Employ a small-cap value strategy

"INVEST only in small-capitalisation value stocks. Don't invest in blue chips. Don't invest in growth stocks."

This advice might alarm you. But if you want the best long-term returns, you have to invest in value small caps. To build your nest egg quickly, you need to defy convention.

What are small-cap stocks? They are companies with small market capitalisation. Market cap is the market value of all the outstanding shares. You get this by multiplying all outstanding shares with the share price.

What is a value stock? A value stock is one that sells at a discounted price to its fair value. For example, if a stock sells for 50 cents and its fair value is $1, then that is a 50% discount to its fair value. Value investors try to pay 50 cents to a dollar of assets. The fair value of a stock is estimated by understanding the business of a company and analysing its financial statements.

And why is a stock that is worth $1 selling for 50 cents? This happens because stock prices are oftentimes driven by the sentiments of market participants and are not based on business fundamentals.

In the dark ages in 1930s, people treated the stock market as a casino. Many still do today. Speculators don't study the fundamentals. Then Benjamin Graham came along. Most people don't know who Graham is, but they know his famous student: Warren Buffett. Graham introduced a systematic way of analysing stocks and is known as the father of value investing.

He introduced the concept of margin of safety. It means that if one were to purchase a stock at well below its estimated fair value, there is a buffer called the margin of safety that will protect one from loss. Graham brought us from the dark ages of stock speculation to investing.

In Asia, the value strategy is clearly superior to the growth strategy. Value outperformed growth in all cases and by a huge quantum too (4-plus per cent).

Later, in the 1980s, Eugene Fama and Kenneth French, better known as Fama and French, came along. They had an advantage over Graham, as in the 1980s, there was sufficient financial data available for analysis using statistical tools and computers. Graham did not have this benefit and had to rely on studying small samples of stocks using pen and paper. Fama and French built upon Graham's work and took investing to another level. They put the science into investing.

Table 1

Global stock market

	SMALL MINUS BIG (%)	VALUE MINUS GROWTH (%)
2012 to 2016 (Last 5 years)	0.26	4.73
2007 to 2016 (Last 10 years)	1.44	-1.29
2002 to 2016 (Last 15 years)	3.18	1.73
1997 to 2016 (Last 20 years)	2.41	3.36

Table 2

Asia ex-Japan stock market

	SMALL MINUS BIG (%)	VALUE MINUS GROWTH (%)
2012 to 2016 (Last 5 years)	-1.64	8.27
2007 to 2016 (Last 10 years)	1.28	4.28
2002 to 2016 (Last 15 years)	1.75	5.92
1997 to 2016 (Last 20 years)	0.26	7.15

In short, Fama and French discovered that small-cap value stocks outperformed the general stock market.

For the benefit of readers, I have summarised some of the data from Fama and French in Table 1.

Table 1 shows the performance of two strategies in the global stock market. "Small minus big" (SMB) means the average performance of small-cap stocks minus that of big-cap stocks per year. For example, from 2012 to 2016, small caps outperformed big caps by an average of 0.26% a year. The same holds true for the last 10, 15 and 20 years.

"Value minus growth" means the average performance of value stocks minus that of growth stocks. In the global stock market, value stocks have outperformed growth stocks by 4.73% a year for the last five years. Over the last 20 years, from 1997 to 2016, value stocks have outperformed growth stocks by 3.36% a year.

What about the Asia ex-Japan stock market? See Table 2.

Asia shows a similar result. There is a general outperformance of small caps and value stocks. A critical reader may point out that in the last five years, small caps have underperformed big caps by 1.64% a year. I think the longer-term results should carry heavier weight — small caps outperformed over 10- to 20-year periods.

In Asia, the value strategy is clearly superior to the growth strategy. Value outperformed growth in all cases and by a huge quantum too (4-plus per cent). One would also notice that value stocks' outperformance in Asia is superior to that in the global stock market.

One can view the table as statistical odds. So, if you want to improve your long-term odds of winning the stock market game, make sure you use a small-cap value strategy. — *www.aggregate.com.sg*