



## The Sweet Spot

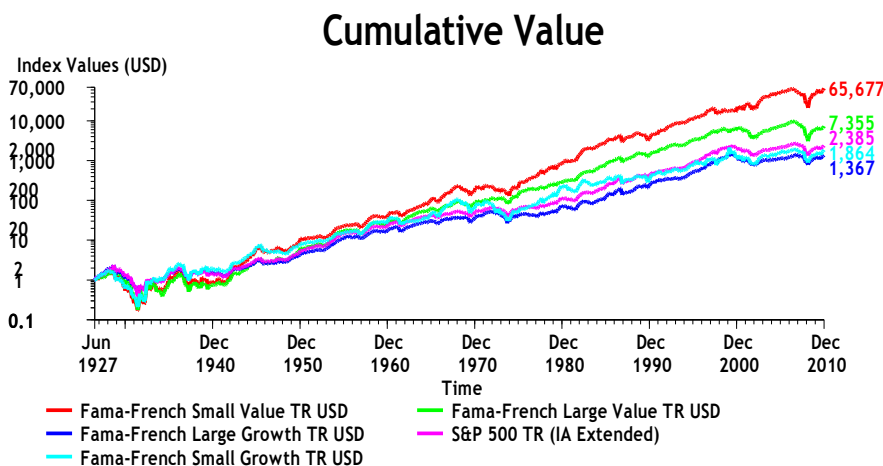
By Michael Nairne

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Investors face the challenge of funding decades of retirement in an environment of low interest rates and lackluster stock valuations. For many, earning market returns alone will not suffice. Hence, thoughtful portfolio construction needs to incorporate asset classes that have higher long-term expected returns. In this regard, small company or small-cap value stocks – the stocks of smaller companies that are low priced in relation to earnings, dividends and book value – have a critical role.

Based on long-term historic indices, small-company value stocks have returned a significant premium to the overall market as well as to small-company growth and large-company growth and value stocks. This premium is illustrated in the following graph which illustrates the growth of \$1.00 U.S. invested in small cap value stocks (in red) compared to the other indices from July 1927 to December 2010.



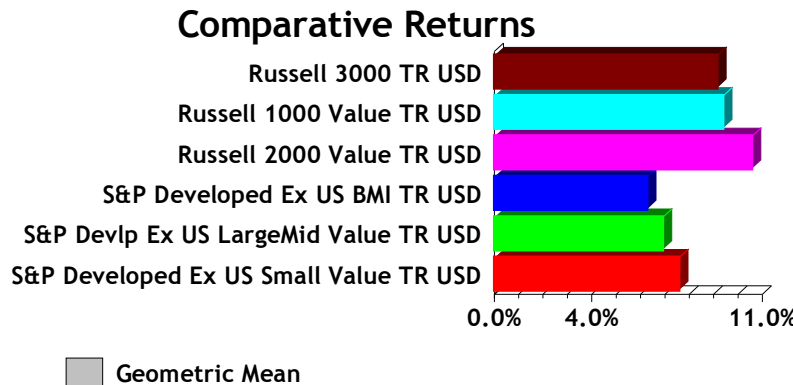
The investment in small company value stocks grew to \$65,677 – nearly 28 times the \$2,385 of the S&P 500 and nearly nine times the \$7,355 of large-company value stocks. Contrary to the popular conception that growth is the place to be, growth stocks, both large and small, lagged their value counterparts.

The historic outperformance of value stocks in general is a well-documented global phenomenon<sup>i</sup>. Until recently, however, research on small-cap value stocks has tended to focus on performance in individual countries. For example, the small-cap value premium



has been found not only in the U.S. but the U.K.<sup>ii</sup> A comprehensive analysis on the performance of small-company value stocks globally has been lacking until the recent publication of sweeping study<sup>iii</sup> by Professors Fama and French. Encompassing 23 countries for the period November 1989 to September 2010, they found that the value premium is larger for the stocks of small companies versus large companies in North America, Europe and Asia Pacific. Only Japan was the exception.

