Factor/Style Investing

Fact, Fiction, and the Size Effect

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The size effect — the notion that small stocks have higher average returns than large stocks, even after risk-adjustment — has for decades been taken as an unwavering fact of financial markets. It was the first market anomaly to challenge asset pricing models and prompt debates about market efficiency. In practice, the path-breaking discovery of the size effect fueled a crowd of small cap indices and active funds and now the investment landscape is segmented into large and small stock universes. Despite its long and illustrious history in academia and its commonplace acceptance in practice, there is still confusion and debate about the size effect. We examine many claims about it and aim to clarify some of the misunderstandings surrounding it by performing simple tests using publicly available data.

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