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## Value and Size Premiums

**Overview:** The stock market's recent activity continues to make headlines. The following article reviews several important concepts, including why investors should expect periods of underperformance by a diversified strategy and why they should not allow this to convince them to abandon their long-term investment strategy.

A friend has been a two-line sport kite flier for years. While not a pro, he has learned a few tricks by observing these kites' flying behavior. He said one of the most difficult skills for beginners to master is what to do when their kite starts to plunge toward Earth. The natural, panicky impulse is to yank backward on the lines. However, this action only accelerates the kite's death spiral. The simple kite-saving technique is to calmly step forward and thrust out your arms. This causes the kite's downward acceleration to stop, allowing you to regain control of the kite and end its plunge.

What does this have to do with investing? Just as yanking on the lines is the natural, panicky reaction when a kite starts to plunge, the natural, panicky reaction when a portfolio's value takes a dive is to pull back and sell. In both cases, pulling back is the wrong strategy. The right strategy is the less-intuitive one of remaining calm and stepping forward by buying stocks to rebalance the portfolio to the desired asset allocation.

Investors who are questioning their strategy should ask themselves the following question: "What has changed that would cause me to abandon my strategy?" Those asking the question should consider the following: The most basic tenet of investment theory is that risk and *expected* return are related. Stocks have provided higher returns than Treasury bills, small-cap stocks have historically provided higher returns than large-cap stocks, and value stocks have historically provided higher returns than growth stocks because the former are riskier. Because there is incremental risk, investors require a risk premium (higher *expected* return) as compensation.

Thus, the answer to the question "What has changed?" is "Nothing." Does the fact that value stocks have provided lower returns than growth stocks in 2011 mean they now have lower expected returns than growth stocks? Does the fact that small-cap stocks have provided lower returns than large-cap stocks in 2011 mean that small-caps now have lower expected returns than large caps? For either of these to be true, small-cap and value stocks would have to be safer than large-cap and growth stocks, or risk and expected return would be unrelated.

## The Value Premium

The value premium is one of the most well-documented facts in finance. To calculate the value premium, financial economists take the return of value stocks, which is defined as stocks within the top 30 percent of stocks ranked by book-to-market (BtM) value, and subtract the return of growth stocks, which is defined as stocks within the bottom 30 percent. The term HmL — the return of high (H) BtM stocks minus (m) the return of low (L) BtM stocks — is used for the value premium. From 1927–2010, the value premium was 4.8 percent on an annual average basis.

Further, the value premium has appeared with a high degree of persistence. The value premium was positive in 52 of the 84 years from 1927–2010, or 62 percent of the time. Of course, that means it was negative 38 percent of the time. That is the nature of risk.

While the value premium has been fairly persistent, there has been no predictable pattern to the premium. The only way investors could have reliably earned the value premium is if they had the discipline to maintain their exposure. This means investors would have to have ignored the clarion calls from Wall Street and the media that are often made after a few years of value outperformance.

## The Size Premium

To calculate the size premium, financial economists take the return of small stocks, which is defined as stocks within the bottom 50 percent of stocks ranked by market capitalization, and subtract the return of large stocks, which is defined as stocks within the top 50 percent when so ranked. The term SmB — the return of small (S) capitalization stocks minus (m) the return of big (B) capitalization stocks — is used for the size premium. From 1927–2010, the size premium was 3.2 percent on an annual average basis.

Much like the value premium, the size premium has appeared with a high degree of persistence. The size premium was positive in 47 of the 84 years from 1927–2010, or 56 percent of the time. That means it was negative 44 percent of the time. Like the value premium, the size premium is a risk story. You do not earn the higher returns year in and year out.

So far in 2011, the value and size premiums have been negative. When portfolios experience negative tracking error (when a portfolio underperforms a broad market index such as the S&P 500 Index), many investors question their strategy of tilting to small and value stocks to capture the premium (the higher expected returns historically generated by small and value stocks). Few investors question their strategy when it generates positive tracking error. However, investors who tilt their investment strategy to small and value stocks to capture the risk premiums must accept the fact that there will be periods of underperformance. Investors who are not prepared for that should not tilt their portfolios in the first place.

## Summary

Warren Buffett is probably the most highly regarded investor of our era. Listen carefully to his statements regarding efforts to time the market:

- ▲ “Inactivity strikes us as intelligent behavior.”<sup>1</sup>
- ▲ “The only value of stock forecasters is to make fortune tellers look good.”<sup>2</sup>
- ▲ “We continue to make more money when snoring than when active.”<sup>3</sup>
- ▲ “Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient.”<sup>4</sup>

One important key to financial success is having knowledge of how markets really work. Those who do not know that there will inevitably be periods of underperformance may fall prey to tracking error risk and abandon their plan. But investors who “know their history” are forewarned. Thus, they will be more likely to have the discipline to stay the course. In fact, disciplined investors look at periods of underperformance as opportunities to buy stocks when they are “on sale.” In other words, the market is a mechanism that transfers wealth from those without a strategy and with weak hands to those with a strategy and strong hands.

The bottom line for investors is that the prudent strategy is to ignore the calls to alter their long-term investment strategy, be they from their stomach, Wall Street or the financial media. The appropriate actions include portfolio rebalancing and harvesting any losses for tax purposes. Those who have the discipline to stay the course will avoid the fate of investors who underperform the very mutual funds they invest in by a significant margin, because they alter their strategy and chase past returns.<sup>5</sup>

<sup>1</sup> Warren Buffett, **Chairman’s Letter**, February 28, 1997.

<sup>2</sup> Warren Buffett, **Chairman’s Letter**, March 1, 1993.

<sup>3</sup> Warren Buffett, **Chairman’s Letter**, February 28, 1997.

<sup>4</sup> Warren Buffett, **Chairman’s Letter**, February 28, 1992.

<sup>5</sup> Russel Kinnel, **Mind the Gap: How Good Funds Can Yield Bad Results**. *Morningstar FundInvestor* (July 2005).

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