These findings are consistent with a review of major indices for the period July 1989 through January 2011. As illustrated in the following graph, small-cap value stocks in the U.S. (in pink) outperformed large cap value stocks (in light blue) and the market overall (in brown). In the balance of the developed world markets, small value (in red) also outperformed large and mid cap value (in green) and the total market (in dark blue).

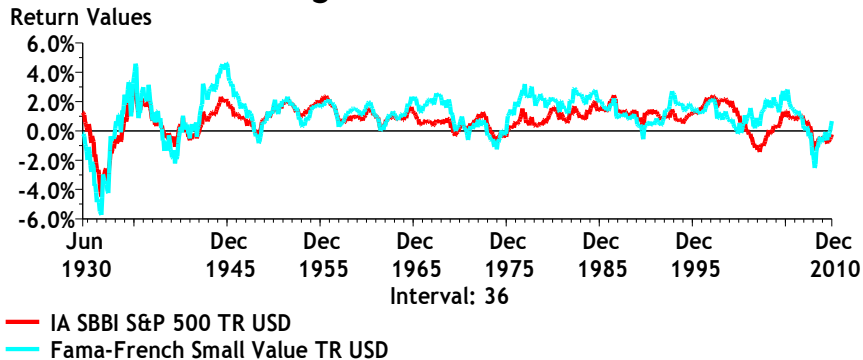


Accessing the superior performance of small-company value stocks, however, requires a much greater tolerance for risk. Small companies typically lack the financial strength of their larger counterparts and their stocks are more thinly traded. They are also much more volatile. Since 1927, small company value stocks have been over 60% more volatile than the total market.

Second, there can be prolonged periods where small-company value stocks underperform the overall market. As illustrated in the following graph, small-company value stocks (in blue) lagged the market (in red) during the early 1930's, the early 1950's, the late 1960's and early 1970's, the late 1980's and the mid to late 1990's.



## Rolling 36-Month Returns



Investment managers face serious hurdles in capturing the small-company value premium. Because transaction costs are much higher than for large-company stocks, high stock turnover can erode results. Also, the superior return of small-company value stocks occurs primarily as a result of a limited number of stocks experiencing robust growth and from a handful of take-overs or mergers at premium stock prices<sup>iv</sup>.

Hence, it is not surprising to find that the performance of active small-cap managers is not persistent. Outperformance tends to be fleeting and random<sup>v</sup>. Unless an investor has a strong and proven qualitative and quantitative basis for selecting an active manager, they are best advised to use indexed solutions.

Small-company value stocks are in the sweet spot when it comes to enhancing long-term portfolio returns. However, their volatility and “streaky” performance requires that portfolio allocations must be judicious.

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<sup>i</sup> See, for example, Fama, E.F. and K.R. French, 1992, "The cross-section of expected stock returns", *Journal of Finance*, Vol. 47, Issue 2, pp. 427-65 as well as Fama, E. F. and K. R. French, 1998, "Value versus growth: the international evidence," *Journal of Finance*, Vol. 53, No. 6, pp. 1975-1999.

<sup>ii</sup> See Dhatt, M.S., Y.H. Kim, S. Mukherji, 1999, "The value premium for small-capitalization stocks," *Financial Analysts Journal*, Vol. 55, pp. 60-68, and Dimson, E., S. Nagel and G. Quigley, 2003, "Capturing the value premium in the United Kingdom", *Financial Analysts Journal*, Vol. 59, pp. 35-45.

<sup>iii</sup> Fama, E. F. and K. R. French. "Size, value, and momentum in international stock returns" (January 15, 2011). *CRSP Working Paper*. Available at SSRN: <http://ssrn.com/abstract=1720139>

<sup>iv</sup> Fama, E. F., French, K. R., 2007. "Migration". *Financial Analysts Journal*, Vol. 63, pp.48-58.

<sup>v</sup> Investment Counseling & Research, The Vanguard Group, 2007. "Evaluating small cap active funds." Valley Forge, Pa.:IC&R. 20 p.