Keeping the Faith (and the Returns): An AI Approach to Values-based Investing*

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Abstract

We demonstrate a new approach for SRI investing that uses techniques from Artificial Intelligence (AI) to enhance investor returns. Our paper draws on Large Language Models (LLMs) and Deep Reinforcement Learning (DRL) to address the challenges posed by moral constraints on portfolio selection. Using the Global X S&P500 CATH ETF (the largest Catholic values fund) as an example, we use textual analysis to identify companies consistent with the values mandate, allowing us to create "synthetic CATH" portfolios of different sizes and with longer time horizons. We further optimize each portfolio using DRL to arrive at an optimal set of portfolio weights that maximize out-of-sample Sharpe ratios. Using the tools of AI, we demonstrate dramatic improvements in risk-adjusted returns closing the performance gap in values-based investing.

JEL classification: G11, G12, G24

Keywords: SRI, Faith-based investing, artificial intelligence, large language models, machine learning, reinforcement learning

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1. Introduction

Socially responsible investing (SRI, also known as ESG) falls into two categories – value-based and values-based (Starks (2023)). Value-based investing incorporates into portfolio selection the risk of holding particular types of assets, adjusting the holding size and return expectation (e.g. green investing)[1]. Values-based investing incorporates moral views into asset selection, with restrictions on what assets are eligible for inclusion into a portfolio (e.g. faith-based investing). While much of the attention in SRI has focused on the first category, values-based investing has been growing, both due to social and politically-based divestment mandates and to increasing interest in faith-based investing.[2] Screening out ineligible stocks that misalign with an investor's values, however, places additional constraints on the portfolio optimization problem. This can lead, all else equal, to a suboptimal trading strategy that trades off portfolio returns for values-conscious investment activity. Moreover, even determining these ineligible stocks poses difficulties for fund managers who have to translate moral-based preferences into specific stock selections. In this paper we propose a framework to rekindle the faith in values-based investment using state-of-the-art machine learning techniques.

To motivate why such an artificial intelligence approach can be fruitful, consider the following. Values-based investing often requires discerning eligible investments where the metrics defining the constraints may not be unequivocal. Identifying these firms with simple numerical metrics may fail to capture the needed moral dimensions of the investment. Moreover, many of the largest U.S. values-based funds and indices share several common characteristics.[3] They are relatively young and thus have limited trading history. Such funds also have limited

[1] This focus on risk is captured in Blackrock's 2020 letter to clients stating that the firm would henceforth consider "ESG risk with the same rigor that it analyzes traditional measures such as a credit risk and liquidity risk" (see discussion in Matos (2020) and "Sustainability as Blackrock's New Standard for Investing", 14 January 2020).
[2] Overall size estimates of faith-based investing are difficult to determine. A recent report by Morningstar (2023) counted 850 faith-based funds and ETFs globally, with combined assets of $100 B, split between Christian and Shariah funds. Most of the assets are Christian-based, with 95% of such funds based in the US. The Interfaith Center for Corporate Responsibility includes 300 global institutional investors with more than $4 trillion in managed assets.

[3] The largest global provider of faith-based ETFs is Inspire Investing with $1.4 billion in ETFs such as BIBL, BLES, and GLRY. The largest faith-based fund is the $5.3 billion Amana Growth Investor (AMAGX) which focuses on Shariah-compliant investments. This fund holds a mix of equities and bonds.

scope and focus on only, say, S&P 500 firms. Most importantly, they value-weight their constituents rather than optimize the holding weights using some model. These latter features speak to restrictions having little to do with moral preferences but much to do with limiting potential returns. In this paper we ask: can we do better?

To this end, we use state-of-the-art Natural Language Processing (NLP) techniques, most notably Large Language Models (LLMs), to uncover what kind of firms align with the values in question. Using the tools of textual analysis, we can learn both from values-based fund managers' revealed preferences in stock selection and from discerning moral dimensions of firms from earnings conference calls. This lets us construct a synthetic fund consistent with these values, but with the longer trading history needed to build better algorithms and to validate trading strategies with higher precision. We can also expand beyond S&P 500 firms to construct values-based portfolios of different sizes taking advantage of opportunities in smaller firms that did not happen to be in the S&P 500.

We further optimize each portfolio using Deep Reinforcement Learning (DRL) to arrive at an optimal set of portfolio weights that maximize out-of-sample Sharpe ratios. Unlike supervised and unsupervised machine learning approaches, reinforcement learning uses a trial-and-error approach and a policy to learn dynamically.[4] This allows the algorithm to choose a particular portfolio design, learn from the market reaction, recommend the next optimal design, and so on. Deep reinforcement learning uses neural networks to approximate the policy function, thereby allowing higher-dimensional state spaces, facilitating the ability to learn more complex strategies and adapt to a changing environment in real time.

Our specific focus in this paper is on faith-based investing, but our broader contribution is to develop a methodology that can be applied to a wide range of settings. In particular, we believe our AI-based methodology is applicable to portfolio optimization problems subject to textual, nebulous, or implicit constraints. Broader SRI mandates such as climate or social impact can fall into this category, as can restrictions on portfolios arising from tax mandates, or geographic limitations, or simply thematic preferences such as sentiment. In these, and many other

[4] The specific class of RL algorithms we base our discussion on and implement in this paper is Policy Gradient Algorithms that suit our setting best – learning an optimal action-state mapping with a continuous action space via gradient ascent. Other powerful methods focus on the value function instead.

applications, restrictions on allowable assets impose constraints on portfolio selection; our AI approach provides a way to reduce this impact on portfolio return.

While faith-based investing comes in many variants, we apply our methodology to the largest Catholic-values based fund, the Global X S&P 500 Catholic Values ETF (CATH). This fund was created in April 2016, it is intended to conform to the investing guidelines given by the U.S. Council of Catholic Bishops, and it is limited to S&P 500 stocks. We demonstrate how any such ETF can be expanded to form portfolios of eligible stocks of a pre-specified size and reoptimized for social gain. Our NLP algorithm uses conference calls to classify stocks as being CATH-eligible, allowing us to create "CATHlike" synthetic portfolios with 500, 750, 1000 and 1500 stocks. In forming our synthetic portfolios, we retain the same restrictions imposed by CATH on maximum allowed individual stock weights.

With CATH holdings being limited to S&P500 universe, VTI (Vanguard Total Stock Market Index Fund ETF) and especially SPY (SPDR S&P 500 ETF Trust) are the best benchmark ETFs. For out-of-sample performance comparison, we focus on the period 2017-2022 since (1) conference call coverage is substantially better starting May of 2017; (2) CATH ETF started trading at the end of April, 2016, and (3) we have ETF holdings data from ETF Global starting January 2017. We can thus only make meaningful comparisons between value-weighted CATHlikes, SPY, VTI, CATH, optimized CATH and CATHlikes for the period limited to 2017-2022.

First, we confirm that, indeed, CATH underperforms SPY. As expected, the performance of unoptimized synthetic value-weighted CATHlike portfolios is generally comparable to CATH itself. We find that both since 2004 and since 2017 all value-weighted CATHlikes have underperformed VTI and SPY in terms of returns and Sharpe ratios, demonstrating the trade-off between portfolio performance and values-based investing. Interestingly enough, large stocks have so far been doing particularly well in the 21st century making performance of value-weighted CATHlikes decreasing in portfolio size.

If, instead of value weighting, we optimize holding weights using Reinforcement learning, the optimized CATHlikes boast impressive performance with Sharpe ratios at least 44% greater than SPY or CATH. Moreover, the performance improves the more stocks are included into a portfolio, with the RL optimized CATHlike portfolio with 1500 stocks having a

100% higher Sharpe ratio than SPY. Cumulative return since 2017 of a RL optimized CATHlike 500, a portfolio most comparable to SPY, is 188 percentage points higher than that of SPY. The largest CATHlike portfolio with 1500 stocks, on the other hand, has a cumulative return 1200 percentage points higher than SPY when RL optimized.

While these expanded portfolio strategy returns are remarkably high, we also find that simply following CATH stock selection, that is keeping CATH stock composition fixed, and reweighting CATH holdings using Reinforcement Learning yields significant improvement: cumulative return is higher than both SPY and CATH by more than 75% over 2017-2022. These enhanced returns show how artificial intelligence tools can improve portfolio weightings even within restrictive selection criteria. Finally, we show that these portfolios have a large Fama-French 4 and 5 alpha ranging from 11% to 70% per year depending on portfolio type and size, implying that the performance is greater than that implied by exposure to common risk factors. Additionally, we confirm that our performance gains survive even very high transaction costs. For faith-based investors, our results suggest that returns and values need not be inexorably opposed.

Our focus on values-based investing relates to what is now a voluminous body of research on the impact of environmental, social and governance issues on asset prices and returns (see, for example, research by Starks (2023); Barber, Morse and Yasuda (2021); Bolton and Kacperczyk (2021); Murfin and Spiegel (2020); Matvos (2020); Krueger, Saunter and Starks (2020)). An excellent survey of this area is Edmonds and Kacpercyzk (2022). Much of this research has focused on the risks posed by various SRI factors. A related SRI literature looks at the effects of impact investing on the cost of capital for the underlying "brown" versus "green" firms (see Pastor, Stambaugh, and Taylor (2021; 2022); Greene and Roth (2024); Berk and van Binsbergen (2021)). The problem we focus on is can you restructure a portfolio so as to offset the missing returns from the ineligible stocks. We view the main contribution of our research as demonstrating a new approach for SRI investing that uses techniques from artificial intelligence to enhance investor returns.

Our research is also closely related to the literature on "sin stocks" which directly looks at investment restrictions motivated by moral concerns. Important papers here include Fabozzi, Ma, and Oliphant (2008); Hong and Kacperczyk (2009); Fabozzi et al (2019); and Pedersen,

Fitzgibbons and Pomorski (2020). Much of this literature focusses on the trade-offs between returns and "moral" values, finding, for example, that portfolios long such precluded sin stocks outperform, while those excluding such stocks underperform.[5] Our analysis also shows such underperformance, but our demonstration that this underperformance can be mitigated (or even surmounted) at least for the Catholic values-based investment ETF shown here has important implications for the "doing good" and "doing well" tradeoff.

