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Small-cap stocks riskier but can bring investors quick growth

End of recession traditionally great time for these companies

VIEWPOINT

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As the NCAA champion Maryland Terrapins will attest, it takes more than size to win. Speed, agility and the ability to score in droves can, as much as anything, win games. Portfolio management can be similar. Large-cap stocks, those imposing inside presences, must be a part of the team. But without smaller, speedier performers, don't expect to win big in the long run.

Aside from the alternating tendency of growth- and value-style outperformance, there is a discernable tendency for the groups to outperform one another for long periods of time based solely on market capitalization. Large-cap stocks, generally viewed as companies with market caps of over $6 billion, outperformed other indices from 1984 through 1999. Particularly, the '90s were a period of above-average large-cap growth returns. According to Callan Associates, the S&P/BARRA 500 growth index placed one or two in overall returns among the eight major indices in seven of 10 years. Of course, times change.

According to Salomon Smith Barney's Consulting Group, small caps — usually defined as corporations with market capitalizations of less than $1.5 billion — have yielded inflation-adjusted average annual returns of 13.2 percent since 1950. During that same period, large-cap stocks have yielded similarly adjusted returns of 10.6 percent. And small caps have outperformed major market indices since March 1999. Last year, while the S&P 500 and Nasdaq indices finished down 13.04 and 21 percent respectively, the Russell 2000, an index tracking small-cap stock performance, finished in the black. The Russell 2000 Value index returned more than 14 percent.

Investors would be remiss not to consider the historical data and allocate a portion of their portfolios to small-cap equities.

Small companies are inherently capable of faster growth, manifested in bigger gains for shareholders. This tends to be especially true coming out of recessions, when small and midsize companies are typically the strongest performers. Because of the small-cap companies' higher risk, volatility and diminished access to capital, small-cap valuations tend to be very depressed compared to their large-cap counterparts during recessions. But during recoveries, small-cap valuations recover sharply.

According to Bill Julian, head of Salomon Smith Barney's emerging growth research, a recession's end results in falling volatility, which aides small-cap stocks as investors return to the asset class deemed too risky during the recession. During periods of high volatility, the limited liquidity of small caps is a disadvantage to investors. The result is usually a migration to more liquid large-cap concerns. This trend toward large caps will create a large-cap premium, widening the valuation between large-cap and small-cap stocks.

When volatility subsides, the valuation gap begins to work in favor of small-cap stocks. So investors return. Julian believes the current environment is strikingly similar to the early 90s, where both volatility and the large-cap premium decreased in tandem. Then, the Fed had aggressively eased interest rates, corporate earnings were weak and the economy was in the midst of a recovery. The result? A period of small-cap outperformance.

So what might unfold now?

After the 1970 recession, which has closely resembled the current economic malaise, small-cap stocks bottomed five months after industrial production turned negative. This time it occurred six months later. In both periods, industrial production bottomed 10 months after first turning negative. Each time, that event appeared to mark the recession's conclusion. The markets rallied in anticipation of industrial production's bottom, pausing only as the timing of the recovery became unclear. If the current recovery continues to mirror 1970, industrial production could turn positive during the summer, and a solid small-cap rally could lead the markets higher between now and then.

Following the conclusion of 1973's bear market, U.S. small-cap equities brought nine straight years of double-digit gains, the lowest return being 13.9 percent and the best being 57.4 percent. Throughout, small stocks were the best performing asset class in every year but one.

Through the beginning of April, the Russell 2000 has outpaced the S&P 500 by 373 basis points, nearly 4 percent. Julian expects this to continue through the summer.

The oft-seen Ibboston chart shows that a dollar invested in small stocks in 1925 is worth more than $6,600 today. The same dollar in large caps yields a little more than $2,800.

According to the *Financial Analysts Journal*, nearly 92 percent of long-term portfolio performance comes from asset allocation. Over the long run, a good balance of size, speed and defense wins. Investors, like NCAA teams, work hard to find that proper balance and earn the right to move on. Too many centers, or too many guards, and you might not qualify for post-season play. But the right combination will get you to The Big Dance.

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