Characteristics-Based Factors

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Abstract

Recent studies have proposed a large set of new powerful characteristics-based factors in the stock market. This study examines the pricing of these factors using portfolios that are formed by directly sorting stocks based on their exposure to these factors. These beta-sorted portfolios have very large ex post factor beta spreads. However, the return spreads between high- and low-beta firms are typically tiny and insignificant (on average, 0.01% per month). The differences between factor-adjusted returns and characteristics-adjusted returns for these beta-sorted portfolios are both economically and statistically significant at about 0.41% per month. More important, we show that factor-adjusted returns and characteristics-adjusted returns can be significantly different for a large number of anomalies and mutual funds. Our results thus urge cautions regarding the common practice of using factor models such as adjusting for investment style, performance evaluation, and performance attribution.

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