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At Buckingham, we follow an evidence-based investment approach and require there to be peer-reviewed, academic studies of the investment strategies we recommend to clients. Academics have been conducting this type of research since the 1950s, and firms like Dimensional have been creating investment strategies based on the differences in risk and expected returns among securities since the 1980s, trying to bring academic theory to the real-world for investors.

This collaboration between academics and investment professionals has led to the introduction of numerous investment strategies that incorporate the higher expected returns from small company stocks, value stocks, profitability and momentum, all of which are utilized in one way or another in your current portfolio. These are sometimes called "risk factors" or "premiums," which must pass the following criteria for us to use them in client portfolios:

1. Persistent – it holds across long periods of time and different economic regimes
2. Pervasive – it holds across different countries, regions, sectors and asset classes
3. Robust – it holds for different measurements of the same phenomenon
4. Investable – it has positive returns after trading and implementation costs
5. Intuitive – there are logical risk-based or behavioral explanations for it to exist

This work is ongoing, and most recently, research into the behavior of stocks with high levels of investment suggest a new way to potentially enhance expected returns. Valuation theory suggests that a stock's current price reflects expected future cash flows discounted back to the present by an expected rate of return. Accordingly, for a given level of future cash flows, the lower the stock price, the higher the expected return. Also, for a given stock price, the higher the expected future cash flows, the higher the expected return.

The future cash flows of a company are related to its future profits, but not all profits are returned to shareholders. This is because companies must make investments to maintain profitability and continue to grow. Those companies that make larger investments should have reduced future cash flows available to shareholders. As a result, if two companies have the same stock price today but one has a higher rate of investment, we would expect it to have a lower expected return.

Since there is no way to directly measure future investment, academics use a company's recent asset growth as a proxy for expected investment. Researchers have found a statistically significant difference in returns between stocks with high and low recent asset growth. The data show that firms with high levels of any type of financing (equity, debt, or retained earnings) tend to underperform, so a comprehensive measure like asset growth that aggregates all three makes sense to use.

In short, companies with higher asset growth have historically had lower subsequent stock returns, all else equal. This relationship exists in the U.S. market as well as in the developed international and emerging markets, and persists across time: 84% of the years in the U.S. market since 1974, 72% of the years since 1990 in the developed international market, and 76% of the years since 1994 in emerging markets.

Looking at the data in detail, we see that the spread in returns is mainly driven by the underperformance of small cap firms with high asset growth. This is not surprising since large companies have smaller differences in their spending rates than small companies. Accordingly, Dimensional has explored ways to utilize this research within only their small cap strategies. They believe an efficient way to improve expected performance is to systematically exclude small cap firms with high asset growth in their funds that own small company stocks.

In determining a threshold for such an exclusion, they recognize that there is a tradeoff between pursing higher expected returns and maintaining broad diversification. They have therefore limited the exclusion threshold to a small percentage of the market capitalization of the small cap market. In other words, they have limited the number stocks they screen out because they want to maintain adequate diversification.

Dimensional refers to this as the Investment Premium and started the exclusion in August in all eligible funds. They look at a firm's asset growth over the most recent four quarters and exclude companies that have grown their assets by 75% or more. They expect to exclude no more than 5% of the small cap universe under normal conditions. They have also conducted historical simulations that showed an increase in return of approximately 0.15%-0.30%.

"At Dimensional, we do want to vet research very thoroughly before implementing anything. We implemented the size factor in 1981, value in the early '90s, and profitability in 2012 to '13."
—Savina Rizova, PhD
Head of Research
Dimensional Fund Advisors

We know this letter is more technical than most of our writings, but we wanted to communicate this important information to you. Please feel free to reach out to us if you have questions or would like additional information.

As always, thank you for you continued trust and confidence.

Warm regards,

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