From a technical perspective, our research relates to a growing literature applying artificial intelligence to asset pricing. A variety of authors (notable papers here include Gu, Kelly, and Xiu (2020); Krauss, Do, and Huck (2022); Kelly, Malamud, and Zhou (2023)) have applied various machine learning techniques to portfolio selection, detecting arbitrage opportunities, and cross-sectional returns. A paper close in spirit to our work here is De Nard, Engle and Kelly (2024) who use a new approach to account for risk and "greenness" to determine factor-mimicking portfolios for hedging climate risk. An excellent survey of this literature is Kelly and Xiu (2023).

There is also a growing literature using NLP to address issues in market behavior (see, for example, Chava, Du, and Malakar (2022)), with more recent work (see Gabaix et al (2023)) using advances in NLP such as transformer-based models to extract information from more complex language models and to process ever larger data sets in practical time frames. Our NLP approach uses similar transformer-based models to extract information from industry dummies, term-frequency – inverse document frequency (TF-IDF) text representations, and features from a Large Language Model (BigBird) that learns from the market reaction to each conference call. The ultimate goal of our NLP pipeline is to detect ineligible stocks that do not align with values-based investing tenets and should be screened out. Our analysis shows how both NLP and Reinforcement Learning can play important roles in affecting the efficient frontier for values-based investors.

Particularly relevant for our research as well is the new research on dynamic asset pricing systems (see Koijen and Yogo (2019)) and direct alpha portfolio construction (Cong, Tang, Wang, and Zhang (2019)). This research area uses a variety of AI techniques including deep

[5] An interesting paper relating machine learning to sustainable investment objectives is Yang and Yasudo (2023) who find a negative correlation between financial and impact goals.

reinforcement learning, large language models and neural networks to extract underlying drivers of asset returns. Our analysis, which draws heavily on the Cong et al (2019) approach, shows how these AI tools can be used to enhance restriction-based values investing.

This paper is organized as follows. Section 2 sets out our research design, sample, and data. We also discuss the challenge of translating moral values into portfolio selections, and we compare the performance of CATH to SPY over our sample period. Section 3 determines eligible and non-eligible stocks using NLP. In training our NLP algorithm, we split our data sample into training, validation, and test sets, and evaluate its performance using standard machine learning metrics. We further form CATHlike synthetic portfolios and examine their performance relative to various benchmarks. Section 4 optimizes the weights of these portfolios, drawing on a deep reinforcement learning approach. We investigate these optimized returns relative to standard asset pricing benchmarks and compare results from our optimization schedule with well-known ETFs. We further demonstrate that our performance gains survive even very large transaction costs. Section 5 concludes with a discussion of the applicability of our methodology to a range of restriction-based investment problems. The Appendix provides more information on the data and variable construction.

2. **Research design and data**

Our research goal is to create portfolios of stocks that are consistent with Catholic values and provide larger returns than are achieved by the CATH ETF. Stock selection is at the heart of any investment product, but faith-based investing imposes the additional constraint that the company's products must be aligned with underlying religious values and principles. In this section we set out the challenges involved in translating these values into portfolio selections. As noted in the introduction, we are focusing on the particular example of Catholic faith-based investing, so we first set out the principles underlying this segment of values-based investing. We then turn to how these are applied in the largest Catholic-values based fund, the Global X S&P 500 Catholic Values ETF (CATH). We next discuss our research design of how we use machine learning techniques to select faith-consistent stocks, create synthetic CATHlike portfolios, and optimize the weights within these portfolios to enhance return. We also discuss the data sets used in our analyses.

A. Translating values into portfolio selections

Catholic faith-based investing is informed by guidance from the Vatican and the US Catholic Conference of Bishops (USCCB)[6]. The USCCB Socially Responsible Investing Guidelines (2021) sets out three strategies that should guide investing: avoid doing harm; actively work for change; and promote the common good. With these guidelines, the USCCB encourages "not investing in" or "divesting from" companies that do not: protect human life; protect human dignity; enhance the common good; pursue economic justice; or are not working to save our global common home.[7] The USCCB does not identify specific companies whose products or services fall within these proscribed areas, but they do list some specific activities (for example, adult entertainment, controversial weapons, euthanasia, abortion, child labor) that would violate church teaching. They also suggest policies such as "not investing in firms whose primary purpose is to derive revenue from gambling or the production of tobacco", or "in companies that manufacture firearms except for hunting [or….] legitimate law enforcement uses".[8]

Implementing these values into portfolio selection is not straightforward. In essence, it involves predicting which companies fall afoul of these guidelines – and by how much. The Global X S&P 500 Catholic Values Index is designed to create a benchmark consistent with Catholic values.[9] To be part of the index, a company must be part of the S&P 500, and must not exceed exposure limits on particular activities. For example, a company is excluded from the index if it has any revenue from adult entertainment production, or has more than 5% of its revenue from adult entertainment distribution. A firm is excluded if more than 50% of its revenue comes from military contracting. It is not included if it has any revenue from the proscribed activities (euthanasia, etc.) noted above. The Index is value-weighed and rebalanced quarterly. The weight on an excluded firm is given to other stocks within the same GICS (Global Industries Classification Standard) sector.

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[6] For recent Vatican guidance see The Pontifical Academy of Social Sciences, 2022, "Mensuram Bonam: Faith-based Measures for Catholic Investors", available at https://www.pass.va/en/publications/other-publications/mensuram_bonam_eng.html

[7] See page 8, "Socially Responsible Investment Guidelines for the United States Conference of Catholic Bishops", November 2021.

[8] The USCCB also encourages pro-active investment in companies whose business models promote environmental goals such as the Paris Accords.

[9] Global X is part of the by Mirae Asset Management Group

The Global X S&P 500 Catholic Values ETF (CATH) is based on the index.[10] This ETF product was introduced in April 2016 and as of September 2024 had assets of $908 million and held 439 stocks. Excluded stocks generally are in consumer staples, healthcare and industrials, and include such names as Johnson & Johnson, Pfizer, Boeing, Lockheed Martin, Caesars Entertainment, and Walmart. While some of the excluded companies seem reasonable given the USCCB guidance – Lockheed Martin makes defense materials, J&J makes contraceptives, Caesars is gambling – others do not. For example, Coca Cola is included in the ETF, but PepsiCo is not. Moreover, some firms enter, leave, and then re-enter the index. A case in point being Proctor & Gamble which starts in the index in 2017, is excluded starting in early 2019, re-enters in 2021, and is currently in the top 10 holdings of CATH.[11] No explanation is given by Global X for how specific exclusions (or conversely, inclusions) are determined, but the overall goal of CATH is to be aligned with Catholic values.

We obtained holdings data monthly for CATH over the period January 2017-December 2022 from the ETF Global database.[12] As Figure 1 shows, the number of S&P 500 stocks excluded from CATH has been growing over time, and is somewhat erratic. This variability makes our research goal of discerning eligible stocks for CATH-like portfolios ever more challenging.

As might be expected, the exclusion of so many stocks can affect returns. A natural comparison benchmark is the SPDR S&P 500 Trust ETF (SPY) which is based on the S&P 500 Index. This product, like CATH, is value based and rebalanced quarterly. The two indexes are often but not always similar. CATH's most recent one-year (3-year) returns of 34.06% (8.84%) which are less than SPY returns of 36.20% (10.43%).[13] A similar picture can be observed in terms of Sharpe ratios with SPY (0.64) having a larger Sharpe ratio than CATH (0.62). It is

[10] For specifics see https://www.globalxetfs.com/funds/cath/ The CATH ETF focusses on excluding stocks, and does not include a pro-active bias for stocks that do "better" in terms of meeting environmental goals. In our analysis, we follow this same approach and do not adjust for a pro-active bias.
[11] A natural concern is that this is simply a data problem, but conversations with S&P personnel indicate that this is not the case.
[12] Data on CATH holdings prior to January 2017 are not available in ETF Global.
[13] Data are from ETF.com as of Sept. 27, 2024. Net returns will also differ due to the CATH expense ratio of .29, substantially higher than SPYs expense ratio of .09.

important to stress, however, that this divergence does not always arise: over our 2017- 2022 sample period, CATH outperformed SPY in 62% of months.

B. *Research design and data*

We use the firms included in CATH as a "ground truth" for what constitutes an eligible stock for a Catholic-values based portfolio. We devise an NLP algorithm to predict the probability of any stock being ineligible drawing on industry classifications, and quarterly conference calls as inputs. We develop an LLM architecture based on the BigBird encoder to produce our probability estimates. We then form CATHlike portfolios and use an extended sample period from 2004 – 2022 in our analysis of synthetic portfolios. We use reinforcement learning to optimize the weights of these CATHlike portfolios, drawing on a variety of firm specific data. We then evaluate their performance relative to common market benchmarks. We train our reinforcement learning algorithm over the period 1975 – 2003, and then test our algorithm over the period 2004 – 2022 letting the algorithm learn from its mistakes after observing each year sequentially. We also investigate whether our artificial intelligence approach can produce superior returns in portfolios restricted to the same stocks held by the CATH ETF.

One objection to our approach is that we are essentially creating an active ETF and comparing its performance to a passive ETF. We have two responses to this concern. First, active investment vehicles in general have struggled to outperform passive investments, so an improved outcome from our efforts is far from guaranteed.[14] Moreover, given that all trading decisions are made by a machine and not a person, we would argue that our approach differs from what is usually viewed as active investing. Second, the CATH ETF is the largest Catholic faith-based ETF and the portfolio construction constraints imposed there (value-based, substitutions in adjoining GSICs) are not faith related per se. Our goal is to show that using AI we can improve on the outcomes relative to holding CATH. We do not address the interesting issue of whether, using our approach, we could improve on outcomes relative to a similarly AI optimized unconstrained portfolio.[15]

[14] The lackluster performance of active ETFs is highlighted in "Investment Industry Loves Active ETFs. You Probably Shouldn't", Wall Street Journal, Oct. 7, 2024.
[15] For example, an AI optimized SPY that allowed for varying weights as opposed to value weighting.

