In last month's blog, " Factors That Figure in Your Evidence-Based Portfolio ," we discussed key factors that are used in constructing evidence-based investment portfolios. Now let's look at a few additional ones—and why incorporating them into a portfolio can be tricky.

First, a quick reminder that the three well-established stock market factors are equity, value and small-cap. For bonds, the key factors are term and credit. These factors have formed the backbone of evidence-based portfolio construction, helping investors strike the most effective balance between return and risk.

Continued research has found additional market factors that provide the potential for additional premiums. As with the earlier factors, these premiums seem to result from accepting added market risk, avoiding ill-advised investor behaviors or both. In academic circles, the most prominent among these are considered to be profitability and momentum.

- The Profitability Factor: Highly profitable companies have historically delivered premium returns over low-profitability companies.
- The Momentum Factor: Stocks that have done well or poorly in the recent past tend to continue doing so for longer than random chance seems to explain.

These "new" factors have only recently been identified, and their staying power remains to be seen. What's more, just because a factor exists in theory doesn't mean it can be implemented in real life. We must be able to capture an expected premium without generating costs/taxes beyond its worth.

One challenge in putting the new factors to work: It can be difficult to build one factor into a portfolio without sacrificing another. One generally can't tilt toward both value and momentum at the same time, for instance. The bottom line is that benefits and tradeoffs must be carefully considered when deciding whether to use these newer factors in portfolio construction.
We would be happy to speak with you individually about our evolving approach.

Before we wrap up this discussion of evidence-based investing, let's look at a little context to illustrate why it's so valuable. Daily headlines about investing and the markets pummel us with myriad, conflicting ideas. This overload can be counterproductive for well-intended investors.

And even when the news is solid (which is never a given), impulsive reaction can strip away all the advantages of an enlightened investment approach.

This is why we believe an evidence-based advisor relationship is critical to your wealth and your wellbeing. As we outlined in " The Essence of Evidence-Based Investing ," whenever we assess the validity of investing theories, we ask pointed questions:

- Have the results been replicated across factors, over time and around the world?
- Is there robust analysis, not only from industry insiders but from disinterested academics?
- Has it survived extensive peer review?

By considering each new potential factor according to strict guidelines, our aim is to extract the diamonds of promising new evidence-based insights from the rough of useless information. We place a very high hurdle rate for the inclusion of anything in our managed portfolios. As Ben Carlson said in his new excellent book, "the majority of the time you should be like the pretty girl at the bar constantly turning down advances from guys hitting on her. She is extremely selective and she very rarely share's her number."