Larchmont resident Ian A. Post, is the Principal of Fifth Set Investment Advisors LLC. Fifth Set is the result of his evolution of thought in regard to conventional investment management. His experience and education led to research for a smarter approach to portfolio management and financial planning. Prior to Fifth Set, Ian conducted fundamental equity research at Citigroup, Credit Lyonnais and CIBC Oppenheimer. Ian earned a BS in Engineering and Public Policy from Washington University and an MBA with concentrations in Finance and Statistics from NYU and is a holder of the Charted Financial Analyst designation, a member of CFA Institute and a CERTIFIED FINANCIAL PLANNER™ certificant.

Return Factors — *Using Academic Research to Achieve Higher Portfolio Returns*

By Ian A. Post, CFA, CFP®

As an investment professional, I am always interested in research on how to design higher expected return portfolios. Since the 1960s, financial research from academia has improved our understanding of markets and translated that understanding into new and better ways to build portfolios. Specifically, academic research has led to asset pricing models that identify specific equity "factors." By utilizing these factors, we can design portfolios with higher expected returns.

The following is a brief history of asset pricing model development and how that research has translated into improved portfolio design.

Capital Asset Pricing Model (CAPM) – Single Factor Model

In 1964, Professor William Sharpe developed the CAPM, which established that a stock's expected return was driven solely by its exposure to the overall Market risk factor. The idea being that the more sensitive a stock is to market risk, the higher the expected return and vice versa.

Fama-French Three-Factor Model

In 1992 and 1993, Professors Eugene Fama and Kenneth French, improved upon the CAPM by adding two factors to the single Market factor of the CAPM. The new factors were Market Capitalization (Size) and Price (Value)[1].

They found that smaller, as measured by market capitalization (number of shares multiplied by stock price) and cheaper stocks, as measured by price to book value[2], had higher expected returns than stocks that were larger and more expensive, all else being equal.

New Factors and Ongoing Research

Academic and practitioner research continues into new factors that help explain stock returns. The most recent commonly accepted factor is Profitability. This factor suggests that companies that are more profitable today are more likely to be more profitable in the future and, all else being equal, should generate higher expected returns.

Designing Factor-Based Portfolios

A factor-based equity portfolio is "tilted" toward known equity factors and away from a standard total market portfolio. For example, the Vanguard Total Stock Market ETF (VTI) replicates the overall U.S. market by buying shares in proportion to their weight in the market. By comparison, a factor portfolio could also cover the entire U.S. market but with more exposure to small and value stocks and less to large and growth stocks. The amount of tilt is a matter of investor preference. More extreme factor tilts result in higher potential expected returns in exchange for a return experience that can differ markedly from the "market."

Well-designed portfolios today are globally diversified, low-cost, tax-efficient and purposely tilted toward the factors that drive equity returns. By utilizing academic research, we can improve portfolio designs by targeting higher expected returns through equity factor exposures.

FACTORS POINT TO SYSTEMATIC DIFFERENCES IN EXPECTED RETURNS

Fifth Set Investment Advisors LLC is a registered investment adviser. Information presented is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities product, service, or investment strategy. Investments involve risk and unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser, tax professional, or attorney before implementing any strategy or recommendation discussed herein.

[1]1992, "The Cross-Section of Expected Stock Returns," Journal of Finance and 1993, "Common Risk Factors in the Returns on Stocks and Bonds," Journal of Financial Economics.2 A subject of a future article. [2] Fama and French used price to book value but other measures of relative price such as price to earnings generate similar findings.