The Bad News Is Beta; the Good News Is Book Value, Size

By James B. Cloonan

Some extremely interesting academic research results have come from the University of Chicago (where else?), that fine institution that gave us first the efficient market theory and then the inefficient market theory of small stocks. Now Professors Eugene Fama and Kenneth French have published (in the June 1992 Journal of Finance) some additional ground-breaking research.

Some of the findings of this research have been discussed in a number of financial publications, but most of these discussions have focused on the research concerning "beta."

Beta measures the amount of stock market risk that exists in an individual stock or portfolio. As such, it had been viewed as a predictor of returns: Higher beta stocks—those with higher stock market risk—would be expected on average to have a higher rate of return because they are taking on higher risk. The research conducted by Professors Fama and French indicates that beta is no longer useful for predicting stock returns.

This particular finding doesn't excite me much because beta is not that useful for those who invest in individual stocks, given the low correlations between different market segments. Most sophisticated investors focus on specific market segments—value stocks or growth stocks, for instance. Few investors would expect the movement of value stocks to correlate closely with the movement of growth stocks, or the movement of cyclicals to correlate closely with consumer non-durables.

Whether the other commonly accepted risk measure—variation in returns (standard deviation)—can predict returns (higher risk equals higher returns) is not addressed by Professors Fama and French.

On the other hand, the research did uncover findings that are particularly important for the individual investor. Specifically, the professors found further proof of the superiority of small capitalization stocks, and they found evidence that there is another effective predictor of high return stocks—the ratio of a stock's book value (common stockholder's equity) to its share price.

While this ratio has long been used (either in this form or its inverse, price divided by book value) as one measure of a stock's potential, particularly by value investors, the new research shows:

- The book-value-to-share-price ratio is a strong indicator of future returns: When stocks were ranked by book value/price over the period 1963 to 1990, the top 10% produced returns of 20% compared to the overall market's return of 15%.
- A significant portion of these high returns were independent of the size effect (many of the top 10% of firms ranked by book value/price were smaller firms) and the use of both book value/price and small market capitalization makes a very significant difference. The stocks in the top 10% rankings by book value/price *and* in the lowest 10% rankings by market capitalization yielded 23% a year, compared to 15% for the overall market and 11% for low book value/price stocks with large market capitalizations.

This research is particularly important to individuals because high book value/price stocks, like small-capitalization stocks, are less liquid and not easy for large institutions to buy in large quantities.

It is also of interest to note that this research, ending in December 1990, included the worst years for small-cap stocks, yet they still beat the market, 18% a year to 15% a year.

Also of note was the finding that if you use market capitalization and book value/price, then price-earnings ratios provide no additional help in predicting returns.

The research provides meat for additional analysis. Even at this point, I feel the evidence is strong enough to justify portfolio adjustments. AAII will examine the practical as well as the theoretical aspects of this approach in a real portfolio, and we will, of course, keep you advised of any useful findings.

James Cloonan is chairman of AAII. His column is his own opinion and does not necessarily reflect the views of the AAII Journal.