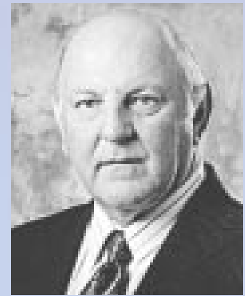
A Three Leg Stool



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Recently, I came across an interesting study conducted by professors Chen and Ibbotson[1] of the Yale School of Management that suggested that investors interested in enhanced returns should focus their attention on less liquid assets. According to their liquidity hypothesis, stocks that have low turnover (defined as average trading volume divided by total shares outstanding) are less liquid and hence present a liquidity risk for which investors should be compensated, resulting in lower valuations for low volume stocks.

Portfolio managers at Perritt Capital Management have long been aware of the extra returns offered by illiquid stocks. For nearly a quarter-century we have been investing client assets in the stocks of very small companies in an attempt to capture the so-called "small firm effect." That effect is the seemingly extra risk-adjusted returns provided by the stocks of small public companies. This crack in the efficient markets hypothesis was first discovered by Rolf Banz and outlined in an article "The Relationship Between Market Value and Return of Common Stocks" in 1981. Mr. Banz found that over the period 1926-1978, portfolios of stocks comprised of the bottom 20 percent of NYSE listed stocks (when ranked from largest to smallest on the basis of market capitalization) produced greater returns than could be accounted for by the capital asset pricing model while portfolios consisting of the top 80 percent produced returns consistent with the efficient markets hypothesis. However, no explanation was given for the source of these extra small firm stock returns.

Subsequent research uncovered a number of unique characteristics of small firm stocks that might explain their superior return potential. These characteristics included: an absence of analyst coverage, a low level of institutional ownership, a high degree of management ownership, and their relatively low level of liquidity in the financial markets. We have long suspected that the first three characteristics contribute to a small firm stock's illiquidity and thus it is actually illiquidity that fully explains the small firm effect. We have reasoned that if institutional investors tend to avoid small firm stocks, there is little reason for professional analysts (whose firms earn "soft dollar" commissions on the research they provide) to follow the fortunes of small companies. Furthermore, large blocks of stocks in the hands of operating managers (who are prohibited from actively trading shares in the companies they manage) restricts available float and thus dampens overall trading activity.

Although we are cognizant of the inverse relationship between liquidity and firm size, what we find intriguing about the Chen and Ibbotson study is that the inverse relationship between liquidity and investment return holds across all firm size categories. Furthermore, their study indicates that the return disparity favoring less liquid stocks increases as market capitalizations decline. For example, over the period 1972 to 2005, the arithmetic

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return for a low liquidity small-cap portfolio was 16.05% while the return for a high liquidity small-cap portfolio averaged 3.26%. That's an average annual return differential of 12.79%. On the other hand, low liquidity large-cap portfolios returned an average of 12.47% while their high liquidity counterparts returned 9.23%, an annual return differential of 3.24%. In other words, their study implies that investors seeking to enhance equity returns should pack their portfolios with less liquid stocks.

The liquidity factor (or should I say illiquidity factor) completes a three leg stool, upon which sits a robust equity portfolio. The other two legs are value-priced securities, and small-cap/micro-cap stocks.

Despite rumors of its demise, the small-firm effect is alive and well. Investors seeking "market beating returns" need to think small. Furthermore, there exists an over-whelming body of evidence indicating that value-priced securities (i.e., value stocks) provide greater returns over the long run than securities with higher valuations (i.e., growth stocks). These two factors have long guided our stock selection and portfolio management techniques. We now can add a third factor, degree of liquidity (or absence thereof), to complete the three leg stool upon which our asset management philosophy rests.

When presenting our micro-cap funds to institutional money managers, we often are rebuked because of the apparent low level of liquidity of the stocks we hold in our portfolios. However, as we have long suspected, these studies demonstrate it is the lack of liquidity that has assisted in producing market-topping long run returns. Furthermore, illiquidity is not a static characteristic. Over time, liquidity tended to increase for a number of reasons, and as liquidity expanded the liquidity premium was squeezed out of these stocks and investors were provided with these extra returns.

In the small-cap/micro-cap arena, liquidity tends to increase as firms grow and their market-caps expand. Growing firms attract investor attention and expanding market-caps allow larger investors to assume meaningful investment positions. In addition, a large number of small public firms receive takeover offers. In these instances, share price usually expanded and the volume of trading exploded. Historically, the liquidity premium disappeared and investors reaped the extra returns.

Furthermore, there is a large difference between the liquidity of individual stocks and portfolio liquidity. This is especially true of highly diversified portfolios containing the stocks of a large number of smaller companies. The law of large numbers suggests that at any point in time some of the stocks contained in a highly diversified portfolio will experience events that cause liquidity to expand dramatically. These stocks provide smaller company portfolio managers with opportunities to raise cash that can be redeployed.

Finally, long-term oriented small-cap investors can potentially reap the rewards of worldwide wealth expansion. As income and wealth expands more money is diverted to capital markets with the rising tide raising all boats. As the supply of capital grows over time all securities should have rising liquidity. However, the least liquid stocks should reap the greatest benefit. Undervalued illiquid small company stocks may become relatively more valued and their investors may reap the extra rewards that increased liquidity provides.

[1] *Liquidity as an Investment Style*, Zhiwu Chen and Roger Ibbotson, Yale School of Management, June 2008.

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Past performance is not a guarantee of future results.

Mutual fund investing involves risk. Principal loss is possible. The Funds invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Funds invest in micro cap companies which tend to perform poorly during times of economic stress. The Emerging Opportunities Fund may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies.

Diversification does not assure a profit or protect against loss in a declining market.

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

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