High Minus Low (HML)

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What Is High Minus Low (HML)?

High Minus Low (HML), also referred to as the value premium, is one of three factors used in the Fama-French three-factor model. HML accounts for the spread in returns between value stocks and growth stocks and argues that companies with high book-to-market ratios, also known as value stocks, outperform those with lower book-to-market values, known as growth stocks.

KEY TAKEAWAYS

- High Minus Low (HML) is a component of the Fama-French three-factor model.
- HML refers to the outperformance of value stocks over growth stocks.
- Along with another factor, Small Minus Big (SMB), HML is used to estimate portfolio managers' excess returns.

Understanding High Minus Low (HML)

To understand HML, it is important to first have a basic understanding of the Fama-French three-factor model. Founded in 1992 by Eugene Fama and Kenneth French, the Fama-French three-factor model uses three factors, one of which is HML, in order to explain the excess returns in a manager's portfolio.

The underlying concept behind the model is that the returns generated by portfolio managers are due in part to factors that are beyond the managers' control. Specifically, value stocks have historically outperformed growth stocks on average, while smaller companies have outperformed larger ones.

> **Important:** Much of portfolio performance can be explained by the observed tendency of small stocks and value stocks to outperform large or growth-oriented ones on average.

The first of these factors (the outperformance of value stocks) is referred to by the term HML, whereas the second factor (the outperformance of smaller companies) is referred to by the term Small Minus Big (SMB). By determining how much of the manager's performance is attributable to these factors, the user of the model can better estimate the manager's skill.

In the case of the HML factor, the model shows whether a manager is relying on the value premium by investing in stocks with high book-to-market ratios to earn an abnormal return. If the manager is buying only value stocks, the model regression shows a positive relation to the HML factor, which explains that the portfolio's returns are attributable to the value premium. Since the model can explain more of the portfolio's return, the original excess return of the manager decreases.

Fama and French's Five Factor Model

In 2014, Fama and French updated their model to include five factors. Along with the original three, the new model adds the concept that companies reporting higher future earnings have higher returns in the stock market, a factor referred to as profitability. The fifth factor, referred to as investment, relates to the company's internal investment and returns, suggesting that companies that invest aggressively in growth projects are likely to underperform in the future.

Fama and French Three Factor Model Definition

The Fama and French Three-Factor model expanded the CAPM to include size risk and value risk to explain differences in diversified portfolio returns. more

Small Minus Big (SMB)

Small Minus Big (SMB) is one of three factors in the Fama/French stock pricing model, used to explain portfolio returns. more

Multi-Factor Model Definition

A multi-factor model uses many factors in its computations to explain market phenomena and/or equilibrium asset prices. more

Small-Value Stock Definition

Small-value stock is stock in a company with a small market capitalization, but the term also refers to stock that is trading at or below its book value. more

Reading Into the Small Firm Effect

The small firm effect is a theory that holds that smaller firms, or those companies with a small market capitalization, outperform larger companies. more

Cross-Sectional Analysis

Cross-sectional analysis compares one company against the industry in which it operates. more

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