Size

Big is not always better, but size can impact both a company's financial outcome and the rate of return from owning its stock. While larger companies have more resources than smaller ones, more can be expected of them as a result. With a smaller scale operation, a successful small company can achieve a high growth rate but also must deploy its limited resources very efficiently and effectively. Differences in company size can be a factor in distinguishing among company stocks and the values they are assigned. Market capitalization – shares outstanding x stock price – is a standard measure of size. A review of some stock size characteristics can provide perspective for investing ahead.

PERSPECTIVE

Recognized market indexes generally weight individual stocks by size, using market capitalization as the measure. A standard convention is to place stocks into three size groups, small, medium and large. Chart I shows the relative return contribution of each of these size groups to the overall U.S. stock market return over time. Returns here are measured over rolling twelve-month horizons. Returns have been dominated by the large group, averaging 71% of the total market return with the medium group at 26% and the small group a distant third at 3%. This history suggests it prudent to have a meaningful portfolio weighting in the large group, but the medium and small groups should not be ignored.

The capitalization scheme for stock market index construction does bias return outcomes toward larger size. Such a scheme may not give an accurate indication of how an index's "average" stock has performed for a given period. This indication is best shown in an index that equally weights each stock. Chart II shows the return difference for rolling twelve-month periods between a size-based index of the total U.S. stock market and an equally-weighted index of these stocks. The difference has varied widely over time with each index experiencing periods of out-performance and under-performance. Over this whole period, the return advantage has gone to the equally-weighted index, but the variability of that index was notably higher as well.

Portfolio theory holds that higher return comes with higher risk. This relationship among U.S. stock size groups is shown in Chart III. Theory would have a line generally sloping upward and to the right. Such is not the case here. The medium size stock group and the small size group each have higher return along with higher risk than the large size group. However, the medium size group dominates the small size group with a higher return and less risk. The frequencies of out-performance versus under-performance for pairings of each group are comparable and not materially different from a 50% coin toss. This suggests each group may have a place in a portfolio.

INVESTMENT IMPLICATIONS

Diversification among and within asset classes is a key principle of prudent portfolio management. Diversifying stock holdings by company size is an appropriate portfolio strategy. Advantages among investment options seldom are consistent over time. As a result, a disciplined framework must be employed to exploit advantages as they arise. Such a framework must also be sensitive to fundamental changes in relationships that could necessitate a shift in a framework's measurement metrics. Pursuit of opportunity has its challenges.

CHART I

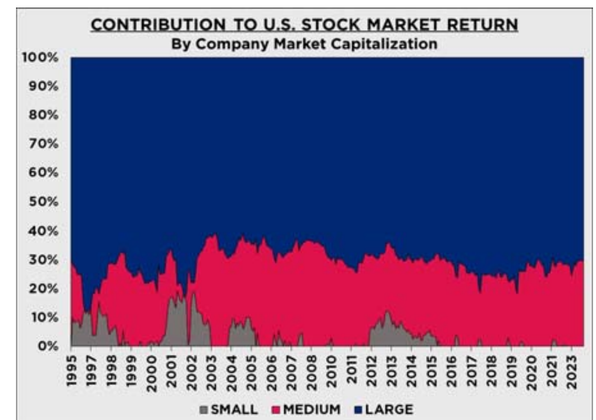

CHART II

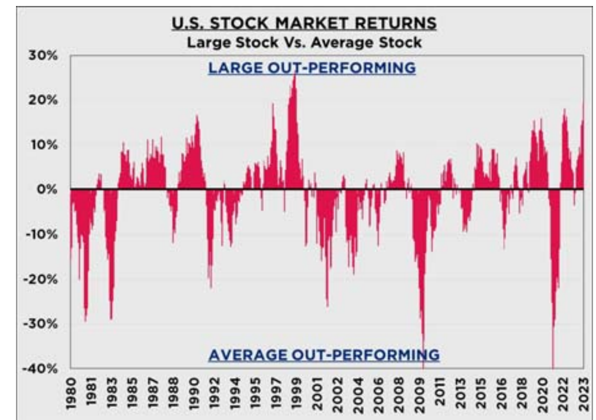

CHART III

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