Stock market: Small firms pack a big punch

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Larger companies do not necessarily generate higher returns for shareholders. Value creation is closely tied to fluctuating interest rates.

Size apparently matters when it comes to creating value for shareholders. This is one of the conclusions to be drawn from "IBEX 35: 1992-2007. Rentabilidad y creación de valor" ("IBEX 35, 1992-2007: Return and Value Creation"), a study in which IESE Prof. Pablo Fernández and research assistant Vicente Bermejo followed the evolution of the Spanish stock market over the past 15 years.

It was the small companies, in fact, not the large ones, that generated higher returns during that 15-year period. In that respect, average return for the ITBM was 16 percent, compared to the 15.1 percent of the dividend-adjusted IBEX. There were only five instances when that situation was reversed.

This phenomenon is not exclusive to Spain's trading floors, but manifests itself in international markets, too. Looking at return according to size of American companies for a period spanning 1926 to 2005, returns for small companies were also higher than the next-largest group of firms.

Shadowing interest rates

What factors affect value creation? It seems that a change of interest rate is one of the most significant. Major dips in interest rates go hand in hand with increases in the IBEX, and vice versa. During the period analyzed, there was a significant drop in interest rates that contributed to an increase in share prices.

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The average return for the IBEX from 1992 to 2007 is owed largely to interest rates being lowered. In fact, if you took away the effect of the interest rate change, average shareholder return due to changed expectations falls below the required return.

One fairly well-established idea is that in order to see greater profitability, one must assume greater risk. One way to measure the risk of stocks, for instance, is volatility, which measures their return variability. If a stock yields the same return each year, it has zero volatility.

Between 1992 and 2007, a total of 68 companies had volatility greater than that of the IBEX 35. But that increased volatility did not translate into increased profitability for the period.

Another factor that seems to determine a company's yield is its being added to or deleted from the IBEX 35. At first glance, there would appear to be some correlation: The day after the announcement of their addition, companies' average return was 2.3 percent greater than that of the IBEX, while returns for those deleted were 1.1 percent lower.

Yet during the 40 days prior to the announcement, companies that were added saw an average return that was 10.1 percent higher than the IBEX, while those deleted saw an average 5.9 percent below the index.

IBEX 35 in retrospect

During 1992-2007, capitalization of the IBEX 35 went from 51.1 billion euros (2,603 points) in December 2001 to 524.6 billion euros (15,182.3 points) in December 2007, with this last year being one of minimal value creation for shareholders (12 billion).

Just nine companies have been part of the IBEX 35 from 1992 to 2007. Nine others, while still on the list, have either changed their name or merged with others. The remaining 17 companies were part of the IBEX 35 in 2007 but were not in 1991. Another 28 were added and deleted from the index during those years.

During those 15 years, the volume of share negotiation for the 35 companies increased from 17.6 billion to 1.48 trillion. That increase is not only absolute, but also relative: while capitalization grew 11-fold, the volume of negotiation was multiplied by 84.

The IBEX 35 companies, as a whole, created value for their shareholders for every year included in the study except for 1992, 1994, 2000, 2001 and 2002. Nevertheless, looking at the overall data, the average annual shareholder return was 16.6 percent, far above the required return of 10.3 percent.

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Ups and downs

Finally, the authors reviewed various stock market crises and their recovery periods. In the case of Spain, they looked at the percentage represented by the drops with respect to the previous all-time high, for the period spanning December 1940 to December 2006.

Following the record high of April 1974, the Madrid Stock Exchange General Index (IGBM) fell 72.9 percent until April 1980, and did not return to its 1974 level until 1986.

In the case of the more recent crisis of the dot-com bubble burst, after hitting a record high in February 2000, the IGBM dropped 48.7 percent until September 2002. Yet by December 2005, it had already climbed to 2 percent above the level attained in February 2000.

Expanding the period studied (1926-1996), the authors noted that the largest single-month decrease happened in October 1987 (-28.6 percent); the annual record decrease occurred for the period October 1976 to September 1977 (-52.4 percent); the five-year record decrease was that of May 1975 to April 1980 (-84.3 percent); and the decade with the largest drop was the one running from March 1973 to February 1983 (-91 percent).

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