

AFTER A DECADE OF STRONG LARGE CAP GROWTH, IS THERE A PLACE FOR SMALL VALUE?

Two of the most-studied and well-documented phenomena in investment management are value- and small-cap-based strategies. Value investing (pioneered by Benjamin Graham and David Dodd in the 1930s) is based on the principle that patient, long-term investors can earn higher expected returns by investing in lower-valuation securities – those with a higher book-to-market ratio, for example. Small-cap investing (described by Rolf Banz in the early 1980s) similarly links higher expected returns with the size of a company – lower market capitalization companies have historically offered higher average expected returns than larger companies. As of late 2017, however, we are currently in a period where over the last 10 years smaller companies and more value-oriented stocks have both underperformed their “large cap growth” counterparts.

Any investor seeking to outperform a given index or benchmark must invest in a strategy that is meaningfully different from that index. However, by being different than a benchmark the investor must also accept the potential for underperformance along with the opportunity to outperform. “Small value” investors are currently experiencing a period where their portfolios may be lagging a core index like the S&P 500. Many benchmarks will have higher exposure to larger and more “expensive” growth stocks, which have seen very strong returns in recent years (technology stocks such as Google, Apple, Facebook, and Netflix being prominent current examples).

Studying the Data

To put in context the discrepancy between the (very) long-term historical premium offered to investors in small-cap and value stocks and the outperformance of large-cap and growth stocks in the last 10 years, we can compare the returns between large-cap growth and small-cap value stocks in the US back to the 1920s in several ways. For example, if we look at the last 90 years, small value outperformed large growth stocks by an annualized 5% or more – a remarkable risk premium based on only two quantitative characteristics of the underlying securities. Additionally, if we break down the US stock market into quintiles for each characteristic (smallest to largest, and highest value to highest growth characteristics), we can see trends where incremental increases in exposure to both factors have generated higher returns historically (see Exhibit 1).

However, in the last 10 years, as mentioned above, this premium has been reversed and large growth has outperformed by just under 3% annualized (see Exhibit 2 for details).

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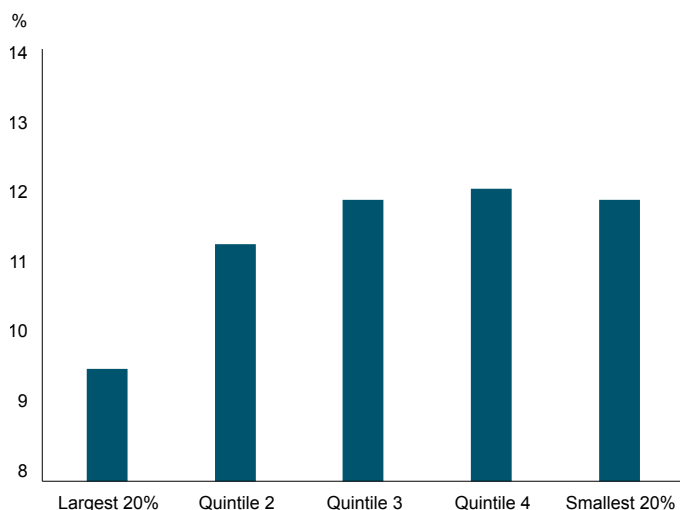
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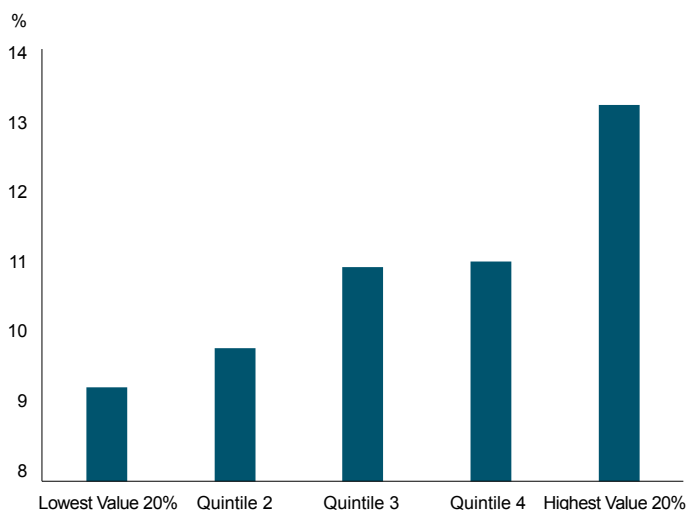
Exhibit 1: Large Cap vs. Small Cap and Value vs. Growth Returns by Quintile

