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Personal Investing

Giant Payoffs from Midget Stocks

by A. F. Ehrbar

For 20 years now, the news coming out of the University of Chicago has been uniformly disheartening for investors. Study after study at Chicago's Center for Research in Security Prices has bolstered the efficient-market notion that it's virtually impossible—other than by blind luck or with the edge of inside information—to beat the stock market. The implications for greed in all the evidence about efficiency have been decidedly negative.

Now comes Rolf W. Banz, a Swiss professor of finance at Chicago, with some surprisingly *good* news for the greedy: it appears that there is a way to pick stocks that will outperform the broad market averages. The market-beating system Banz has uncovered is remarkably simple. All it entails is buying the stocks of little companies—lots of them. In the universe of publicly owned corporations, the little ones are those with market values (the stock price times the number of shares outstanding) of less than $50 million or so. That category includes about one-fifth of the corporations on the New York Stock Exchange and most American Stock Exchange and over-the-counter companies.

A wild, lucrative ride

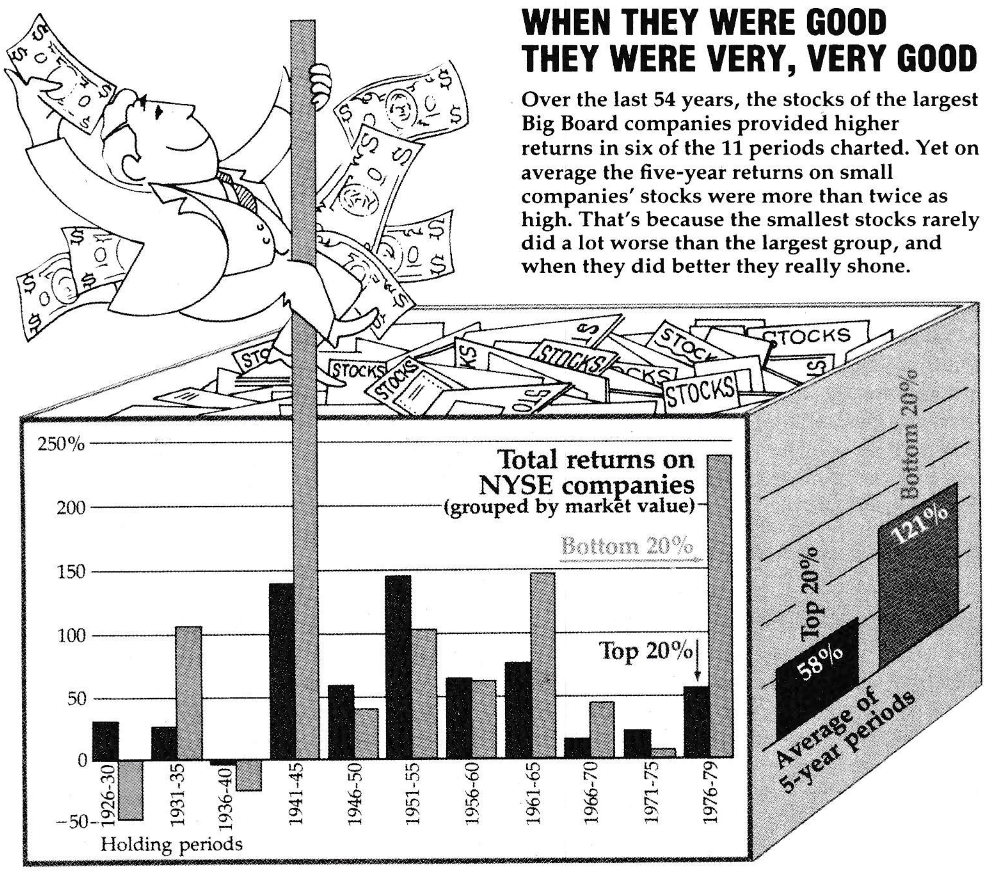
Just about every investor knows, of course, that small stocks have been the ones to own lately. (See Personal Investing, February 25.) Last year the total return (capital gains plus reinvested dividends) for the blue-chip S&P 500 was 18.4%. In contrast, the "second tier" of smaller, non-S&P stocks—from the NYSE, the Amex, and the NASDAQ over-the-counter lists—had a combined total return of 38.7%. And over the last five years this second tier provided a total return of 206%, more than double the 99% return for the S&P.

After half a decade of such incredible results, it would be reasonable to suppose that the chance to cash in on small companies has passed. In fact, Banz's research shows that the small stocks' greater gains weren't just a fluke of the recent bull market. The midgets have been outperforming the averages fairly consistently for at least 50 years.

