Small Minus Big (SMB)

By WILL KENTON | Updated Apr 8, 2019

What Does Small Minus Big Mean?

Small minus big (SMB) is one of three factors in the Fama/French stock pricing model. Along with other factors, SMB is used to explain portfolio returns. This factor is also referred to as the "small firm effect," or the "size effect," where size is based on a company's market capitalization.

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Understanding Small Minus Big (SMB)

The Fama/French Three-Factor Model is an extension of the Capital Asset Pricing Model (CAPM). CAPM is a one-factor model, and that factor is the performance of the market as a whole. This factor is known as the market factor. CAPM explains a portfolio's returns in terms of the amount of risk it contains relative to the market. In other words, according to CAPM, the primary explanation for the performance of a portfolio is the performance of the market as a whole.

The Fama/Three-Factor model adds two factors to CAPM. The model essentially says there are two other factors in addition to market performance that consistently contribute to a portfolio's performance. One of the is SMB. In other words, if a portfolio has more small-cap companies in it, it should outperform the market over the long run.

The third factor in the Three-Factor model is High Minus Low (HML). "High" refers to companies with a high book value to market value ratio. "Low'" refers to companies with a low book value to market value ratio. This factor is also referred to as the "value factor" or the "value versus

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The Fama/French model can be used to evaluate a portfolio manager's returns. Essentially, if the portfolio's performance can be attributed to the three factors, then the portfolio manager has not added any value or demonstrated any skill. This is because if the three factors can completely explain the portfolio's performance, then none of the performance can be attributed to the manager's ability. A good portfolio manager should add to a performance by picking good stocks. This outperformance is also known as "alpha."

Researchers have expanded the Three-Factor model in recent years to include other factors. These include "momentum," "quality," and "low volatility," among others.

Related Terms

Understanding High Minus Low (HML)

High Minus Low (HML), also referred to as the value premium, is one of three factors used in the Fama-French three-factor model. more

Fama and French Three Factor Model Definition

The Fama and French Three-Factor model expanded the CAPM to include size risk and value risk to explain differences in diversified portfolio returns. more

Multi-Factor Model Definition

A multi-factor model uses many factors in its computations to explain market phenomena and/or equilibrium asset prices. more

Heteroskedasticity

In statistics, heteroskedasticity happens when the standard deviations of a variable, monitored over a specific amount of time, are nonconstant. more

Jensen's Measure

Jensen's measure, or "Jensen's alpha," indicates the portion of an investment manager's performance that did not have to do with the market. more

Small Value Stock Definition

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