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Small vs. Large Bank Stocks: Which Have the Better Return?

By Justin Lahart
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Too big to fail isn t too good a deal for the shares of small banks, according to a pair of UCLA researchers.

Economists Priyank Gandhiand Hanno Lustiganalyzed the performanceof U.S. bank stocks from 1970 to 2005, comparing the returns generated by the bottom ten percent, by market capitalization, with the returns of the top ten percent. They found that the returns for the large banks were much, much worse. A portfolio that bet on the largest banks and against the smallest banks underperformed a portfolio of nonbank stocks and bonds (with the same risk characteristics) by nearly 8% a year.

That s akin to saying that the large bank stocks tend to be much less attractively priced than their smaller peers. But then again, the large banks have something that the small banks don t: A free insurance policy, courtesy of U.S. taxpayers.

Investors have long been of the view that policymakers would be unwilling to allow large banks to collapse, for fear of what might happen to the financial system. That s a view that seems to have been borne out over the past two years. Since the failure of IndyMacin 2008, over 250 banks have failed, nearly all of them, the economists point out, small by most standards.