



FACTOR / STYLE INVESTING

Size Matters, If You Control Your Junk

January 22, 2015

Journal of Financial Economics

When it comes to equity investing, size matters — and in a much bigger way than previously thought — but only when controlling for junk. The authors examine seven empirical challenges that have been hurled at the size effect and systematically dismantle each one by controlling for a firm's quality.

The authors contend that previous evidence on the variability of the size effect is largely due to the volatile performance of small, low quality “junk” firms. Controlling for junk, a much stronger and more stable size premium emerges that is robust across time. These results are robust across a variety of quality measures as well.

We further find that interactions between size and other firm characteristics, such as value and momentum, can also be fully or partially explained by quality versus junk. Hence, the quality of a firm helps clean up the relation between size and the cross-section of expected returns.

These results revive the size anomaly, putting it on more equal footing with other anomalies such as value and momentum in terms of its efficacy and robustness, and dismiss several previous explanations for the size effect. Size should therefore be restored as one of the central cross-sectional empirical regularities, presenting an even further challenge for asset-pricing theory.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC (“AQR”) to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.