Publication: Financial Times (UK); Date: Jan 27, 2015; Section: Markets & Investing; Page: 28

SMART MONEY

# Small can be beautiful but avoid urge to punt on riskiest stocks

James Mackintosh

"Small ones are more juicy," ran the jingle for Outspan oranges in the 1980s. Whether this is true for citrus fruit, or merely an advertising man's effort to attract a premium price, it was not the case for shareholders last year.

Investors who stuck with smaller companies in the US made a return including dividends of 5 per cent, and in Britain lost 2 per cent, underperforming larger indices by nearly 9 and 3 percentage points respectively. They have continued to lag behind so far this year. This is not how it is supposed to be. Small capitalisation stocks have been pushed at investors as a way to juice up returns without taking extra risk. The "small-cap effect" demonstrated in the 1980s that smaller companies outperform even when adjusted for volatility, and it has entered popular mythology that small stocks offer a way to beat the market.

Since then, study after study has shown if a small-cap effect ever did exist, it was never that big and has anyway stopped working. Investors do not seem to have noticed, with 100 small-cap exchange traded funds in the US and a bias among active fund managers towards smaller stocks

— perhaps because investors focus on returns, and in a bull market smaller companies should still be expected to produce higher returns than large stocks, simply because they are riskier. The failed promise of the small-cap effect was that when adjusted for risk small stocks would offer better returns; in other words, they would not just give back all their gains and then some in a down market.

Perhaps, however, there is magic in small-caps after all. A new study* by researchers at US hedge fund AQR resurrects the idea, and has the potential to shake up the world of smaller company investing.

AQR's team, including Tobias Moskowitz, a finance professor at Chicago Booth, found that small companies have beaten larger companies when the quality of the companies is taken into account. Businesses with steady earnings, profitability or payouts, among other measures, have long been known to do better than highly speculative "junk" stocks. Compare like with like, and small high-quality companies outperformed larger high-quality companies, while small junk beat large junk (again, adjusted for volatility). The problem for small-cap indices such as the Russell 2000 or FTSE Small Cap is that there are more junky stocks at the bottom end of the market, offsetting the benefits a small size brings. But control for quality, and small-caps have offered a decent return.

Intuitively this makes sense. It has been amply demonstrated that over time high-quality stocks perform better (again, adjusted for risk). This is probably because of the "lottery ticket" effect of lower-quality stocks; while most will do badly, those which turn out well can do really well, turning in extraordinary returns. The natural urge to gamble sucks in many fund managers and investors, pushing up prices of speculative stocks above what is appropriate, meaning future returns are lower as a result.

The same applies to small-caps. At the extreme, the light regulation of London's Aim attracts the lowest quality stocks, and has offered abysmal returns: last year it lost 18 per cent and over the past 19 years lost more than 30 per cent, while the FTSE 100 rose 80 per cent. Small-caps on the main markets have been nothing like as bad, but over the past 20 years the Russell 2000 has underperformed the S&P 500, while the FTSE Small has underperformed the FTSE 100 (although the Numis Smaller Companies excelled until last year). With the small-cap effect back in play, investors should be looking for better-quality small companies for the long run. In the short term, of course, "beta", or sensitivity to the broad direction of markets, will be much more important than risk-adjusted return, and small stocks should do relatively well if the market rises. This is especially true in January, a month when the quality effect has frequently gone into reverse and the lowest quality stocks outperformed, says Mr Moskowitz's research.

Investors have woken up to the power of quality in the broader market. Assuming the research is validated and replicated, it is likely to affect portfolios slowly over the next few years. Those wanting to juice up portfolios should buy small, but avoid the urge to punt on the riskiest stocks.

* "Size matters, if you control your junk", by Cliff Asness, Andrea Frazzini, Ronen Israel, Tobias Moskowitz and Lasse Pedersen. james.mackintosh@ft.com