The relationship between size and performance is strikingly evident in some returns on Big Board stocks that Banz computed for FORTUNE. He calculated how much investors would have made in each of the five-year periods from 1926 through 1975, and in the four years since then, by buying stock in either the top fifth or the bottom fifth of the companies on the NYSE, ranked by market value. For instance, the hypothetical small-stock investor bought equal dollar amounts of the bottom fifth on December 31, 1925, and held the stocks, reinvesting the dividends, until December 31, 1930. He then shifted his money so that he had equal amounts in each of the stocks that made up the bottom fifth on that date.

The small stocks gave investors a wild ride, with five-year returns ranging from minus 47% (1926-30) to plus 658% (1941-45). The comparatively sedate large stocks had returns that varied between minus 2.4% (1936-40) and plus 146% (1951-55). Over the entire 54 years the annual rate of return on the large stocks was 8.8%, while the small stocks had an 11.6% rate of return.

That difference of 2.8 percentage points may seem modest, but it was enough to



WHEN THEY WERE GOOD THEY WERE VERY, VERY GOOD

Over the last 54 years, the stocks of the largest Big Board companies provided higher returns in six of the 11 periods charted. Yet on average the five-year returns on small companies' stocks were more than twice as high. That's because the smallest stocks rarely did a lot worse than the largest group, and when they did better they really shone.

is possible that there is a flaw in the concept of defining risk as the volatility of returns. There may be some other element of risk that is peculiar to small companies, and that, if added to the risk-return equation, would offset the apparently superior small-company returns.

Bad news for money managers

The evidence about small stocks obviously undermines the efficient-market theory, but the damage isn't as severe as it might seem. Even the most ardent proponents of the theory have said all along that the market appears to be highly, not perfectly, efficient, and that with all those analysts studying companies, any opportunities for profitable research probably are among the small stocks that most of them ignore.

But the new findings will not be comforting to professional money managers either. The performance standard that most of them haven't been able to match is the S&P 500. Now it is revealed that the second tier—which includes 90% of all actively traded stocks, accounting for about 30% of the market value—has trounced the S&P.

Ironically, the small-stock phenomenon has indirectly refuted the most serious challenge yet to the efficient-market theory. A number of researchers have demonstrated that portfolios of stocks with low price-earnings ratios have regularly outperformed the market averages. That finding, trumpeted by David Dreman in his book *Contrarian Investment Strategy*, is wholly inconsistent with an efficient market. It turns out, however, that low p/e stocks appear to offer superior returns onlv because small stocks have lower p/e's, on average, than large ones.

Marc Reinganum, a University of Southern California professor who studied with Banz, compared the performances of stocks that were grouped in portfolios on the basis of both size and p/e ratios. He found that large-company stocks with low p/e's perform no better than those with high p/e's. There also is no difference in the returns on small-company stocks with high and low p/e's.

Whatever the reasons for the small stocks' superior results, the implication is obvious: buy little. A few sophisticated institutional investors have begun to do just that. The American National Bank in Chicago is offering its pension-fund clients a second-tier "market expansion fund" to augment the S&P index fund that it has had for five years now. The new fund holds about 500 second-tier stocks, and eventually will have 1,500. AT&T may start a similar fund as an investment alternative for Bell System pension funds.

How to buy little

The logistics of small-stock investing are more difficult for individuals because investors have to buy a large number of companies to be reasonably assured of getting the average results. Small companies have a better chance both of going bankrupt and of growing geometrically, so an investor has to have a lot of stocks to avoid getting clobbered by a handful of failures or missing all the wild successes. Someone with, say, $200,000 in the equity market probably could get as much diversification with 50 or so well-chosen small stocks as he could with 15 or 20 blue chips, and it seems almost certain that he would reap higher returns.

An alternative for the less wealthy is to spread money among the handful of mutual funds—such as Acorn, Evergreen, and American General Venture—that concentrate on small stocks. Unsurprisingly, those three have been near the top of Lipper Analytical Services' mutual-fund rankings since they were started in 1970 and 1971. One small-stock fund that has had outstanding results is Over-the-Counter Securities. Its Lipper rank was eighth for the last 12 months, sixth for the last five years, and eighth for the last ten years; it ranked third among the 157 funds whose results have been compiled since the end of 1959. O-T-C holds a startling 363 stocks, about half of them in companies that aren't even traded actively enough to make the NASDAQ list.