

## Small Market Capitalization Low Price/Earnings Ratio Companies as Compared to Large Market Capitalization Low Price/Earnings Ratio Companies

Sanjoy Basu examined the effects of market capitalization and price/earnings ratios on investment returns in "The Relationship Between Earnings Yield, Market Value, and Return for NYSE Common Stocks", *Journal of Financial Economics*, December 1983. Professor Basu ranked all companies listed on the New York Stock Exchange according to price/earnings ratios and sorted the companies into quintiles. Then, each quintile was ranked according to market capitalization and sorted into sub-quintiles within each of the price/earnings ratio groups. This process occurred as of each April 30 from 1963 through 1980 (a 17-year period ended April 30, 1980) and the annual investment returns were computed. Table 16 shows the results of this study.

### 1963 through 1980 Annual Investment Returns for Low versus High Price/Earnings Ratio Stocks According to Market Capitalization within Each Price/Earnings Ratio Category for New York Stock Exchange Listed Companies.

| Market Capitalization Category | (Lowest P/E) |       |       |       |       | (Highest P/E) |
|--------------------------------|--------------|-------|-------|-------|-------|---------------|
|                                | 1            | 2     | 3     | 4     | 5     |               |
| 1 (Smallest)                   | 19.1%        | 16.3% | 14.8% | 11.6% | 14.4% |               |
| 2                              | 18.1         | 14.5  | 9.5   | 8.2   | 9.8   |               |
| 3                              | 17.2         | 13.2  | 9.6   | 7.6   | 6.1   |               |
| 4                              | 15.5         | 13.3  | 10.3  | 7.8   | 6.6   |               |
| 5 (Largest)                    | 13.1         | 10.8  | 7.9   | 6.6   | 6.4   |               |

One million dollars invested in the smallest fifth of the companies listed on the New York Stock Exchange which were priced in the bottom fifth in terms of price/earnings ratios, would have increased to \$19,500,000 over the 17-year study period. By comparison \$1,000,000 invested in the largest market capitalization stocks with the lowest price/earnings ratios would have increased to \$8,107,000 over the same period.

During the period, the annual investment returns for the market capitalization weighted and equal weighted NYSE Indexes were 7.68% and 12.12%, respectively. One million dollars invested in the market capitalization weighted and equal weighted NYSE Indexes would have increased to \$3,518,000 and \$6,992,000 respectively.