Jan. 1, 1927–Jun. 30, 2017

US Market by Size – Annualized Return (%)



US Market by Valuation – Annualized Return



Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

Exhibit 2: Return Comparison – Large Cap Growth vs. Small Cap Value Stocks

Jan. 1, 1927–Jun. 30, 2017

	Annualized Return
Small Cap Value	14.81%
Large Cap Growth	9.56%
Small Value Premium	5.25%

Jul. 1, 2007–Jun. 30, 2017

Small Cap Value	6.59%
Large Cap Growth	9.47%
Small Value Premium	-2.88%

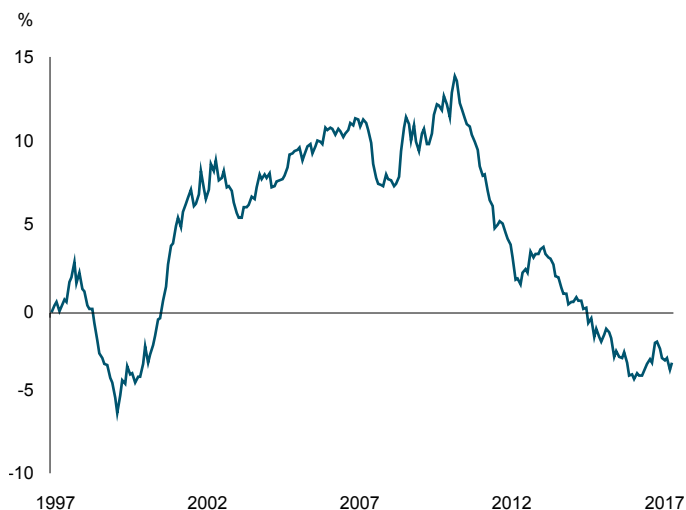
Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

While the last 10 years obviously represent a meaningful length of time for an investor, any specific “look back” is obviously influenced by the circumstances of when that period started and ended. 2007 to 2017 specifically encompasses a remarkable degree of market volatility, including the 2008–2009 Global Financial Crisis and its aftermath. Thus, while a 10-year investment horizon is reasonably long, any *specific* 10-year period is bound to be idiosyncratic and not necessarily indicative of what to expect going forward. To account for this time period

bias, in addition to looking backwards (whether to the 1920s or for the last 10 years) we can also look at every 10-year period – from 1950 to 1960, 1951 to 1961, and so on. When we do so, we can see that small-cap value outperforms large-cap growth in an overwhelming majority of time periods, but also that the specific premium earned by a small-value investor changes over time and tends to move in cycles based on the market environment (see Exhibit 3).

