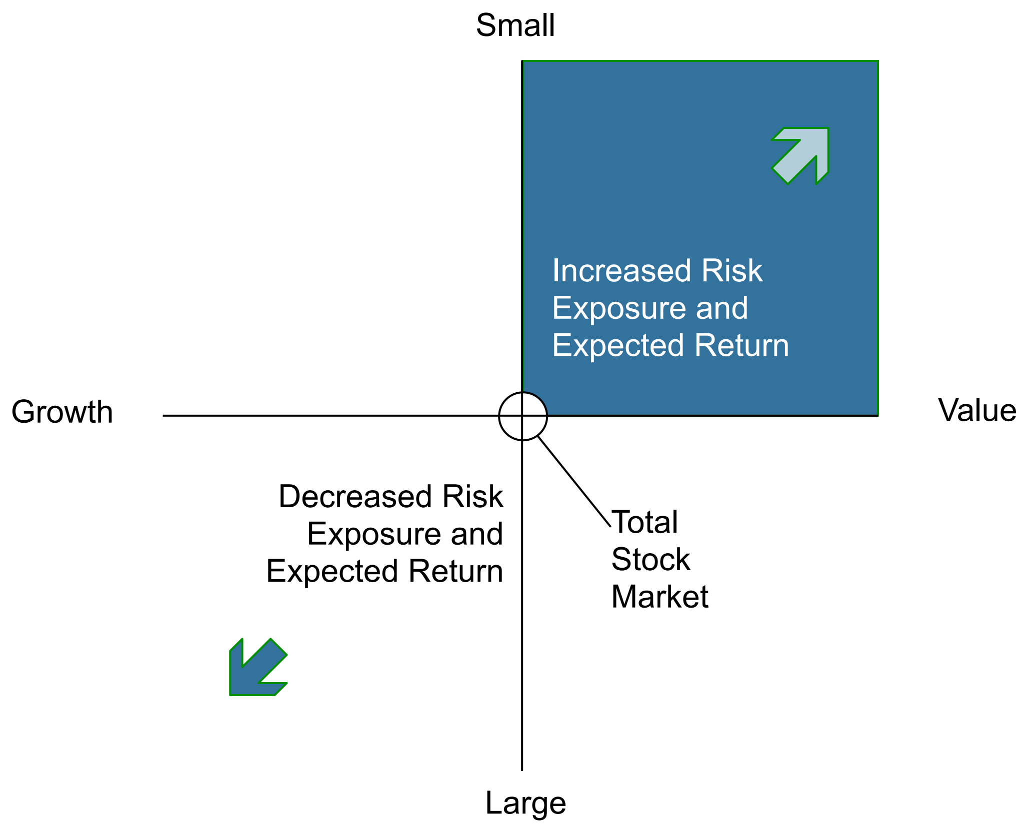
Risk and Return Are Related

Dimensions of Stock Returns around the World

- **Equity Market**
  (complete value-weighted universe of stocks)
  Stocks tend to have higher expected returns than fixed income over time.

- **Company Size**
  (measured by market capitalization)
  Small company stocks tend to have higher expected returns than large company stocks over time.

- **Company Price**
  (measured by ratio of company book value to market equity)
  Lower-priced "value" stocks tend to have higher expected returns than higher-priced "growth" stocks over time.



Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47, no. 2 (June 1992): 427-65.

The difference in returns among portfolios is largely determined by relative exposure to the market, small cap stocks, and value stocks. Stocks offer higher expected returns than fixed income due to the higher perceived risk of being in the market. Many economists further believe that small cap and value stocks outperform large cap and growth because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk.

Investors who want to earn above-market returns must take higher risks in their portfolio. The cross-hair map illustrates that tilting a portfolio toward small cap and value stocks increases the exposure to risk and expected return. Decreasing this exposure relative to the market results in lower risk and lower expected return.