The data used in our study come from a variety of sources. We use ETF Global data to establish ETF constituent stocks over time. CRSP data provide daily, and monthly stock returns, and S&P 500 historical composition. We use Compustat data for quarterly and annual firm fundamentals. Additional data are drawn from the WRDS Financial Ratio Firm Level database. Conference call transcripts from 2002 onward are from Refinitiv. We use the Fama-French library for the Fama-French 5 factors and the risk-free rate. More information about the data and variable definitions are in the Appendix.

Finally, we raise one important caveat about our research. As noted earlier, we view the main contribution of this research as demonstrating a new approach for SRI investing that uses techniques from artificial intelligence to enhance returns. We do not view this research as promising a "free lunch" for every type of restrictive investment strategy; precluding the holdings of classes of stock may well depress returns relative to unrestricted portfolios. What our approach can do is potentially enhance these returns, reducing the trade-offs that may arise in values-based investing.

3. Determining Eligible and Noneligible Stocks using NLP

Most major values-based funds have relatively short history, but a longer trading history is needed to build better algorithms, validate our trading strategies with higher precision and uncover long-term patterns. These funds also tend to limit themselves to subsets of the largest firms such as those included in S&P500. In this section, we explain how we use state-of-the-art Natural Language Processing (NLP) techniques to extend beyond recent history and S&P500 stocks, allowing us to take advantage of a longer training sample and of opportunities in smaller firms.

Values-based indices are commonly constructed on a screening-out basis. Companies that do not meet some predetermined criteria such as a smaller than desired percentage of revenue attributable to unwanted activities are deemed ineligible. These criteria may change over time and require an in-depth knowledge of revenue sources and product lines of each company considered. For lack of a granular dataset of this sort for every traded stock we turn to NLP to learn from fund managers' revealed preferences (stock selection) what kind of stocks are likely to be eligible for values-based investment.

The inputs to our NLP pipeline are quarterly earnings conference calls and industry definitions for each firm. Text is highly expressive and is the most descriptive data source when it comes to screening out firms based on their activities, second only to a comprehensive granular dataset of activities and revenue sources by company which are typically proprietary products of financial analytics companies. The two commonly used textual data sources in finance research are earnings conference calls and firm 10-K filings, each having their own weaknesses and strengths.

Our conference call dataset starts in 2001 and grows in coverage of firms over time (see Figure 2), while 10-K filings date as far back as the early 1990s. Description of businesses in these 10-K filings is somewhat static over time, while conference calls may provide useful and variable cues through dialogue. One may suggest that managers are likely to start adapting to machines listening to them and there, indeed, is research finding some evidence in support of this (Cao et al, 2023). Managers, however, are likely to succeed by regulating their tone rather than by withholding information since analysts and investors demand accountability and a reasonable answer addressing pressing issues, many of which are directly related to the degree such firms align with values-based investing during a conference call. In this research, we focus on earnings conference calls as our input to the NLP pipeline, but in principle the analysis could also be complemented with newsfeeds, company websites or 10-K filings.

The goal of our NLP pipeline is to model the probability of an S&P500 stock being ineligible conditional on inputs with the ground truth being CATH actual holdings over time. Most stocks, around 88%, are consistent with values-based investing. We, therefore, formulate the problem as a rare event detection and choose the task of finding ineligible stocks as this is the harder task with the same end goal.

Our NLP approach combines three types of inputs of ascending complexity: industry dummies (Fama-French 48), TF-IDF (term frequency–inverse document frequency) representation of each conference call, features from a Large Language Model that learned from the market reaction to each conference call. Each input type improves out-of-sample performance in detecting ineligible stocks.

Early versions of NLP essentially produced a simple vector with word counts from a pre-defined vocabulary and this approach has been and still is popular in finance research.[16] TF-IDF representation enhances the bag of words representation by adjusting for the frequency of words across documents, giving a larger weight to less common words and discounting less informative common words. In essence, it represents a normalized word count of each word token in the dictionary for each document. In constructing the vocabulary, we omit stop words (grammatical or function words) and explicitly require that each word appear in at least 1000 documents in total and at most in 30% of all documents. This way we exclude words that are too common and those that are too rare, arriving at a reasonable dictionary size (3000 words) and representation dimensionality. The latter directly affects the complexity of the model, but also its ability to generalize, which is especially topical given the small sample size that we are working with.

Large Language Models have revolutionized NLP. These are commonly based on some transformer architecture selected based on application. At the heart of such transformer-based models is the self-attention mechanism that produces a contextualized representation of each word token based on words in the same text passage. This mechanism bypasses the sequential dependency inherent in recurrent neural networks, the state-of-the-art in NLP prior to transformers, allowing large-scale parallelization and consequently much greater model complexity, i.e. ever larger language models, and ability to process very large datasets in practical timeframes. These two virtues paired with the self-supervised nature of language gave rise to a plethora of powerful transformers-based pretrained models and have brought transformers to the forefront of the NLP research.

A major setback of vanilla transformers is that the memory and computational complexity of the full self-attention mechanism is quadratic in the sequence length making them computationally intractable in many applications requiring concurrent analysis of longer text passages such as conference calls. Most conference call transcripts are considerably longer than 512-word tokens, the maximum input length for popular transformer-based models such as BERT. More specifically, the average number of word tokens is 1200 and 1700 for introduction and Q&A sections respectively, while roughly 99% of sections, introduction and Q&A each,

[16] The seminal paper introducing signed LM word lists in finance has nearly 6000 citations (Loughran and McDonald, 2011).

have less than 4096 tokens. We take advantage of the latest developments in NLP and opt for a next-generation transformer architecture, BigBird, that approximates the self-attention matrix reducing the quadratic dependency to linear. BigBird is able to support up to 4096 word tokens in a single sequence which is enough to fit full conference call sections without losing too much information.

We pass the management introduction and the Q&A section of each conference call separately in parallel through the same BigBird model, i.e. the BigBird encoder is shared by the two sections, and further send the representation returned by the transformer through another deep neural network predicting cumulative abnormal returns around the event. The architecture of the model is depicted in Figure 3. All layers of the model, including the transformer BigBird encoder, are trained together. The neural network constructs a set of common conference call derived asset pricing factors with each conference call having a different exposure to each such common factor. These exposures, the 16×1 representations from the Deep Neural Network (DNN) hidden layer, for each conference call are our final type of input. Such layers are referred to as hidden or latent as they do not directly interact with either the inputs, the conference call text in our case, or the outputs, the market reaction.

Mathematically speaking, given the cumulative 1-day abnormal return around conference call i denoted as y_i and 1536-dimensional representation of each conference call returned by the BigBird encoder denoted as $x_i \in \mathbb{R}^{1536\times 1}$, we find, together with optimal BigBird parameters collectively denoted as BB_{params} for simplicity, two weight matrices, $W_1 \in \mathbb{R}^{16\times 1536}$ and $W_2 \in \mathbb{R}^{1\times 16}$, and two bias vectors (similar to regression intercepts they re-center the left-hand side variables), $b_1 \in \mathbb{R}^{16\times 1}$ and $b_2 \in \mathbb{R}^{1\times 1}$, such that

$$\left(W_1, W_2, b_1, b_2, BB_{params}\right) \in argmin \frac{1}{n}\sum_i (y_i - \hat{y_i})^2 \ \ where$$

$$a_i^1 = \max\left(0, W_1 x_i + b_1\right)$$

$$\hat{y_i} = a_i^1 W_2 + b_2$$

The 16-dimensional exposures used as inputs in our NLP algorithm are the activations a_i^1 defined above.

We use an L2-regularized logistic regression to produce a probability estimate of a stock being ineligible in quarter t. Regularization strength is a hyperparameter that needs to be tuned. Additionally, we need to determine the threshold on the predicted probability above which we consider a stock ineligible: $ineligible\ if\ P(ineligible) \geq threshold$. A lower threshold would make the algorithm flag more stocks as ineligible or equivalently consider eligible only stocks unlikely to be ineligible. A lower threshold thus produces a more conservative set of eligible stocks.

We decide on these hyperparameters and train the model as follows. We first split the sample into training (2017-2018), validation (2019) and test sets (2020-2021) using S&P500 stocks. We determine the optimal regularization strength hyperparameter via 5-fold cross-validation on the training set. Further using the optimal regularization hyperparameter we evaluate on the validation set and choose a threshold that maximizes validation F1 score (a harmonic average between recall and precision, i.e. what share of truly ineligible stocks are detected by an algorithm and what share of stocks flagged by an algorithm as ineligible are indeed so). Having chosen both the threshold and the regularization strength, we perform a final evaluation on the test set and produce ineligibility probabilities for all stocks in the sample since 2003.

We track several performance metrics in evaluating the power of our model out-of-sample. Accuracy is the most basic metric measuring the percentage of stocks labelled correctly as either eligible or not. Our dataset is highly imbalanced due to most stocks being eligible for CATH investing which makes accuracy an unreliable metric: a naïve and completely useless model classifying all stocks as eligible would automatically have a high accuracy. For this reason, we focus on measures more sensitive to class imbalances such as precision, share of correctly predicted ineligible stocks among all stocks predicted as such, recall, share of correctly predicted ineligible stocks relative to the total number of truly ineligible stocks, and their harmonic average, F1-score.

The Precision-Recall curve is one canonical visualization used in machine learning classification problems. The curve is generally concave, and a perfect classifier has a recall and precision of 1 implying that the area under the Precision-Recall curve, termed the average

precision, equals 1. The curve is traced by varying the confidence level threshold for classifying a stock as ineligible. In choosing the threshold, one can either opt for the one corresponding to an optimal combination of precision and recall as defined by their F1-score or one may want to minimize an error of a specific type – false positives or false negatives. An alternative graphic, a Receiver Operating Curve, compares directly true positive and false positive rates. The area under this curve, ROC-AUC, is a commonly used measure summarizing how well a model is able to distinguish positive examples from negative at different confidence levels and has a maximum value of 1. A higher value of all the above-mentioned measures (precision, recall, F1-score, average precision, ROC-AUC) indicates a better model.

