PORTFOLIO MANAGEMENT

Are the Best Small Companies the Best Investments?

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In the past, financial researchers have examined the stock market performance of companies featured in such magazines and books as *Fortune* and *In Search of Excellence*. These findings, in general, have shown that the stocks of "most admired" or "excellent" companies have either underperformed or performed about the same as the stocks not so considered. The authors use *Business Week*'s list of highly rated growth companies and find evidence of underperformance of these stocks during the post-publication period.

Numerous studies have examined the return performance of growth versus value stocks. Overall, researchers have found that growth stocks tend to underperform value stocks. One explanation for the disappointing performance of growth stocks is the apparent mean reversion in their growth rates. Another explanation is the relatively higher risk associated with value stocks versus growth stocks, which accounts for the relatively lower return of growth stocks versus value stocks. To investigate this issue, the authors evaluate the investment performance of companies listed in "Hot Growth Companies—The 100 Best Small Companies" published annually in *Business Week*.

Unlike previous studies that have examined larger growth companies, the authors focus on smaller growth companies. The sample for the study is generated from 11 consecutive annual surveys of the "best" small corporations as denoted by *Business Week* from 1985 to 1995.

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The companies that were featured more than once in the annual surveys were counted only once. The final sample of 732 companies had median sales of $43.3 million and a median market cap of $67.5 million. In the empirical analysis, the authors compare pre- and post-publication return performance of the sample companies over a three-year window on either side of their publication date in *Business Week*. For benchmarks, the authors use two indexes—the equally weighted CRSP index and the CRSP decile 10 index. For statistical analysis, the authors use paired *t*-tests, Wilcoxon rank-sum tests, and *F*-tests.

During the pre-publication, 36-month-window period, the stocks of "hot growth" companies, on average, produced a total return of 146.83 percent, yielding excess returns of 81.14 percent and 99.49 percent relative to the two CRSP indexes used as benchmarks. Compared with this pre-publication stellar performance, the post-publication 36-month mean total return for the same stocks was 31.86 percent, and the excess returns over the two indexes were negative at –49.68 percent and –16.46 percent. On an annualized basis, the underperformance was 16.56 percent relative to the CRSP equally weighted index and 5.52 percent relative to the CRSP smallest decile index. This evidence is similar to that reported in previous studies based on companies featured in *Fortune* and *In Search of Excellence*. The authors note that the reversal in stock performance could be caused by mean reversion in corporate performance and/or market overreaction that drove the prices of featured stocks to excessively high levels subsequent to publication in *Business Week*.

Analyzing further, the authors divide the sample into quartiles on the basis of *Business Week*'s overall company rankings as well as each company's ranking of past growth rates in sales and earnings, return on investment, price–earnings ratio, and company size. The evidence shows that for the post-publication period, the mean excess returns for all quartiles were uniformly negative. Also, two-tailed *t*-tests revealed no statistically significant differences between the excess returns of companies in Quartile 1 and Quartile 4. Next, the authors examine the differences between pre- and post-publication growth rates and return on investment of sample companies to assess the reason for underperformance during the post-publication period. The findings show that the mean post-publication period sales growth was

22.21 percent, compared with 65.47 percent during the pre-publication period. Mean earnings growth declined to –147.02 percent from 237.86 percent. The mean return on investment also fell to 4.79 percent from a pre-publication high of 14.86 percent. According to two-tailed *t*-tests, the mean differences were found to be highly significant at the 1 percent level. Based on this evidence, mean reversion appears to have occurred in all three measures of performance, which probably led to the observed underperformance of these hot growth stocks during the post-publication period.

In sum, the authors show that investing in stocks subsequent to their appearance in *Business Week*'s "100 Best Small Companies," on average, provides negative excess returns relative to the benchmarks. The authors identify mean reversion of corporate operating performance, overly optimistic growth projections, and the bidding up of the prices of growth stocks to unrealistic levels as potential factors for this underperformance. The authors conclude that "any attempt to find winning investments from a 'hot growth' listing . . . appears futile."

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