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# Explaining Small Size Firm Returns through Growth Premium in Indian Capital Markets : An Empirical Investigation

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**Abstract**

We find that small companies consistently earn higher returns than big companies in the Indian capital market. Also, instead of value premium, as in the US market, there is growth premium that works in the Indian capital market. We use the Fama-French 2006 methodology and find that investors earn growth premium on three out of the four smallest size quintiles, but for the largest size quintile they earn a high value premium. Further, we find that though CAPM is able to explain the value premium in big stocks, it fails to explain the growth premium in small stocks. This study has clear implications for evaluating the performance of managers. An investor should use the market factor, the SBM factor and an alternate form of the HML factor - GMV or Growth min val for evaluating the performance of managers investing in small firm. For evaluating the performance of managers investing in big firms only market factor i.e. CAPM should be used.

## I. Introduction

MARKOWITZ (1952) IS credited with providing a theoretical-based explanation for predicting stock prices. The Capital Asset Pricing Model (CAPM) builds on the model of portfolio choice developed by Harry Markowitz (1952) in order to explain excess stock return by excess market return. Sharpe(1964) and Lintner (1965) jointly developed CAPM, and for years, it remained the standpoint of finance theory. According to CAPM, only one risk factor market beta, i.e., covariance of stock return to market return can explain excess market return. However, soon CAPM started losing its ground on the basis of contrary empirical evidence across different markets (Banz, 1981; Basu, 1977). Fama and French (1993) proposed a three-factor model to explain excess market returns and to solve the CAPM anomaly. They argued that excess return can be explained by market return

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## V. Conclusion

We conclude that small firms consistently earn higher returns than big firms in the Indian capital market. By investing in small firms, an investor can also expect to earn a growth premium,but by investing in big firms the investor can only expect a value premium. This study has clear implications for evaluating the performance of managers. An investor should use the market factor, the SMB factor, and an alternate form of the HML factor - GMV or Growth *minus* Value for evaluating the performance of managers investing in small firms. For evaluating the performance of managers investing in big firms, only the market factor, i.e., CAPM should be used.

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