If you want to make big bucks go small

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By Brett Arends, MarketWatch

Investors should buy high-quality small cap stocks

What if there was no great mystery to beating the stock market?

What if building an investment portfolio of great stocks was easier than you think -- and something so straightforward pretty much anyone could do it?

It sounds ridiculous -- something pitched by a charlatan or a huckster offering a dubious advisory service. But according to new research it might be reality.

Five independent stock-market experts, including three hedge-fund managers, and two business-school professors, have just published the first draft of an absolutely fascinating research paper that may turn out to be pure gold for ordinary investors (or, given the disastrous performance of gold bullion recently, better than gold).

"Size Matters, If You Control for Junk" (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2553889) has been written by Cliff Asness, Andrea Frazzini and Ronan Israel of AQR Capital, a Greenwich, Conn.,-based hedge-fund company; Tobias Moskowitz, a professor at the University of Chicago's Booth School of Business; and Lasse Pederson at the Copenhagen School of Business in Denmark.

They've conducted fresh analyses of over 50 years of U.S. stock market data, and over 30 years of data for overseas stock markets, and they've reached a startlingly simple conclusion.

If you had wanted to beat pretty much any stock market over time, at any point, all you had to do was buy the stocks of companies that were both small and "high quality" when measured by things like balance-sheet strength, profitability, stability and growth.

Indeed, according to their analysis, the broad portfolio of such "small cap, high quality" stocks have beaten the overall market by just under five percentage points a year -- which, for the uninitiated, is an absolutely stunning performance.

How did they get there?

Academics and stock market experts have long debated something called the "small-cap effect" -- the question of whether small-company stocks have outperformed large-company stocks over time. Lots of financial advisers and commentators claim airily that small-cap stocks do indeed "outperform," but with "more volatility."

But as Asness and his associates point out, the truth is much more complex. Most of that historic outperformance came in the 1960s and 1970s. During the 1980s and 1990s, for example, small caps did not outperform the wider market. Furthermore, they point out that most small-cap outperformance came during January each year -- during the other 11 months the extra gains from small-cap stocks was minimal.

And when you take into account other things, such as the higher costs typically involved in running small-cap funds, and the greater volatility, the actual benefits from small caps were pretty slight. They weren't a free lunch. They might not even be a free canapé.

But according to the new research, the biggest drag on small-cap performance has been something simple but widely overlooked: Small-cap stocks, overall, tend to be of lower quality than bigger blue chips. Smaller companies, on average, tend to have weaker balance sheets, more volatile businesses, and lower levels of profitability than their bigger peers.

And in recent years researchers -- including the same five experts who have produced the latest paper -- have increasingly demonstrated that, when all other things are equal, the stocks of "quality" companies have beaten "junk" companies by a country mile.

What this means: If you had only invested in small cap, high quality stocks over time then you would have ended up eating two free lunches -- one because they were small, and another because they were high quality. Your portfolio would be stuffed to the gills with profits.

There are some important caveats. None of this addresses the key investment questions of, say, whether this is a good time to invest a lot in stocks at all, or how much of your portfolio you should invest in stocks as opposed to other assets, such as real estate, bonds, or commodities. Both questions are complex.

The only question this research tries to answer is, "If I am going to invest a certain amount in stocks right now, which stocks should I buy?"

Furthermore, a stock is only a claim on future cash flows, and how much you pay for it is going to have a huge influence on your subsequent investment returns. Any investment strategy becomes self-defeating if everyone starts following it, because they will drive up the price. Small-company stocks, and high-quality stocks, have outperformed substantially in recent years. That may -- repeat: may -- be followed by weaker gains.

Nonetheless, the advantage of "small cap, high quality" seems to have been persistent over a long period of time, and in almost every developed overseas market as well (with the odd exception, apparently, of Ireland). Could it really be this easy?

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