Large vs. Small and Value vs. Growth

What does it mean to be Large or Small, Value or Growth?

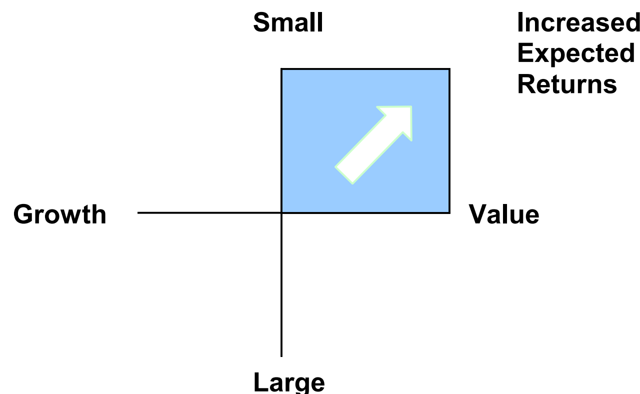
The stock market universe can be divided into large and small company stocks on the basis of market value. Market value (market capitalization) is calculated by taking the number of shares a company has issued and multiplying by the price of each share. For instance, Exxon Corp. has 6.37 billion shares outstanding. Using a recent price of $60US per share, Exxon has a total market capitalization of $382.2US billion. By calculating each company's market capitalization and ranking them by size, we can characterize them as relatively large or small.

Two other measures help us separate the expensive stocks from the inexpensive ones. Using market capitalization again, we compare it to the company's so-called intrinsic value, such as "annual profits" or "net assets", to determine how cheap or expensive a stock is relative to that intrinsic value. For instance, by applying Exxon's market capitalization of $382US billion to its annual profits (earnings) of $27.7US billion, we arrive at a price/earnings multiple of 13.8 times. Another important multiple is obtained by comparing market capitalization to net assets (book value): in this case $102US billion, for a price/book value ratio of 3.8 times. Both these calculations are commonly used to give stocks the moniker "growth" or "value". Growth stocks or high priced stocks are often considered "glamour" stocks. They carry high investor expectations for profit growth in future years for some specific reason. For example, a fancy product with a patent, strong management, or even exceptional customer relationships may be reasons investors will bid up a growth company's stock price to lofty levels. Value stocks, on the other hand, are often characterized as boring like bank and pipeline stocks or even distressed companies suffering from weak products, poor management or sub-par customer relationships. Since the company's prospects are out of favour with investors, their stock price languishes and becomes "cheap". Just the opposite.

What are the implications of these measures for investors?

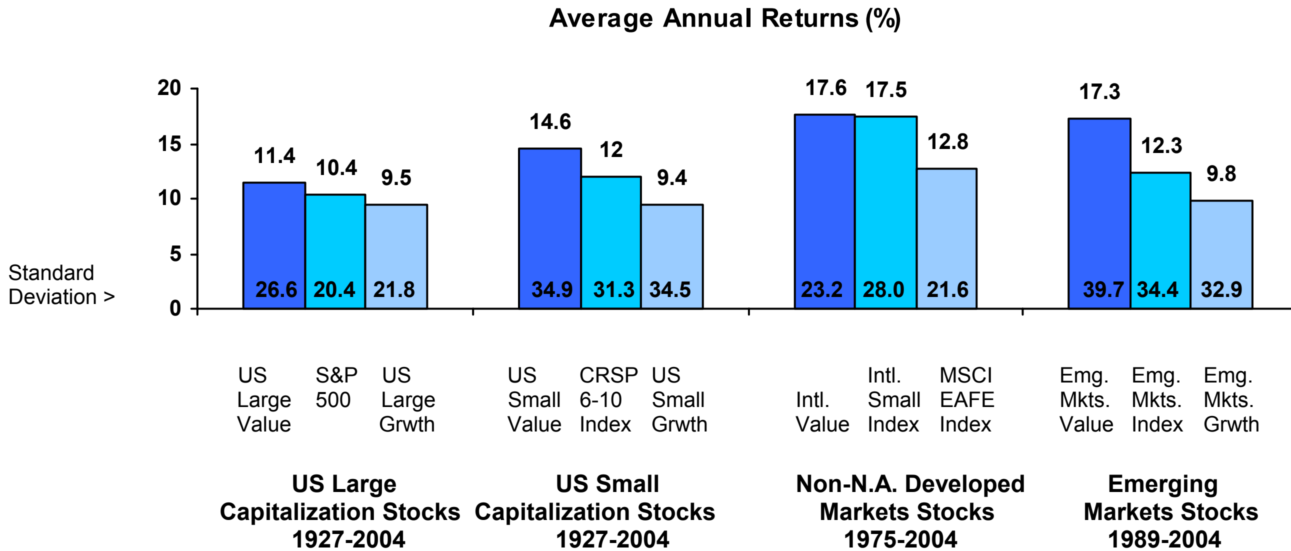
It is a commonly held belief that, as a group, small company stocks provide investors with higher returns than large ones do over the long term. The reasoning is that smaller companies have higher risk levels than their larger company counterparts and investors demand compensation through higher returns for taking on this added risk. Small companies, for instance, have a greater probability of falling into bankruptcy. Of course, if these small companies thrive, their stocks then have a greater potential of doubling or tripling in a short period of time. Regardless of which, in the financial world of risk and reward, more volatility (up or down) must be compensated with higher returns.

Similarly, value stocks are also widely viewed to have greater return potential than growth stocks but the rationale is not as clear and sometimes debated. Some behaviorists will argue that investors have a tendency to extrapolate past financial results into the future, creating overly favourable sentiment for growth stocks and overly negative or disinterested sentiment for value stocks. They also point to the influences of “agency costs” - meaning the press and the brokerage industry pump up "exciting" stories which they can easily sell, and downplay or ignore boring/negative ones, which present more challenges to create investor interest. An exciting new technology touted to change the world is much easier to talk about than a boring bank or a company in need of a management shakeup. Even institutional managers of pension funds have an easier time maintaining positions in so-called success stories rather than negative ones. This almost always results in overly inflated prices for growth stocks and overly depressed prices for value stocks.



Another camp, led by Dimensional Fund Advisors (DFA), believes the “value effect”, just like the "small cap effect", is also one of risk and reward. They theorize that value stocks (many of which are distressed companies) also carry higher levels of risk. Therefore, investors of value stocks must be offered higher returns to compensate. Both of these theories make some sense, but the real test is in the evidence, which we present in the illustration below.

Using the longest reliable data available, the bar charts show how strongly the "small companies" effect and the "value companies" effect holds true in stock markets around the world. In each region, groups of small and value stocks have offered superior returns since the beginning of the relevant data. It is also worth noting that the highest returns (the longest bars) generally have the greatest volatility (standard deviations) although not always (US Large Growth vs. the S&P500 Index).



Source: DFA

Our Approach

At Milestone, we are convinced that small cap and value effects are real. We think the key to capturing the premium performance of these groups is to maintain healthy doses of both diversification and patience. We hold small and value stocks in the context of the broader portfolio of all stocks, recognizing that there may be periods of time where the small and value premiums do not materialize. Among total equity holdings of literally thousands of stocks, this effectively creates a "tilt" toward small cap and value which is expected to add value over broadly based indices like the TSX/S&P Composite, the S&P500 or the EAFE Index. The extent of the tilt is determined by the investment risk parameters of each client's situation and incorporates the likelihood that there may be extended periods (as much as 10 years) where value and small companies will underperform their growth and large company counterparts. The rewards are obvious, but not surprisingly, time and discipline is the key to success.

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