Financial Analysts Journal ›
Volume 59, 2003 - Issue 6

PORTFOLIO MANAGEMENT

Capturing the Value Premium in the United Kingdom

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Pages 35-45 | Published online: 02 Jan 2019
Cite this article https://doi.org/10.2469/faj.v59.n6.2573

Abstract

Using a new data set of accounting information merged with share price data, we found a strong value premium in the United Kingdom for the period 1955–2001. It existed among small-capitalization and large-capitalization stocks. But small-cap stock managers who wish to capture the higher expected returns face some challenges. We show that rebalancing-induced portfolio turnover for indexed small-cap value strategies can be substantial. Coupled with the relative illiquidity of the U.K. market for small-cap value stocks, such high turnover calls for strategies that sacrifice tracking accuracy in favor of

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Stock Exchange going back to the 1950s. Unlike many previously existing databases, this set of data is free of survivor bias.

Using book value of equity to market value of equity (BE/ME) as the measure of value, we found a strong value premium in the United Kingdom for the 1955–2001 period. The return spread we found between our high-BE/ME and low-BE/ME portfolios (averaged across large- and small-cap stocks) is about 0.5 percent a month. The value premium was particularly strong among small-cap stocks, and it was surprisingly stable until the mid-1970s. In recent years, the spread between high-BE/ME and low-BE/ME stocks has been highly volatile. We also show that returns on value strategies based on dividend yield move closely with returns on BE/ME strategies. The premium earned by dividend yield strategies is smaller, but the results suggest that dividend yield may be a useful auxiliary measure of value when BE/ME data deliver doubtful results.

Although the historical returns seem impressive, implementation of strategies designed to capture the value premium is potentially costly, particularly within the small-cap segment. Stocks migrating in and out of the small-cap value universe, dividends, and delistings—all give rise to trading needs, even for a passive manager. We found rebalancing-induced portfolio turnover for a passive small-cap value strategy to be approximately 40 percent a year. In a high-trading-cost environment, this mechanical trading strategy could easily cut several percentage points off annual performance.

We show that high trading costs are an important concern in the U.K. market. Even today, the equity market for small-cap value stocks in the United Kingdom is substantially less liquid than the market for large-cap stocks. The typical small-cap value stock tends to trade only every other day. This illiquidity implies that traders who demand immediacy of execution are likely to face substantial trading costs. Patient investors, however, may find opportunities to earn a premium by supplying liquidity to less pati

Rebalanc ... minant of achievab ... s designed to mi ... ng needs beca ... alancing needs ca ... ample, using a flexible ... nefit from a patient ... ng costs (and possibly slow execution) into their assessments of prospective excess returns. Clever management of the trade-off between tracking accuracy and trading cost can thus be a source of substantial competitive advantage for small-cap value managers. Furthermore, small-cap value stocks in the United Kingdom may be most suitable for the managers who are less subject to daily inflows and outflows and the trading needs they cause.

Finally, the concerns our results raise for the U.K. equity market may be even more relevant for other non-U.S. markets, where liquidity is likely to be even lower than in the United Kingdom.

We appreciate contributions from Paul Marsh and Mike Staunton and the comments of James Davis, Ken French, and Rex Sinquefield.