

The Performance of Canadian Equity Funds Constructed with Fundamental Weights

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ABSTRACT

In recent years cap-weighted indices have been questioned for overweighting overvalued stocks and underweighting undervalued stocks. Research started by Arnott, Hsu and Moore (2005) sparked a debate after presenting research that indices created using price insensitive information consistently outperform cap-weighted indices with lower levels of volatility. We construct equity portfolios from a group of Canadian stocks ranked by their 'fundamental' weights. Our fundamental factors differ from AHM and they include: dividend record, growth in dividends, dividend payout ratio, return on invested capital, dividend yield and price to book value ratio. Initially we take the position of a passive investor and create four indices employing different weighting strategies. These strategies include Fundamental weighted, Cap-weighted, Equal weighted and Markowitz weighted. Using daily data from January 2, 2007-May 26, 2014 we find that the Fundamental Weighted portfolio performed the best in terms of geometric return. Furthermore we use our fundamentals to form an active investment strategy taking into consideration a realistic rebalancing approach and transaction costs. We compare our results to an actively managed portfolio that selects from the same group of assets. We find that our fundamental portfolio performs better on risk adjusted basis. We argue that fundamental factors should be considered when forming an investment strategy.