



Financial Fables

Risk Factor Indexing

Our style of investing is known as “passive asset allocation”. As passive investors we do not attempt to pick stocks or time markets. We use index funds to build portfolios that are tilted toward small and value stocks, because we believe this tilt provides extra expected return. Traditional indexers claim that a weighted index based on the market capitalization value is the only legitimate type of index. In other words, they say that the index should buy stocks in exactly the same proportion as they are found in the economy.

It is interesting, however, that traditional indexers advocate putting lighter-than-market proportions of money into international stocks. If they really believed in indexing every publicly traded security in proportion, they’d invest 60% of their assets overseas. However, most indexers only want to mimic markets within countries, but not across countries—which is reasonable. Because there's no evidence of a common engine driving expected returns for stocks across all countries, there's no obvious reason to hold them in market proportions.

But the same logic applies within the US market. Since there is strong evidence that market volatility is only one of several factors that drive US portfolio returns, the market is no longer the only legitimate indexing solution. Academic research over the last ten years suggests that market risk is only one of three distinct risk factors in stock investing. Small company stocks expose investors to a completely different form of volatility. Distressed stocks with poor earnings prospects, usually mislabeled "value" stocks, also have unique risk-return characteristics. Each of these three risk factors is unrelated to the others. Small stocks can do well when the overall market does poorly and value stocks can have dreadful returns when small stocks do well, and so on.

In the presence of more than one risk factor, the goal of indexing switches from diversification across the available stocks to diversification across the available risk-return dimensions. It is the investment advisor’s job to build portfolios using combinations of the different risk exposures that best suit their clients’ time horizon and needs. As long as the portfolios used to gain these exposures are index funds, and as long as the exposures are consistent and not timed to predict markets, this sort of portfolio structuring is not a "sector bet"—it's risk factor indexing.