In Figure 4 we depict the Test set Precision-Recall curve of our classifier. A substantial improvement over the naïve estimator baseline (predict all ineligible, red line) is evident as the blue curve, the precision of our classifier, is much higher than the red line for all recall levels. Naturally, we should expect average precision, the area under a precision-recall curve, to be substantially higher for our algorithm as compared to the naïve baseline.

Quantitatively speaking, at the threshold level maximizing validation set F1-score, 80% model confidence level, our model's test set performance substantially exceeds that of the naïve baseline (random chance): accuracy of 93% against 78% for a random chance baseline, F1-score of 0.70 against 0.21, precision of 0.82, recall of 0.62, ROC-AUC of 0.88 against 0.5 and average precision of 0.75 against 0.12. Using this set of hyperparameters, we further refit the model on the full dataset and predict ineligibility of stocks outside of S&P500 and of stocks before 2017 when the CATH holdings data start.

To start with, we use our measure of stock CATHlikeness, the probability of a stock being eligible for inclusion into CATH produced by our model, to demonstrate that faith-based investing underperforms. This evidence emphasizes the trade-off between investing well and investing for good. More specifically, every quarter we sort stocks into quintiles based on their CATH ineligibility and within each quintile form a value-weighted portfolio since 2004. We also construct a long-short portfolio whereby we go long the least CATHlike quintile portfolio and short the most CATHlike quintile portfolio. We further compare excess returns and Fama-French 4 alphas across portfolios.

As follows from Table 1, each portfolio has a statistically significant and positive excess return, but this return monotonically decreases in the degree of CATHlikeness with average monthly excess return ranging from 0.89% for least CATHlike stocks to 0.64% for most CATHlike stocks. In addition, a long-short portfolio going long the least CATHlike quintile portfolio and short the most CATHlike has a statistically significant average monthly return of 0.25%. In terms of annualized Fama-French 4 alphas, the least CATHlike portfolio has a statistically significant alpha of 2.87% per year, while the long-short portfolio has a statistically significant alpha of 3.59% per year. We have thus established that least CATHlike stocks are considered riskier and command a greater premium or alternatively that CATHlike stocks underperform.

Armed with quarterly stock-level probabilities of CATHlikeness, we next construct an array of CATHlike portfolios since 2004 with 500, 750, 1000 and 1500 stocks. Conference call coverage increases over time such that only after 2007, 2011 and 2017 are there enough stocks to form proper 750-stock, 1000-stock and 1500-stock eligible portfolios. Interestingly enough, this conference call coverage issue is not limited to small stocks with many S&P500 stocks also affected especially in early years. Conference call coverage gets wider from 2017 onward.

Fortunately, since CATH inception we have enough data to form proper portfolios of all sizes. We require for each stock-month at least 80% of valid values for our feature set used for Reinforcement Learning optimization purposes (the list of predictors is covered in the appendix) and impute whatever values missing with a median value within each industry-month. This requires reasonable coverage by Compustat fundamentals and WRDS Financial Ratios datasets for each stock-month under consideration in addition to availability of conference call data[17].

Our baseline CATHlike portfolios follow the construction of the original S&P500 Catholic Values Index: rebalancing is quarterly with constituents updated in March, June, September and December; weights are value-weighted with a cap such that no individual stock has a weight greater than 24%; and the sum of weights of stocks with weight above 4.8% cannot be greater than 50%. For the sake of comparison, the only S&P500 stocks included into our CATHlike 500

[17] A smaller number of eligible stocks before 2016, an issue that arises due to data availability, makes our ultimate task harder and our performance, therefore, is a conservative lower bound.

portfolio, the portfolio closest to CATH, that are not in the original CATH in at least 10% of the months are Regeron Pharma (REGN-29% of months), Biogen (BIIB -24%), Eli Lilly (LLY -24%), Costco (COST -17%), Leidos Holdings (LDOS -16%), Paramount Global (PARA -14%) and Ball Corporation (BALL -10%).[18]

4. Optimization using Reinforcement Learning and Results

In previous sections we described the need to close the performance gap between values-based and unconstrained investing paradigms. We further showed how we can mimic and expand portfolio composition of ETFs such as CATH to years long before CATH inception and to stocks outside S&P500. In this section, we demonstrate how using advanced deep learning techniques we can close this gap through (1) portfolio optimization and (2) inclusion of stocks outside S&P500.

The economic environment is incredibly complex, ever-changing, and is represented by generally non-stationary observable variables of high dimensionality, all of which prove to be major challenges for any characteristics-based portfolio optimization technique. Being able to account for complex relationships among a large number of variables and to adapt dynamically to changes over time gives Reinforcement Learning methods an edge over traditional methods.

At the core of reinforcement learning is learning what actions to take upon observing a certain state of the environment. This mapping from states to actions is called a policy function. Having decided on the action, the environment transitions to the next state and rewards from actions taken at the previous step are revealed. The learner's task is to figure out by trial-and-error what actions in response to what state of the environment yield greatest cumulative rewards.

Mathematically speaking, let there be N_t eligible stocks at time t. Given time t state $s_t \in S_t \equiv \mathbb{R}^{N_t \times 12 \times K}$, a 12-month history for each stock of K stock-level predictors ($K = 52$ in our case), the agent is to choose an action $\boldsymbol{a_t} \in A_t \equiv [0,1]^{N_t}$, a vector of portfolio weights for each stock, from policy function $\pi: S \to A$. Reward at time t, r_t, is a function of both the time t and time $t+1$ states as well as the action taken at time t. It is customary to define a state-action-

[18] These firms are a varied lot ranging from aluminum packing (BALL) to entertainment (PARA), consumer products (COST), software (BIIB), and pharmaceuticals.

reward triplet $(s_t, \boldsymbol{a_t}, r_t) = (s_t, \boldsymbol{a_t} \in \pi(s_t), r_t)$ fully describing the game at time t. Given an episode of T such periods, the learner generates a state-action-reward trajectory $\tau = \{s_1, \boldsymbol{a_1}, r_1, \dots, s_T, \boldsymbol{a_T}, r_T\}$. In the context of our problem, $\boldsymbol{a_t}$ is a vector of holding weights between 0 and 1 of each stock in portfolio at time t sampled from the policy function π parametrized by a deep neural network. s_t are the input variables describing the state of the environment and r_t is the holding return of the corresponding portfolio. We set $T = 12$, that is for 12 consecutive months at a monthly frequency the agent rebalances their portfolio using the latest available information on the state of the environment and is rewarded with a monthly return. The parameters of the deep learning model, the policy function, are improved once the whole trajectory over 12 months is observed.

Our goal is to maximize the Sharpe ratio computed within each year from monthly returns across trajectories. We use return on an equal-weighted portfolio of the N_t eligible stocks as the benchmark in computing the Sharpe ratio instead of a risk-free rate in the objective function to maximize during training. The model learns from how well it does in terms of the objective function, the Sharpe ratio. Sometimes the economic environment sets a long-only trader up for failure such as during economic crises and there is little the model restricted to long-only positions in N_t stocks could have done to have a positive return that year. To avoid over penalizing the model in such instances, we reward the model for doing better than the equal-weighted index instead. Keep in mind that we use the conventional definition of the Sharpe ratio with the risk-free rate as the baseline in reporting any of our performance metrics.

Denoting parameters of the policy function after k epochs ("full" pass of the training data through the model) as θ_k, action at time t, $\boldsymbol{a_t}$, is sampled from policy $\pi_{\theta_k}(s_t)$ where the current state of the environment, s_t, also affects that action sampling distribution. We can also denote the vector of returns from trajectory τ generated using policy with parameters θ as r_τ^θ. The objective function of the agent is then $J(\theta) = Sharpe(r_\tau^\theta)$ and it is optimized to find the optimal weights of the policy function $\theta^* = argmax_\theta\, J(\theta)$ via gradient ascent as $\theta_{k+1} = \theta_k + \eta \nabla J(\theta)|_{\theta=\theta_k}$ at a learning rate η.

The model architecture closely resembles AlphaPortfolio by Cong et al (2019). The model has three components (see Figure 5). The first component is a sequence feature extractor which constructs a representation of each stock from its 12-month history of P attributes using a

Transformer Encoder. The predictors are based on Compustat, CRSP and WRDS Financial Ratios. We list variable definitions in the appendix. In a sense, the sequence feature extractor re-expresses each predictor as a function of other predictors guided by how predictors are related to each other across time. The second component, a cross-attention network, captures interrelationships among stocks. It is based on a Multihead Attention module. Finally, winning scores are constructed using the third component by a linear layer transformation of the outputs from the cross-attention network and provided to the Reinforcement Learning agent who decides on action $\boldsymbol{a_t}$, a vector of portfolio weights. We focus on long-only portfolios and apply a Softmax operation to winning scores which rescales weights to be between 0 and 1 and to sum to 1 to determine portfolio weights, $\boldsymbol{a_t}$. The RL agent's goal is to maximize episode Sharpe ratio of the portfolio chosen by the agent.

We consider data from 1975 up to 2022 and split the sample into distinct training and test sets. More specifically, due to conference call data availability we use 1975-2003 years for training and 2004-2022 for testing. During training we split the training set into consecutive 2-year windows and each epoch, corresponding to one "full" pass of the data through the model, we sample a month within the first year of each 2-year window. The agent then interacts with the environment in the 12 consecutive months following that randomly chosen month. This data augmentation allows the agent to adapt to slightly different representations of similar environments reducing risks of overfitting and facilitating exploration. We repeat this training schedule for 30 epochs.

Each month the agent observes states of all stocks, both eligible and ineligible, and holds a long portfolio in 10% of stocks with the highest winning score irrespective of CATHlikeness or eligibility status. This way, the agent first becomes an expert in portfolio management learning from stocks both aligning with values-based investing and not. The agent's choice set will further be restricted to eligible stocks during testing. In Figure 6 we depict the in-sample learning curve. The red line representing the average annualized Sharpe ratio for epochs across trajectories is roughly upward slowing and approaches a Sharpe ratio of 1.1 by end of training. All portfolios are long-only.

