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THE ANGLE

August 2018

Fresh perspectives on the market outlook.

DOES SIZE STILL MATTER?

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KEY POINTS

- The existence of the size premium – the idea that smaller companies tend to outperform larger companies – is disputed, but still expected by some investors.
- Small caps have not outperformed large caps for over a decade, with three possible explanations: the outperformance of tech, low interest rates and a weak dollar.
- The argument for holding small caps in your portfolio hinges on whether this ‘perfect storm’ is likely to continue – and how best to navigate the cycle.

In the 1990s, Nobel Laureate Eugene Fama and Professor Kenneth French established the ‘three-factor model’ as a way to better explain equity returns. Their research concludes that value stocks tend to outperform growth stocks, and small-capitalisation stocks tend to outperform large-capitalisation stocks.

The idea that smaller companies have higher risk-adjusted returns had been floating around for several decades. But this was the official birth of the size risk premium.

A risk premium could be defined as the above-average return that should compensate investors for taking a risk. Without a premium, no rationale investor would take the risk in the first place. Smaller companies tend to be a riskier investment than their larger counterparts for several reasons:

Research: It’s usually more expensive to obtain information on less well-known, less-researched smaller companies than it is for larger ones. This ‘information cost’ should be reflected in the rate of return.

Liquidity: Stocks of small companies tend to be less liquid than those of large ones, warranting a liquidity premium as compensation for the potential costs of selling the stock.

Risk: Small companies tend to have higher business risk than large companies, as they commonly have fewer resources, are more concentrated and less diversified,

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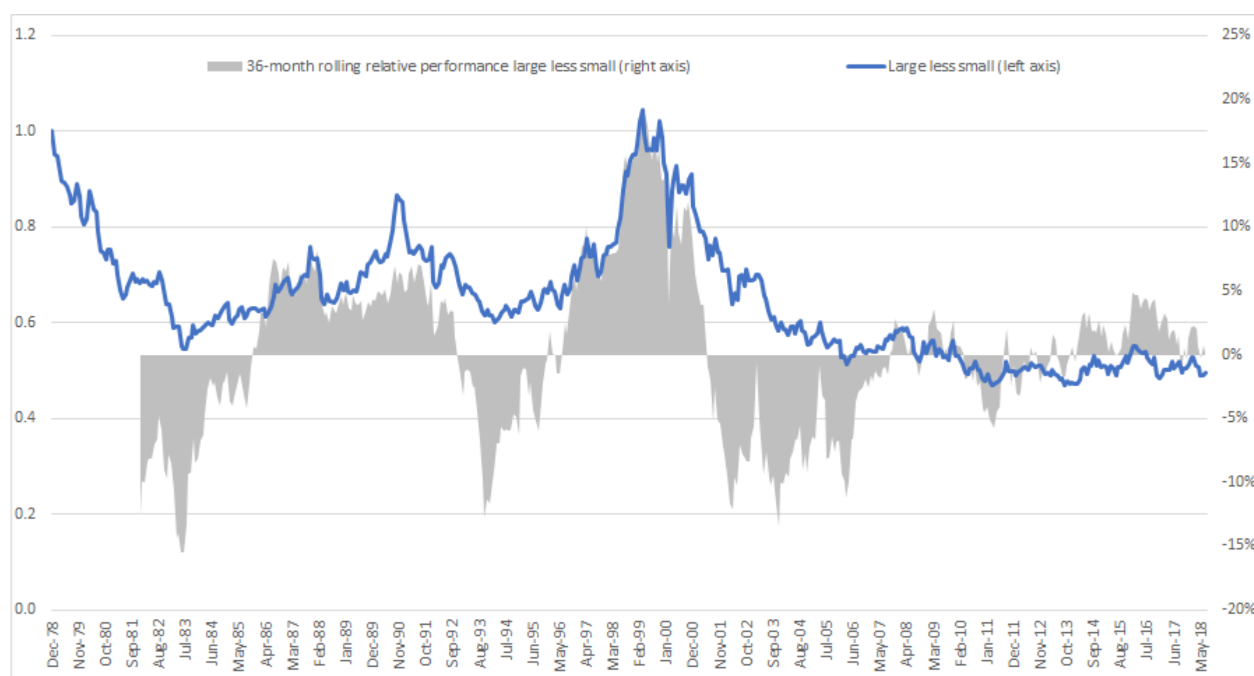
and sell to the local market rather than overseas. Small firms are therefore more sensitive to economic downturn and falling demand. This risk of painful losses in bad times is theoretically offset by high returns in good times[1].

That's the theory, anyway.

Figure 1 shows the cumulative performance of large stocks relative to small ones. Although small companies have indeed delivered an overall higher return than large companies since 1979, they have offered no such relative premium since 2006.

Figure 1: Performance of large versus small stocks



Source: T. Rowe Price and Bloomberg, January 1979 to July 2018. Large is represented by Russell 1000 Index and small by Russell 2000 Index.

HAS THE SIZE PREMIUM DISAPPEARED?

We see three possible reasons for the breakdown of the small-cap premium: a strong rally in technology stocks; a low interest-rate environment; and general dollar weakness.

Looking at the sector exposure of large versus small caps, the most obvious difference is their relative exposure to technology stocks: tech accounts for a considerable 25% of large caps versus only 15% for small caps.[2] The tremendous outperformance of tech companies in the last decade – particularly Facebook, Apple, Amazon, Netflix and Google (aka FAANG) – goes some way to explaining the recent strength of large caps.

[1] The returns of small companies are more volatile than those of large companies. The annualised volatility of monthly returns of Russell 1000 Index has been 14.9% while that of Russell 2000 Index has been 19.1% over the period January 1979 through July 2018.
[2] Source: T. Rowe Price and FTSE Russell. As of 31 July 2017.

Low interest rates could be another catalyst. Small companies tend to outperform in the aftermath of policy tightening, as rising interest rates usually correspond with periods of economic recovery (which, in turn, particularly bolsters small caps). However, the last ten years have been characterised by persistently low interest rates. What is more, this low-rate environment has also supported high-dividend-paying companies – which are usually large caps.

A final possible cause of the shifting paradigm is currency. Large companies tend to export more than smaller ones, and so a strong US dollar might hurt the competitiveness of large US firms as their goods and services are more expensive. Meanwhile, small firms – which sell domestically – are less sensitive to the dollar. Since the turn of the millennium, the US dollar has undergone long periods of weakness, making large caps more competitive.

INTEGRATING THE SIZE PREMIUM INTO YOUR PORTFOLIO

While most portfolios are likely to have an exposure to large caps, it is important to maintain a strategic allocation to small caps too – not just for diversification, but also because small companies have the potential to grow faster than their larger peers. Some of today's small companies will invariably be tomorrow's household names. Small caps also bring exposure to risk factors and sources of returns that are less available through large companies, such as momentum and liquidity premium.

What's more, the next decade may paint a very different picture for small companies. Tech firms could wane due to rich valuations and regulatory headwinds, US interest rates are on the rise and the dollar has been on a strengthening trend since April 2018. Add to that the larger impact of tax cuts in the US on small companies than on large companies, and the environment could begin to support small companies.

The case for holding small caps is clear, but how best to approach them? In this universe, active management is key. The small-cap space – with its less-researched, less-known and less liquid stocks – is fruitful for security selection.

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201808-569125