metric financial

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The Market Factor

What is Market?

Perhaps the most well-known and intuitive of all of the factors is the data demonstrating that stocks outperform bonds over time. The original work on this goes back to 1964 and is attributable to William Sharpe. This is also referred to as the equity risk premium, specifically stating that stocks will outperform the risk-free rate.

How is it captured?

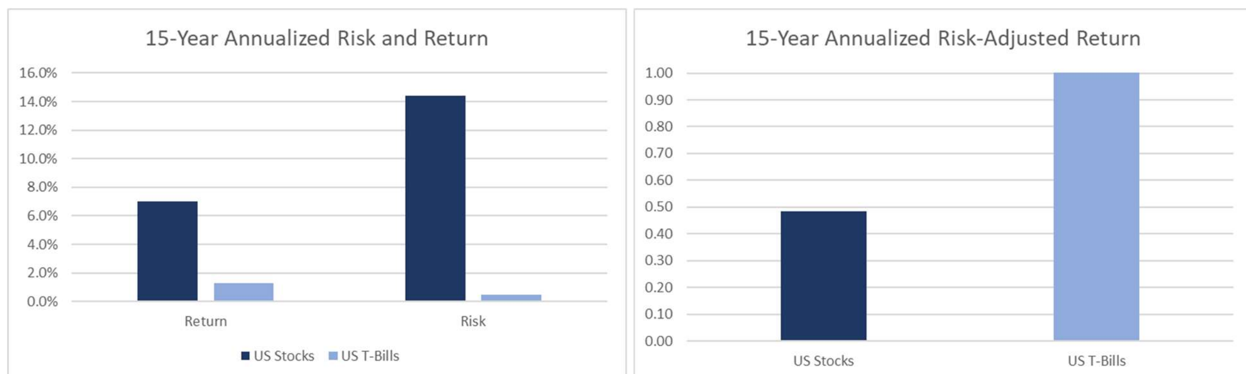
The Market factor can really be measured using any stock or portfolio of stocks compared to a risk-free rate. For our purposes, and given the proliferation of factor indexes, we think of the Market factor as any stock index that is weighted by market capitalization (share price x number of shares outstanding) such as the S&P 500.

Why does it work?

The Market factor is the ultimate embodiment of the risk-reward payoff. Stocks carry with them significantly more risk (in terms of volatility and likelihood of capital loss) than short-term government bonds. Therefore, investors should be rewarded with an excess return for taking on that risk.

How has it worked?

Over a 15-year period, Market (as measured by the MSCI USA Index) has outperformed the risk-free investment (as measured by the Bloomberg Barclays US T-Bill 1-3 Month Index) on an absolute, but not risk-adjusted, basis.



Source: Morningstar; As of March 31, 2020

How do we use it in a portfolio?

Metric portfolios currently gain exposure to the Market factor via ETFs that track the S&P 500 and the FTSE Emerging Markets indices. The key benefit of including Market in a portfolio is the potential long-term growth (in exchange for risk) and inflation protection offered by stocks.

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