During testing, from 2004 onward, on the other hand, we sequentially apply the model to each new consecutive year restricting the choice set to only eligible or CATHlike stocks, record

the agent's performance and then let the agent learn from its mistakes by taking 3 gradient ascent steps in the direction maximizing Sharpe ratio on this year. Importantly, since (1) conference call coverage is substantially better starting May of 2017; (2) CATH ETF started trading in 2016 and (3) we have holding data from ETF Global starting January 2017, we can only make meaningful comparisons between SPY, VTI, CATH ETF, optimized CATH and CATHlikes for the period limited to 2017-2022. We, therefore, use the out-of-sample period before 2017 starting in 2004 to transform our agent from an expert in unconstrained portfolio management to one proficient in values-based investing and thus ready for "prime time" which starts in year 2017.

We propose several ways to close the unfortunate performance gap between CATH and SPY. First, we ask if the underperformance of CATH, being limited to a subset of S&P500 stocks, is due to its having measurably fewer stocks included than SPY? We investigate whether simply adding stocks outside S&P500 that still look CATHlike and value weighting would boost performance of our synthetic values-based fund. Second, we ask whether value-weighting being a suboptimal portfolio optimization schedule is the cause of the underperformance? We apply our Reinforcement Learning algorithm to take stocks actually held by CATH but replace holding weights with optimal holding weights (we refer to this RL optimized portfolio as "CATH reweight"). Finally, we ask if using our methodology unconstrainted by portfolio size and value weighting can overcome the performance gap? To do so, we optimize portfolio holding weights of CATHlike portfolios.

In Table 2 we report annualized Fama-French 4 and 5 alphas, average returns, Sharpe ratios, Value-at-Risk and the corresponding Expected Shortfall at 5% for VTI, SPY, CATH, CATH reweight, value-weighted and RL optimized CATHlikes for the period 2017-2022. A number of observations can be made.

First, CATH performed measurably worse than SPY in terms of all performance metrics, while also having more negative VAR and Expected Shortfall at 5%. Earlier we showed that CATH generally underperformed its benchmarks with respect to returns. But now we demonstrate that CATH not only has worse returns, it also bears more risk than SPY.

Secondly, our synthetic value-weighted CATHlikes perform similarly to CATH and underperform SPY, CATH and at times VTI. Thus, adding more stocks did not rectify the underperformance problem. This once again demonstrates the trade-off between performance

and values-based investing. This widened performance gap indicates that our synthetic portfolios likely closely reflect values-based investment preferences, potentially even better than CATH itself. Our result also highlights the limitations that value-weighting imposes on performance.

Thirdly, using our RL algorithm to optimize and reweight CATH weights brings substantial improvements in performance metrics over the real CATH: Sharpe ratio of 0.67 vs 0.62; Fama-French 4 and 5 annualized alphas of 13.46%, 11.71% vs 0.36% and -0.1%. The RL reweighted CATH is notably riskier than the true CATH with the standard deviation of monthly returns being 66% higher than CATH itself. The average returns, however, are 80% higher which more than compensates for the added risk.

Finally, RL optimizing CATHlike portfolios yield substantial gains and the greater the number of CATHlike stocks we include, the better the performance overall. For instance, the RL optimized CATHlike portfolio with 500 stocks has a Sharpe ratio of 0.92 compared to value-weighted CATHlike 500's 0.60, CATH ETF's 0.62 and SPY's 0.64. RL optimized CATHlikes also command a large Fama-French 4 and 5 annualized alpha, 15% and 19% respectively for RL optimized CATHlike 500 and 62% and 70% for RL optimized CATHlike 1500, implying that the performance cannot be attributed to a greater exposure to well-known risk factors. In Figure 7 we juxtapose cumulative returns since 2017 of value-weighted and RL optimized CATHlikes, CATH, SPY and RL reweighted CATH demonstrating substantial benefits from RL optimization and from forming larger portfolios.

One might ask why does reweighted CATH not perform nearly as well as the RL optimized CATHlike 500? The answer lies in the learning involved in the RL algorithm. In Figures 8 and 9 we plot cumulative returns of CATH reweighted and CATHlike 500 respectively against SPY, VTI and CATH. We see a substantial dip in the first year of the CATH reweighted portfolio (in 2017), a dip that is not observed for any other portfolio and definitely not for RL optimized CATHlike 500. The agent in charge of CATHlike 500 had an opportunity to become a values-based investing expert, started implementing its strategies in 2004 and has been improving ever since. Unlike CATHlike 500, the agent making decisions on CATH reweighted holding weights just arrived at its post in 2017 after years of general portfolio management training in mostly the 20th century and, after an unsuccessful first year in the job, quickly learned how to do better. This means that, all else equal, it is reasonable to expect the CATH reweighting

agent to continue improving and to eventually perform comparably to the CATHlike 500 manager. It also means that there likely is a better way to pretrain the CATH re-weighting manager using the data prior to 2017.

4.1 RL Optimization and Transaction Costs

One common belief is that the impressive performance of many machine learning models in finance is attributable to trading frictions such as illiquidity of stocks traded by the model. In this subsection we demonstrate that our model performs well even after accounting for trading costs.

We start by constructing a measure of portfolio turnover following Gu et al (2020). More specifically, average monthly turnover of a portfolio is defined as

$$Turnover = \frac{1}{T}\sum_{t=1}^{T}\sum_{i=1}^{N}\left|\frac{w_{i,t}(1+r_{i,t+1})}{1+\sum_j w_{j,t}r_{j,t+1}} - w_{i,t+1}\right|$$

with $w_{i,t}$ being portfolio weight of stock i at time t and $r_{i,t}$ the corresponding monthly return. Gu et al (2020) demonstrate that machine learning models often outperform at the cost of a greater portfolio turnover and virtually all machine learning models considered in that paper have a turnover of at least 110%.

In Table 3 we report turnovers for our RL optimized and value-weighted portfolios. Value-weighted portfolios have a dramatically smaller turnover - less than 10% for all portfolio sizes. We expect SPY and CATH to have a comparable turnover estimate as these are constructed in a similar manner to our value-weighted synthetic CATHlikes. Turnover of RL optimized portfolios, however, largely depends on portfolio size. Nevertheless, nearly all RL optimized portfolios have turnovers smaller than 110%, the minimum turnover reported in Gu et al (2020), with RL reweighted CATH, RL optimized CATHlike 500 and 750 having a turnover of 63%, 83% and 109% respectively. Only portfolios with 1000 and 1500 stocks have a higher turnover – 122% and 136% respectively.

Finally, we follow Bollerslev et al (2018) and account for transaction costs using the median bid-ask spread in the last 9 months for each stock. We adjust for transaction costs equal to a double "half-spread" or one full bid-ask spread as is done in that paper, but also consider costs equal to 2 full spreads and 5 full spreads. We report performance metrics adjusted for bid-ask spreads in Table 4.

As expected, performance is decreasing in transaction costs. Most importantly, the performance of RL optimized models holds up remarkably well. Even if adjusted for 5 full bid-ask spreads, RL optimized CATHlike 500, 750, 1000, 1500 and CATH reweight portfolios boast a Sharpe ratio of 0.82, 0.81, 1.03, 1.17 and 0.64 respectively, in comparison to value-weighted CATHlike 500's Sharpe ratio of 0.6. Fama-French 4 and 5 alphas of our RL optimized portfolios stay substantial and significant throughout as well. The performance of our model is thus robust to transaction costs.

5. Conclusions

Incorporating values-based restrictions into portfolio selection has long been viewed as inducing a "doing good versus doing well" tradeoff for investors. Using the tools of artificial intelligence, we have demonstrated that this outcome need not be inevitable. Drawing on recent advances in Large Language Models and Deep Reinforcement Learning, we showed how risk-adjusted returns can be substantially improved via enhanced asset selection and more complex portfolio weighting optimization. Our application is to faith-based investing, where issues related to values-appropriate asset selection are particularly challenging, and shorter trade histories combined with value-weighted investment vehicles often limit investment returns. This faith-based setting seems particularly well-suited to AI-based analytics.

Can this approach be applied more generally? We believe our AI-based approach is applicable to any portfolio optimization problem that is subject to textual, nebulous, or implicit constraints. As noted earlier, broader SRI mandates can fall into this category, but so, too, can restrictions on portfolios arising from tax mandates, or geographic limitations, or simply thematic preferences such as sentiment. An interesting question we want to address in future research is the impact on returns and risk imposed by diversification-based regulatory constraints on portfolio weights and construction. In our analysis here, we stayed in within the confines dictated by such constraints as they applied to CATH but still found that we could create portfolios with lower sharp ratios. We conjecture that such regulatory constraints, while useful in times past for restricting risk, may now be more of an impediment than a protection for investors risk exposure.

One aspect of our research that we think important to emphasize is the role played by advances in artificial intelligence in explaining our out-performance. AI-based investing is not actually new, with the first AI-based ETF (AIEQ) introduced in late 2017. AIEQ used IBM Watson to select stocks, but the resulting ETF had a lower Sharpe ratio and higher risk than its benchmark. As a result, it has underperformed the S&P index every year since its inception.[19] Newer generations of AI-based ETFs have emerged, but again their track record has been mixed, with some posting particularly poor performance.[20] The advent of transformer-based architecture has revolutionized AI analyses, paving the way for greater success in crafting investment strategies. The success of our methodology, which relies on machines rather than a person making portfolio decisions, suggests that such algorithmic-based investing can play an important role in asset management.

