Session 17

Investing on hope: Growth and Small Cap Investing

Test

1. If you are a growth investor, which of the following do you believe about the market?
    a. The market always under values growth assets
    b. The market always over values growth assets
    c. The market is more likely to make mistakes in valuing growth assets than assets-in-place.
    d. The market is more likely to make mistakes in valuing assets-in-place than growth assets.
    e. None of the above.
2. Which of the following empirical findings best characterizes the "small cap" premium"?
    a. Young companies, on average, have earned higher risk-adjusted returns than older companies.
    b. Growth companies, on average, have earned higher risk-adjusted returns than mature companies.
    c. Companies with small revenues have earned higher risk adjusted returns than companies with larger revenues.
    d. Companies with low market capitalization have earned higher risk adjusted returns than companies with high market capitalization
3. If you have a ten-year time horizon, you would have always done better investing in small cap stocks than in larger cap companies in the US between 1925 and 2000.
    a. True
    b. False
4. If you invest in small cap stocks, you may see some or all of your excess returns dissipate as a result of transactions costs. Which of the following may cause these higher transactions costs?
    a. Small cap stocks tend to be held less by institutional investors.
    b. Small cap stocks generally have lower trading volume.
    c. Small cap stocks are more likely to be traded over the counter.
    d. Small cap companies are more likely to have low-priced shares.
    e. All of the above
5. A concern when investing in small cap companies is that they are far less likely to be followed by equity research analysts and there is less public information on these companies. That makes them more risky as investments.
    a. True
    b. False

    Explain.

Solution

1. If you are a growth investor, which of the following do you believe about the market?
    a. The market always under values growth assets
    b. The market always over values growth assets
    c. **The market is more likely to make mistakes in valuing growth assets than assets-in-place**.
    d. The market is more likely to make mistakes in valuing assets-in-place than growth assets.
    e. None of the above.

    Explanation: You believe that the market is less capable of valuing growth assets, both under and over valuing them by more. You also believe that you have the skill to value these growth assets better than the market.

2. Which of the following empirical findings best characterizes the "small cap" premium"?
    a. Young companies, on average, have earned higher risk-adjusted returns than older companies.
    b. Growth companies, on average, have earned higher risk-adjusted returns than mature companies.
    c. Companies with small revenues have earned higher risk adjusted returns than companies with larger revenues.
    d. Companies with low market capitalization have earned higher risk adjusted returns than companies with high market capitalization

    Explanation: Small companies in these studies are defined as companies with small market capitalization, not small revenues, earnings or book value.

3. If you have a five-year time horizon, you would have always done better investing in small cap stocks than in larger cap companies in the US between 1925 and 2000.
    a. True
    b. False

    False: There have been extended periods (ranging to five years or longer) where small cap stocks have under performed large cap stocks.

4. If you invest in small cap stocks, you may see some or all of your excess returns dissipate as a result of transactions costs. Which of the following may cause these higher transactions costs?
    a. Small cap stocks tend to be held less by institutional investors.
    b. Small cap stocks generally have lower trading volume.
    c. Small cap stocks may not be traded on the most active stock exchanges.
    d. Small cap companies are more likely to have low-priced shares.
    e. All of the above

Explanation: Small cap stocks are more likely to be low priced, unlisted, illiquid and not institutionally held, all of which contribute to the higher trading costs that you see on them.

5. A concern when investing in small cap companies is that they are far less likely to be followed by equity research analysts and there is less external information available on these companies. That makes them more risky as investments.
   a. True
   b. False

      Explain.

   Explanation: It is true that there is less known about small companies than large ones. While this is clearly a source of risk if you put all of your money in one small company (as opposed to one large one), it may be less problematic if you create a portfolio of small companies, since much of what you do not know is firm specific (and will get averaged out across the portfolio). It is only if you believe that what you do not know is more likely to be bad news than good that you have an additional risk.