

PORTFOLIO PERSPECTIVES

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A “Profitable” Development in Investing



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Imagine a world without the internet. Suddenly you can't comparison shop for that flight online, download your favorite song while taking a walk, or easily keep in touch with that family member on the other side of the country. Knowing what we do today, it would be hard to go back to living like we did just a mere 10 or 20 years ago. Just as evolutions in technology bring benefits to our lives, evolutions in financial research can bring benefits to our investment portfolio.

When building portfolios we look to academic research with a solid foundation which maintains relevance when applied to the real world. With our close ties to many of the most esteemed thought leaders in the financial field, we incorporate their work to help us create portfolios which evolve over time. We believe this allows us to best position our portfolios for the long term, while ignoring the short term noise and dangerous predictions which sidetrack many other portfolios.

Risk and return are related, but some risks have historically been better compensated for than others. Identifying those tradeoffs requires significant work and ongoing questioning of your current process. Recently research has pointed to an additional way of exploiting characteristics of stocks to try and best position investments for long term success.

Professors Eugene Fama of the University of Chicago and Ken French of Dartmouth College authored a working paper last year entitled *A Four-Factor Model for the Size, Value, and Profitability Patterns in Stock Returns*. In this paper the authors expand on their original work putting forth that in addition to the expected premiums from taking the risk of stocks over bonds, value companies over growth and small companies over large companies, we can also now view companies with high profitability as having higher expected returns than those companies with low profitability.

The concept of profitability, or quality stocks was also studied by Professor Novy-Marx at the University of Rochester. In a recent paper published in the *Journal of Financial Economics*, *The Quality Dimension of Value Investing*, Novy-Marx puts forth the idea that “buying high quality assets without paying premium prices is just as much value investing as buying average quality assets at discount prices.” He finds that these stocks outperformed the overall market by more than four percentage points annually between 1963 and 2011. He concludes that, “Quality investing exploits another dimension of value.”

As we've discussed previously, not all stocks behave the same way over the long term. While the track record of active managers being able to predict which stocks will outperform individually has been dismal, when grouping stocks by measures such as market capitalization or the amount of growth already priced into the market value, we can get a better idea of which long term risks are going to have better long term expected returns. The new research mentioned above looks at another way to sort stocks, this time by their internal profitability.

It makes sense that investors would want to own profitable companies; after all, the reason we buy a stock is because we will think the company will produce profits and our investment will increase in value through dividends or capital gains over time. Buying companies with high current profitability makes sense intuitively, but why should we expect higher returns over the long run when compared to other lower profitability companies?

When looking at stocks, it's important to consider all of the information that the market is giving us, and one of the biggest pieces is prices. You would think that if two companies have the same relative price, their profitability levels would be similar. But sometimes, a company with higher profitability is priced similar to a company with lower profitability. That indicates that either there is something about the higher profitability company that the market has deemed more risky, or there is some reason that analysts do not believe the profitability will continue into the future. As with all investments, risk and return are related. You could put all of your money in a bank CD and have very little risk, but you would also have an extremely low expected return.

One key component to the new research is the findings that profitability is more consistent than we might expect. Investors are always looking forward, so may not pay as much attention to what profitability is today as what they think it may be several years down the road. Additionally, many investors likely assume that current profitability may erode over time. However, the research showed that current profitability was actually a good predictor of future profitability. It appears those companies which exhibit high profits today, are likely to maintain healthy profits into the future.

As with any addition to a portfolio, a key consideration is how it will behave with respect to your other exposures and how it lines up with your risk tolerance. Historically the research shows that adding a tilt towards highly profitable companies can improve the expected returns of a portfolio. Weighting companies by their profitability may be an additional way to find those securities that are currently "on sale." By having an academically proven method for building an efficient portfolio, you can feel confident that you are taking only those risks worth taking as you move towards your financial goals.

Sources:

Fama, Eugene F. and French, Kenneth R., A Four-Factor Model for the Size, Value and Profitability Patterns in Stock Returns (July 1, 2013)

Robery Novy-Marx, The Quality Dimension of Value Investing (December 2012)

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