[19] The current year is no exception. 2024 year to date returns are 5.59 compared to SPY returns of 22.36.
[20] An interesting discussion of AI-based ETF performance is "Hype vs Reality: How are AI-Driven ETFs Performing?" at https://www.dividend.com/active-etfs-channel/how-are-ai-driven-etfs-performing/

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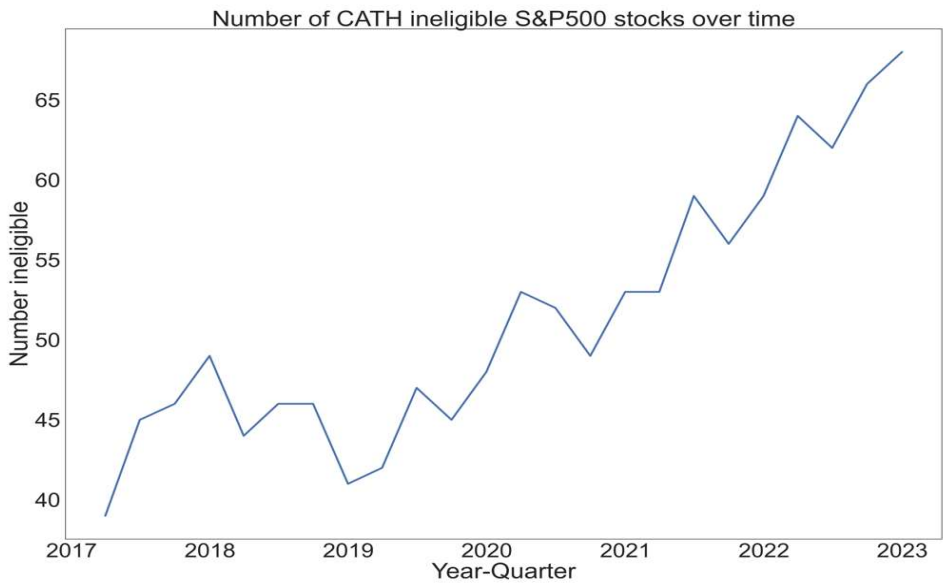


