Is the size factor broken? No, it never existed in the first place

No outperformance over past four decades

by XyuFell
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Academics and investment houses alike are warning size is another factor investors can throw on the smart beta bonfire after recent research has found the factor is not just broken but never existed in the first place.

There is little evidence for the size premium’s outperformance over the past four decades following the factor’s discovery in the early 1980s as part of Fama-French’s three-factor model. The MSCI World Size Tilt index, for example, has delivered annualised returns of 9.4% over the past decade versus 10.7% for the MSCI World and has underperformed the same index by 6.1% this year, as at 31 August.

While the original research found smaller companies outperformed larger ones, a re-examination of those findings has been undertaken.

Earlier this month, ETF Access, co-founder and CIO of AQR Capital Management, released research highlighting the lack of a size premium due to its high market beta meaning the factor outperforms when the market is going up and vice-versa in a down market.

According to Asness, the original research exaggerated the strength of the size factor as it did not take into account the liquidity differences between large and small cap stocks.

Small cap stocks are far more liquid than their large cap counterparts and therefore Asness’s research found their market beta had been underestimated.

As Asness said: “In coming up with the market beta of small and large stocks, one simple way to adjust for illiquidity is to add in logged market returns to the regressions used to determine the beta.

“So, net of using the more accurate databases today versus those used in the original work and this adjustment for underestimated betas (using logs), you really do not find any size effect. Zip. Nada.”

Meanwhile, a paper from Robeco’s David Blitz and Matthias Hansauer entitled Settling The Size Matter released a week earlier than Asness’s, also weighed in on the size factor premium.
“significant value”.

While there are over 400 factors, as documented in a Census of the Factor Zoo by Campbell Harvey and Yan Liu, the majority have not been turned into financial instruments and in particular ETFs.

This is not the case for size which has traditionally been seen as one of the five historically-backed well documented factors alongside value, momentum, volatility and quality.

As a result, ETF issuers in Europe have launched strategies over the past 10 years tracking the size factor. The largest of these is the MSCI World Size Factor UCITS ETF (WSZ) which has $821m assets under management (AUM).

The other three ETFs are the $94m MSCI USA Size Factor UCITS ETF (USZ), the $26m iShares MSCI Europe Low Size Factor UCITS ETF (DEM) and the $21m MSCI Europe Size Factor UCITS ETF (RES).

Plenty of food for thought for investors.

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