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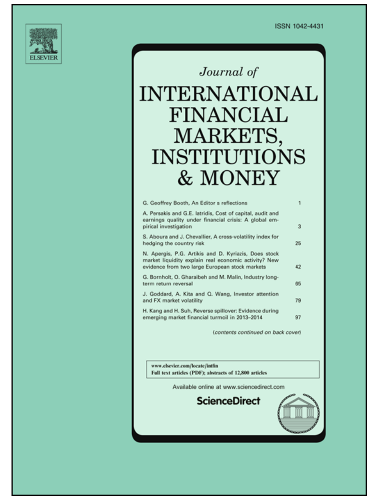

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Multi-factor asset pricing models: factor construction choices and the revisit of pricing factors

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Abstract

We introduce the eight-factor asset pricing model as an extension of the Fama and French (2016b) five-factor model. In addition to capturing market premium, size, value, profitability and investment pricing factors, we propose three additional factors that represent momentum, liquidity and default risk. Albeit these factors are not new to the literature, our aim is to comprehensively and jointly test the performance of the model which accounts for all the suggested factors simultaneously. We find that the incorporation of additional factors improves the model's explanatory power. In addition to market, size and value factors, the profitability and momentum pricing factors exhibit higher explanatory power compared to investment, default risk, and liquidity pricing factors. The use of different stock allocation (number of sorting portfolios) and portfolio sorting approaches to factor construction has some, albeit statistically limited, effect.

Keywords: multi-factor models, factor construction, pricing factors, sorting portfolios, liquidity factor, default risk factor

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