Selectivity information under the portfolio approach is restricted to be information that is uninformative about the timing portfolio returns but informative about some other asset returns. Alternatively, under the factor approach, timing information is information about the realizations of factors that affect the returns of many assets, without necessarily being confined to pre-specified timing portfolios. Selectivity information under the factor approach allows for information to be any specific determinants of individual asset returns without restriction. Although ABPR go to some length to promote each approach as a potential candidate for the concepts of timing and selectivity, their even-handedness may be a potential source of confusion in that the portfolio approach is conceptually inferior.

The portfolio approach, in addition to capturing well those characteristics of timing and selectivity suggested by previous authors in the portfolio performance evaluation literature, has the advantage of yielding an interpretation of timing and selectivity that is amenable to empirical tests. This is because selectivity information under the portfolio approach is by definition completely uninformative about the returns to be earned on the timing portfolio. The estimation problem is therefore considerably simplified. But this advantage comes at some cost: definitionally, it requires an artificial relation between the information about asset returns and the assets themselves. As ABPR concede, they do not have an appealing economic story to tell about how the information underlying the portfolio approach originates.

The factor approach, on the other hand, provides a very natural explanation of the origin of timing and selectivity information. I find it a compelling economic interpretation of these phenomena. But the factor approach raises serious econometric problems associated with designing tests to detect and distinguish timing and selectivity. Although ABPR suggest regression procedures for overcoming these problems, suffice it to say that they are more sanguine than am I about implementing these tests on a practical basis.

In short, how should we interpret the evidence in the ABPR analysis? The conceptual problems inherent in the portfolio approach would appear to rule this out as a viable interpretation of timing and selectivity, despite its advantage of allowing easier empirical investigation. The factor approach has considerable economic appeal, but introduces additional econometric problems. On balance, this would seem to suggest that the evidence is essentially negative: where timing and selectivity information are well-defined, they will be difficult to detect and distinguish.

ABPR provide a useful contribution to the portfolio performance evaluation literature by directly confronting the problem of defining notions of timing and selectivity, and their analysis should be commended for its rigor. They also address various econometric issues that need to be resolved before empirical tests can be implemented. My only reservation concerns whether one should be encouraged about the possibility of detecting and distinguishing timing and

selectivity information on the basis of their study. While I interpret their analysis as an essentially negative result about this possibility, I look forward to any additional work on this topic that clarifies my concerns.

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