Exhibit 3: 10-Year Rolling Premium – Small Cap Value vs. Large Cap Growth Stocks

Jul. 1, 1987–Jun. 30, 2017

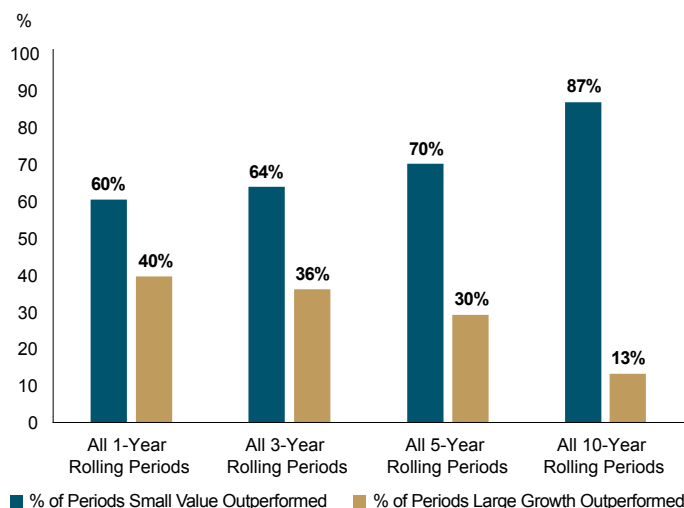


Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

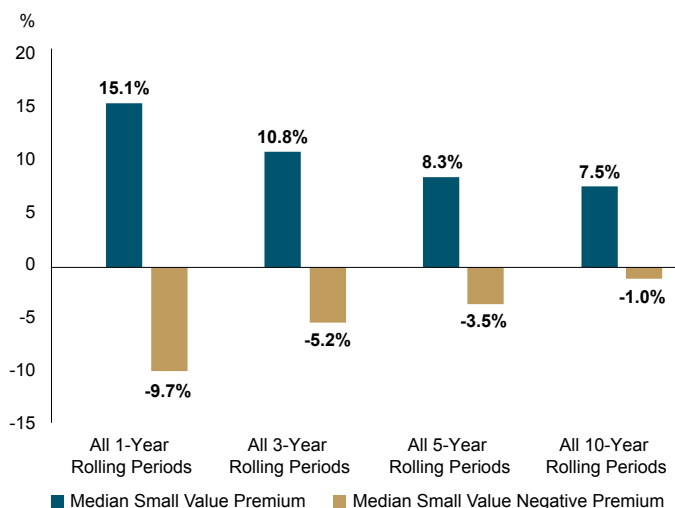
Exhibit 4: Out- and Under-Performance Comparison – Small Cap Value vs. Large Cap Growth Stocks

Jan. 1, 1927–Jun. 30, 2017

Ratio of Outperformance – SCV vs. LCG



Median Outperformance – SCV vs. LCG



Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

As we can see, over the last 20 years, the 10-year small-value premium has swung between positive 15% and negative 5% annualized. Currently, we are in a stretch of negative premium, but even in the recent past there have also been periods where small value has tended to outperform (see the 10 years ending in 2010, for example) and when it has offered a significantly higher premium than a large growth-oriented strategy would have. Using this idea of looking at all possible time frames, we also find that historically, the longer the time period, the more likely a small-value strategy outperformed and the smaller the negative premium for those periods in which large growth outperformed (see Exhibit 4).

Thus, based on nine decades of data, what we see is a significant premium for “tilting” a US stock portfolio to small and value stocks over the longest possible time frame. At the same time, this premium (as with all long-term performance) can be tied to a given level of risk, seen by investors during those periods where small and value securities have underperformed. However, the more patient the investor (that is, the longer the time frame invested in small value), the more significant that premium was and the less common were the periods of underperformance.

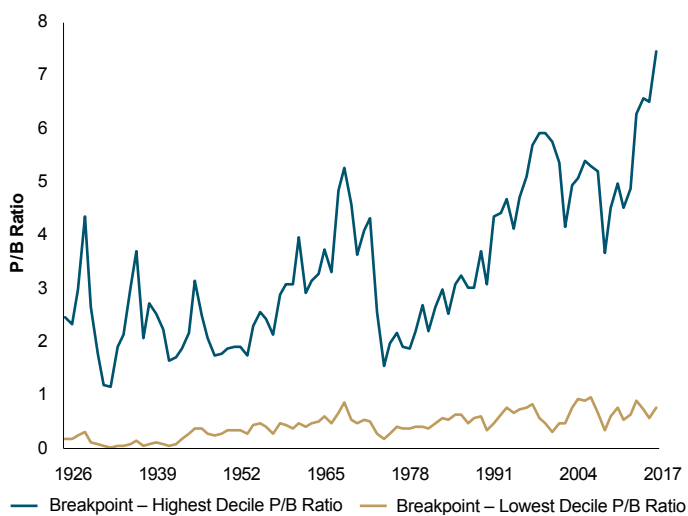
Returning to First Principles – What if History Doesn’t Matter?

While the data, research, and historical trends make a very strong case for small-cap and value-based investing, we recognize that history rarely (if ever) repeats itself, and that historical data alone isn’t enough to build an investment strategy. It’s important to review and understand the basic economic logic underlying *why* small value stocks should outperform large growth stocks over long time periods, and how that framework ties into very fundamental concepts of risk.

Value investing implies lower-valuation securities – that is, securities with a lower price relative to their earnings (or sales, or book value) than other companies should have greater expected returns than higher-priced stocks. If a company’s share price is lower than might be expected, this lower price is typically driven by perceptions of risk, as investors seek alternatives viewed as safer. This lower share valuation also leads to a higher cost of capital – the company has to offer more shares to the market to raise the same amount of money from investors. Investors (in theory) will therefore require a higher expected return, justified by the perception of the company being riskier than other investments. A classic example of this is a large, healthy, and rapidly growing technology firm with very high valuations (and a low cost of capital) and an older industrial firm with modest growth and high costs, which consequently must offer investors higher (potential) returns to attract money.