Figure 1. The number of CATH ineligible stocks over time

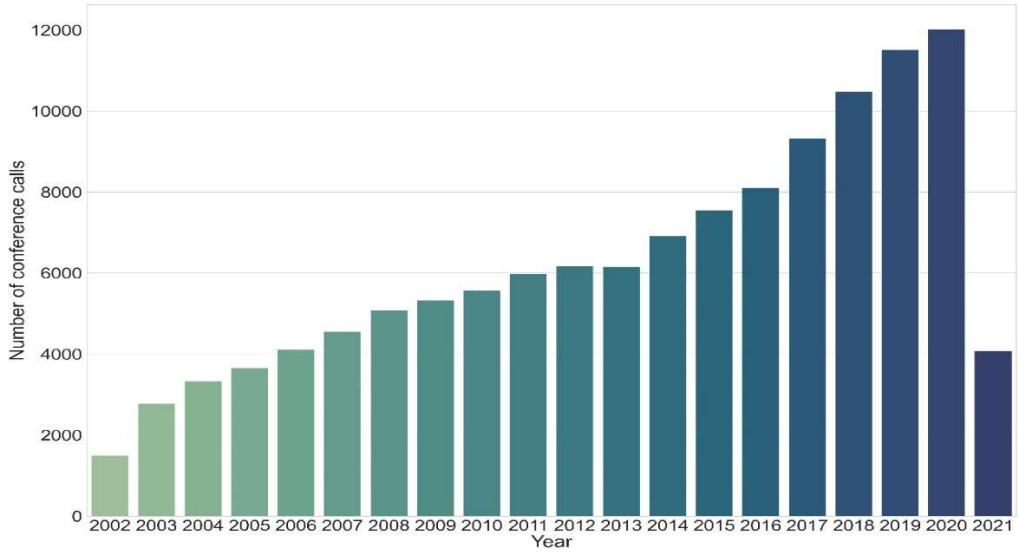


Figure 2. Number of Conference Calls over time

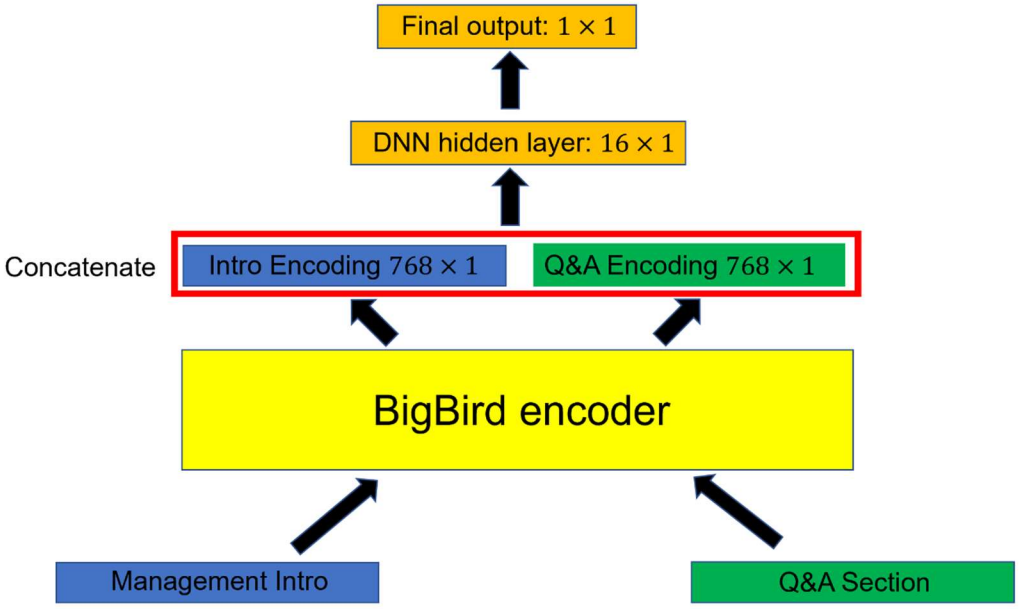


Figure 3. Large Language Model Architecture

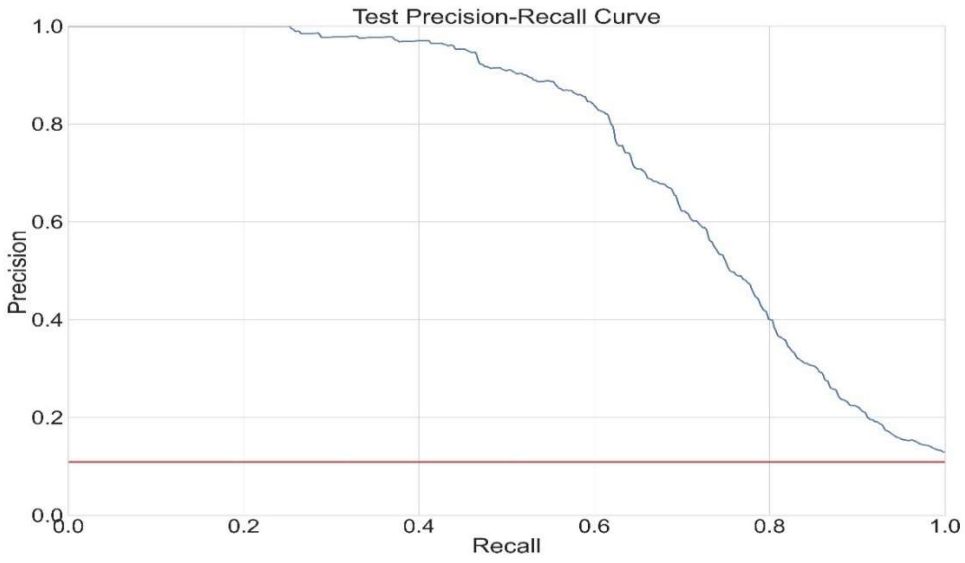


Figure 4. Test set precision-recall curve

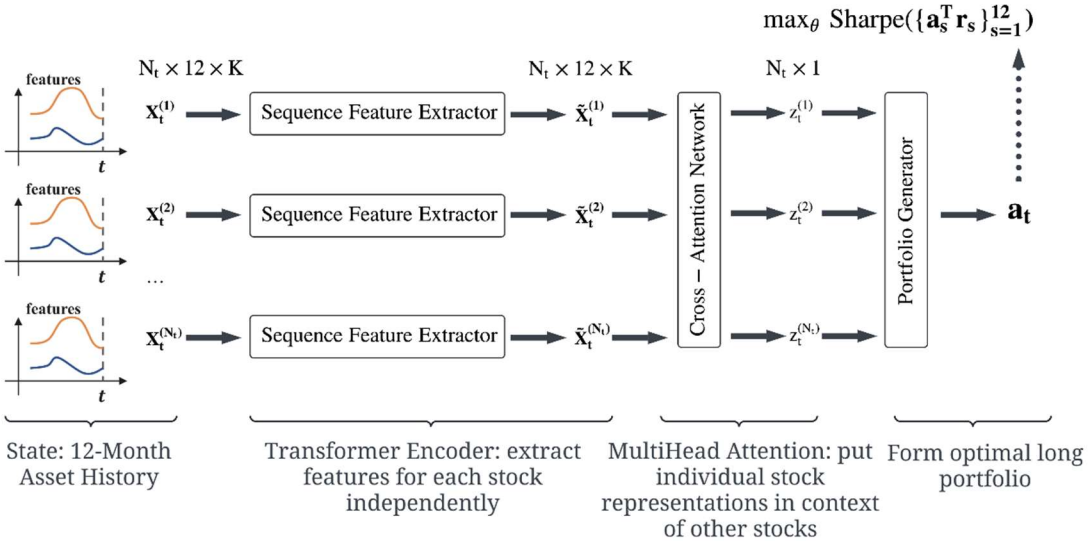


Figure 5. Proposed Reinforcement Learning pipeline

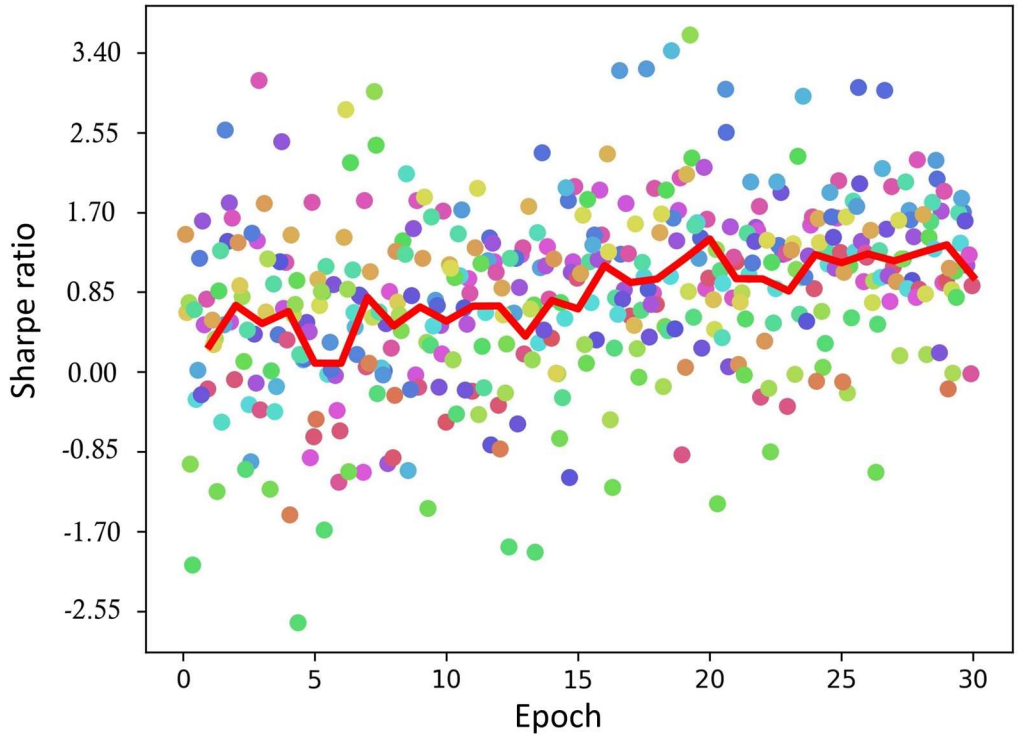


Figure 6. In-sample Learning Curve of our Reinforcement Learning Algorithm

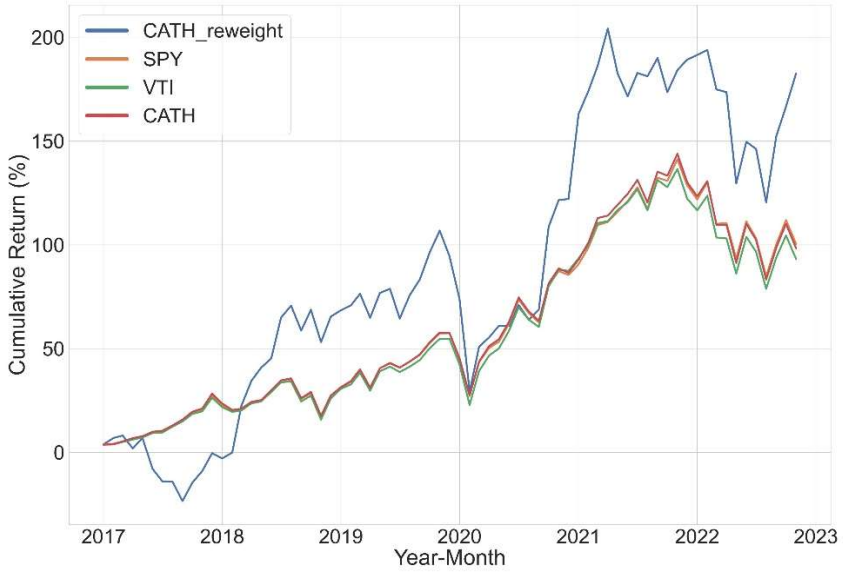


Figure 7. Cumulative returns of CATH reweighted, CATH, SPY and VTI

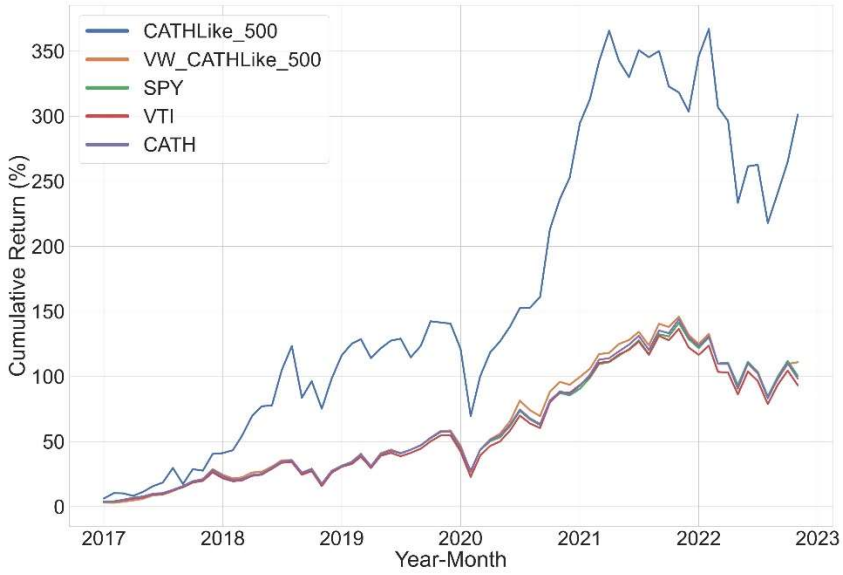


Figure 8. Cumulative returns of RL optimized and value-weighted CATHlike 500, CATH, SPY and VTI

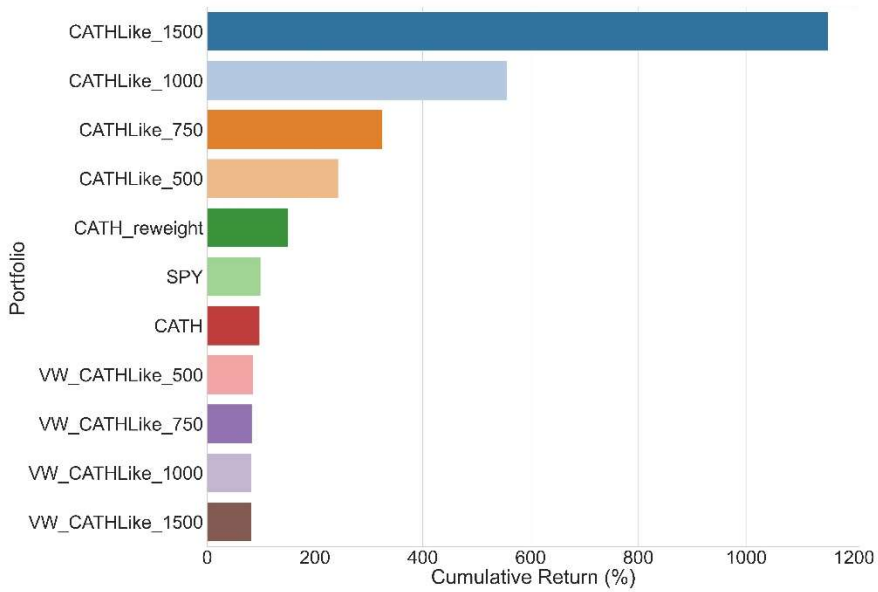


Figure 9. Cumulative return since 2017 for value-weighted and RL optimized CATHlikes, CATH, SPY and RL reweighted CATH

	Q1	Q2	Q3	Q4	Q5	Q1-Q5
Average return (%)	0.89***	0.86**	0.74**	0.71**	0.64**	0.25**
	3.17	2.39	2.39	2.31	2.07	2.47
FF4 alpha (%)	2.87***	1.07	-0.05	-0.2	-0.7	3.59***
	2.74	0.87	-0.05	-0.16	-1.05	2.99

Table 1. Comparison of average returns and annualized Fama-French 4 alphas across CATHlike sorts since 2004

	Annualized alpha (%)		Average return	Sharpe	VAR 5%	Exp Shortfall 5%
	FF4	FF5				
CATHLike 500	15.05**	18.76***	2.11	0.92	-12.81	-17.67
CATHLike 750	22.6*	29.15**	2.58	0.89	-14.19	-19.95
CATHLike 1000	37.17***	40.65***	3.22	1.13	-13.71	-19.05
CATHLike 1500	62.16***	69.8***	4.33	1.28	-12.77	-19.43
CATH reweight	13.46	11.71	1.64	0.67	-11	-16.84
VW CATHLike 500	1.04	1.15	1.01	0.67	-9.40	-10.93
VW CATHLike 750	0.91	1.06	0.99	0.65	-9.48	-11.05
VW CATHLike 1000	0.92	1.04	0.99	0.65	-9.51	-11.13
VW CATHLike 1500	0.92	1.03	0.99	0.64	-9.49	-11.22
SPY	0.57	0	0.92	0.64	-8.52	-9.92
VTI	0.02	-0.18	0.88	0.59	-8.73	-10.47
CATH	0.36	-0.1	0.91	0.62	-8.99	-10.23

Table 2. Comparison of out-of-sample performance of value-weighted and RL optimized CATHLikes, RL reweighted CATH with true CATH, SPY and VTI over 2017-2022 period

Portfolio	Turnover (%)
CATHLike 500	83.38
CATHLike 750	109.28
CATHLike 1000	121.67
CATHLike 1500	135.61
CATH reweight	62.53
VW CATHLike 500	9.33
VW CATHLike 750	9.54
VW CATHLike 1000	9.71
VW CATHLike 1500	9.91

Table 3. Portfolio turnover for value-weighted and RL optimized CATHLikes, RL reweighted CATH over 2017-2022 period following Gu et al (2020)