There is also research that theorizes a behavioral component to value investing – based on the idea that while the market is efficient in that it reacts quickly to new information, it may not always react “correctly” to that new information. This potential for over- or under-reaction (willingness by investors to take risk in a “bull” market, or the rush to sell at a loss during a correction) may in part explain the swings in the relative performance between the highest- and lowest-valuation securities in the US market. In some market cycles, it has been observed, investors sell their “riskier” investments during a downturn, driving the price of value securities even lower. Once the market begins to recover, those value stocks recover strongly, leaving growth behind in terms of performance. Later in a positive market cycle, the lowest hanging fruit of value stocks “with nowhere to go but up” is exhausted, and larger and “healthier” growth companies look more attractive. In fact, we can also see some evidence that investors’ collective appetite for higher valuations has grown over time – the price-to-book ratio for the most “expensive” 10% of the market is significantly higher in recent decades (see Exhibit 5). Given that the spread between the lowest- and highest-valuation securities in the US market has never been higher, a case can be made that investors would be well served to maintain their value exposure – whether the explanation for the value premium is based purely on risk, on investor reaction to perceived risk, or a combination of the two, it is unlikely that relatively expensive securities will continue to rise in price in perpetuity.

Exhibit 5: Highest and Lowest Valuation Comparison
Dec. 31, 1926–Jul. 31, 2017



Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

Small-cap investing looks to overweight smaller companies relative to the larger stocks that tend to dominate traditional indexes. Similar to our understanding of the value premium, we would look at the relative risk of smaller securities to larger securities – with generally less cash reserves, lower name recognition, and less-diversified business operations and cash flows, smaller stocks are inherently riskier than larger companies. With higher risk should come higher expected return, at least over a sufficiently long time period (in fact, we have even recently expanded on this concept to look at global and country-level data – see our recent paper, “[Should You Tilt Your Equity Portfolio to Smaller Countries?](#)”). Nothing we have seen in our research or the research of others has yet convinced us that this fundamental principle of finance and investing is no longer valid or is likely to change in the future.

However, even if we were to assume that the value and size premiums in the future will be 0% in perpetuity, we would still argue for targeted small-value exposure and managing a multi-factor portfolio rather than a basic index-based approach. Holding multiple asset classes in a diversified portfolio (even if there is no direct return benefit) allows a manager to use the imperfect correlations between different parts of the portfolio to reap a diversification premium. For example, when small cap and value are high, a diversified portfolio can trim those gains and rebalance into larger and growth securities, and vice versa, offering a better risk-adjusted return over the long term. Additionally, on a practical level we also incorporate other factors beyond small cap and value into our strategies to diversify and better manage risk – beyond the scope of this paper, but a brief introduction to these other factors can be found by watching, “[The Science of Multi-Factor Investing](#)”.

Recent years, as we’ve mentioned, have been challenging ones for small and value stocks in general, but let us attempt to illustrate the value of diversification with a very simple portfolio example. In the last 5 years, large cap growth stocks have outperformed small cap value stocks by just over 0.5%. However, if we were to compare large cap growth stocks, small cap value stocks, and a 75%/25% blend of the two, we would see that the 2-asset class portfolio combining the two had a very similar risk and return profile to the “better” large cap growth stocks alone (see Exhibit 6). Our portfolio management is in part based on the idea that no investor should tie his success to any single source of return – so if we can achieve similar results with a more diversified portfolio as with a more concentrated one, we count that result as a success even if the returns are identical. By consistently rebalancing (selling small cap value when high, buying it when low), the more diversified mix was arguably the “best of both worlds” for this specific example.

Exhibit 6: Blended US Equity Portfolio Example

Jul. 1, 2012–Jun. 30, 2017

	Annualized Return	Standard Deviation
US Large Cap Growth Index	15.42%	9.92%
US Small Cap Value Index	14.88%	14.74%
75% Large Cap Growth / 25% Small Cap Value	15.42%	10.12%

Sources: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Gerstein Fisher Research

Conclusion

Investors seeking to outperform a given benchmark must seek intelligent ways to be different from that benchmark. By taking risks that distinguish their portfolios from the index, they will experience periods of both under- and out-performance. Small-cap and value investing have solid foundations in theory, data, and history, but investors and managers must still acknowledge the reality of potentially extended periods of underperformance for those styles. By investing in portfolios that are managed in a disciplined, quantitative way, we seek to take advantage of the long-term benefits of risk factors such as small cap and value while balancing those advantages with a broadly diversified approach that limits the potential for excessive underperformance.

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