	Annualized alpha (%)		Average return	Sharpe	VAR 5%	Exp Shortfall 5%
	FF4	FF5				
CATHLike 500 less ba x 1	12.85**	16.66***	1.95	0.87	-11.95	-17.65
CATHLike 500 less ba x 2	12.53**	16.34***	1.93	0.86	-11.96	-17.68
CATHLike 500 less ba x 5	11.59**	15.36**	1.86	0.83	-12.00	-17.75
CATHLike 750 less ba x 1	21.03*	27.68**	2.47	0.86	-14.21	-19.99
CATHLike 750 less ba x 2	20.52*	27.15**	2.43	0.84	-14.23	-20.03
CATHLike 750 less ba x 5	18.99*	25.59**	2.33	0.81	-14.29	-20.16
CATHLike 1000 less ba x 1	35.09***	38.66***	3.10	1.10	-11.63	-18.02
CATHLike 1000 less ba x 2	34.29***	37.85***	3.05	1.09	-11.69	-18.08
CATHLike 1000 less ba x 5	31.9***	35.44***	2.90	1.03	-11.85	-18.27
CATHLike 1500 less ba x 1	60.24***	68.55***	4.28	1.27	-12.84	-19.46
CATHLike 1500 less ba x 2	58.71***	66.92***	4.20	1.24	-12.90	-19.55
CATHLike 1500 less ba x 5	54.18***	62.11***	3.95	1.17	-13.11	-19.82
CATH reweight less ba x 1	12.93	11.6	1.62	0.67	-11.09	-16.37
CATH reweight less ba x 2	12.69	11.37	1.60	0.67	-11.10	-16.38
CATH reweight less ba x 5	12	10.69	1.55	0.64	-11.12	-16.42
VW CATHLike 500 less ba x 1	-0.11	0	0.91	0.60	-9.53	-11.06
VW CATHLike 500 less ba x 2	-0.12	-0.01	0.91	0.60	-9.53	-11.06
VW CATHLike 500 less ba x 5	-0.16	-0.05	0.91	0.60	-9.53	-11.06
VW CATHLike 750 less ba x 1	-0.23	-0.09	0.90	0.59	-9.59	-11.19
VW CATHLike 750 less ba x 2	-0.24	-0.11	0.90	0.59	-9.59	-11.19
VW CATHLike 750 less ba x 5	-0.28	-0.15	0.89	0.59	-9.59	-11.19
VW CATHLike 1000 less ba x 1	-0.23	-0.11	0.90	0.58	-9.55	-11.26
VW CATHLike 1000 less ba x 2	-0.24	-0.13	0.89	0.58	-9.55	-11.26

VW CATHLike 1000 less ba x 5	-0.28	-0.17	0.89	0.58	-9.55	-11.26
VW CATHLike 1500 less ba x 1	-0.23	-0.12	0.89	0.58	-9.53	-11.35
VW CATHLike 1500 less ba x 2	-0.24	-0.14	0.89	0.58	-9.53	-11.35
VW CATHLike 1500 less ba x 5	-0.29	-0.19	0.89	0.58	-9.53	-11.35

Table 4. Performance of value-weighted and RL optimized CATHLikes and RL reweighted CATH adjusted for bid-ask spreads (x1, x2, x5) over 2017-2022 period

Appendix. RL Optimization Variable Definitions

Below we list variable definitions for the 52 predictors used in the RL optimization part of the paper. The data come from the Merged CRSP-Compustat, CRSP and WRDS Financial Ratio Firm Level databases. Most of the variable definitions follow Cong et al (2019).

A2ME: We define assets-to-market cap as total assets over market capitalization.

$$A2ME_t = \frac{AT_t}{SHROUT_t * PRC_t}$$

OA: We define operating accruals as change in non-cash working capital minus depreciation scaled by lagged total asset.

$$OA_t = \frac{\Delta\left((ACT_t + CHE_t - LCT_t - DLC_t - TXP_t) - DP_t\right)}{AT_{t-1}}$$

AOA: We define AOA as absolute value of operation accruals.

AT: Total asset.

BEME (WRDS Financial Ratios Firm Level database): Ratio of book value of equity to market equity.

Beta_daily: Beta daily is the sum of the regression coefficients of daily excess returns on the market excess return and one lag of the market excess return.

C: Ratio of cash and short-term investments to total assets.

$$C_t = CHE_t/AT_t$$

C2D: Cash flow to price is the ratio of income and extraordinary items and depreciation and amortization to total liabilities.

$$C2D_t = (IB_t + DP_t)/LT_t$$

CTO: We define capital turnover as ratio of net sales to lagged total assets.

$$CTO_t = SALE_t/AT_{t-1}$$

CAPEI: Shiller's Cyclically Adjusted P/E Ratio

Dept2P: Debt to price is the ratio of long-term debt and debt in current liability to the market

capitalization.

$$\text{Dept2P}_t = \frac{DLTT_t + DLC_t}{SHROUT_t * PRC_t}$$

Δceq: The percentage change in the book value of equity.

$$\Delta ceq_t = (CEQ_t - CEQ_{t-1})/CEQ_{t-1}$$

Δ(ΔGm - ΔSales:) The difference in the percentage change in gross margin and the percentage change in sales.

$$\Delta(\Delta Gm - \Delta Sales)_t = \frac{SALE_t - COGS_t}{SALE_{t-1} - COGS_{t-1}} - \frac{SALE_t}{SALE_{t-1}}$$

ΔSo: Log change in the split adjusted shares outstanding.

$$\Delta So_t = log(CSHO_t * AJEX_t) - log(CSHO_{t-1} * AJEX_{t-1})$$

Δshrout: Percentage change in shares outstanding.

$$\Delta shrout_t = (SHROUT_t - SHROUT_{t-1}) / SHROUT_{t-1}$$

ΔPI2A: The change in property, plants, and equipment over lagged total assets.

$$\Delta P12A_t = \frac{\Delta(PPENT_t + INVT_t)}{AT_{t-1}}$$

E2P: We define earnings to price as the ratio of income before extraordinary items to the market capitalization.

$$E2P_t = IB_t / (SHROUT_t * PRC_t)$$

EPS: We define earnings per share as the ratio of income before extraordinary items to shares outstanding.

$$EPS_t = IB_t / SHROUT_t$$

Free CF: Cash flow to book value of equity.

$$FreeCF_t = \frac{NI_t + DP_t + WCAPCH_t + CAPX_t}{BE_t}$$

Idol vol: Idiosyncratic volatility is the standard deviation of the residuals from a regress of excess

returns on the Fama and French three-factor model.

Investment: We define investment as the percentage year-on-year growth rate in total assets.

$$Investment_t = (AT_t - AT_{t-1}) / AT_{t-1}$$

IPM (WRDS Financial Ratios Firm Level database): Pretax profit margin, *EBT/Revenue*.

IVC: We define IVC as change in inventories over the average total assets of t and $t-1$

$$IVC_t = \frac{2 * (INVT_t - INVT_{t-1})}{AT_t + AT_{t-1}}$$

Lev: Leverage is the ratio of long-term debt and debt in current liabilities to the sum of long-term debt, debt in current liabilities, and stockholder's equity.

$$Lev_t = (DLTT_t + DLC_t) / SEQ_t$$

LDP: We define the dividend-price ratio as annual dividends over price.

$$LDP_t = \frac{\sum_j (RET_j - RETX_j)}{PRC_t}$$

ME: Size is the market capitalization.

Turnover: Turnover is volume over shares outstanding.

$$Turnover_t = VOL_t / SHROUT_t$$

NOA: Net operating assets are the difference between operating assets minus operating liabilities scaled by lagged total assets.

$$NOA_t = \frac{AT_t - CHE_t - IVAO_t - (AT_t - DLC_t - DLTT_t - MIB_t - PSTK_t - CEQ_t)}{AT_{t-1}}$$

NOP: Net payout ratio is common dividends plus purchase of common and preferred stock minus the sale of common and preferred stock over the market capitalization.

$$NOP_t = \frac{DVC_t + PRSTKC_t - SSTK_t}{ME_t}$$

O2P: Payout ratio is common dividends plus purchase of common and preferred stock minus the change in value of the net number of preferred stocks outstanding over the market capitalization.

$$O2P_t = \frac{DVC_t + PRSTKC_t - \Delta PSTKRV_t}{ME_t}$$

OL: Operating leverage is the sum of cost of goods sold and selling, general, and administrative expenses over total assets.

$$OL_t = (COGS_t + XSGA_t)/AT_t$$

PCM: The price-to-cost margin is the difference between net sales and costs of goods sold divided by net sales.

$$PCM_t = (SALE_t - COGS_t)/SALE_t$$

PM (WRDS Financial Ratios Firm Level database): The profit margin (operating income/sales).

Prof: We define profitability as gross profitability divided by the book value of equity.

$$Prof_t = GP_t/BE_t$$

Q: Tobin's Q is total assets plus the market value of equity minus cash and short-term investments minus deferred taxes scaled by total assets.

$$Q_t = \frac{AT_t + \frac{ME_t}{1000} - CEQ_t - TXDB_t}{AT_t}$$

Ret: Return in the month.

Ret_max: Maximum daily return in the month.

RNA (WRDS Financial Ratios Firm Level database): The return on net operating assets.

ROA (WRDS Financial Ratios Firm Level database): Return-on-assets.

ROC: ROC is the ratio of market value of equity plus long-term debt minus total assets to cash and short-term investments.

$$ROC_t = \frac{DLTT_t + \frac{ME_t}{1000} - AT_t}{CHE_t}$$

ROE (WRDS Financial Ratios Firm Level database): Return-on-equity.

ROIC (WRDS Financial Ratios Firm Level database): Return on invested capital.

S2C: Sales-to-cash is the ratio of net sales to cash and short-term investments.

$$S2C_t = SALE_t/CHE_t$$

Sale_g: Sales growth is the percentage growth annual rate in annual sales.

$$Sale_g = SALE_t/SALE_{t-1} - 1$$

SAT: We define asset turnover as the ratio of sales to total assets.

$$SAT_t = SALE_t/AT_t$$

S2P (WRDS Financial Ratios Firm Level database): Sale-to-price is the ratio of net sales to the market capitalization.

SGA2S: SG&A to sales is the ratio of selling, general and administrative expenses to net sales.

$$SGA2S_t = XGSA_t/SALE_t$$

Spread: The bid-ask spread is the average daily bid-ask spread in the month.

Std_turnover: Standard deviation of daily turnover in the month.

Std_vol: Standard deviation of daily trading volume in the month.

Tan: Tangibility.

$$Tan_t = \frac{0.715 * RECT_t + 0.547 * INVT_t + 0.535 * PPENT_t + CHE_t}{AT_t}$$

Total_vol: Standard deviation of daily return in the month.