

## Are Small Caps' Outsized Gains Over?

### Momentum seems to favor small-cap stocks over their large-cap counterparts.

By Bruce W. Fraser  
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Can David continue to prevail over Goliath? That's the \$64,000 question today as smaller companies in the U.S. stock market continue to lead the charge up from the market's lows in March 2009.

So far, the stars seem to be favoring the little guys despite an anemic recovery, a volatile stock market and the still-unresolved economic crisis in Europe. From the March 2009 market low through July of this year, the Russell 2000 index, the benchmark for small-capitalization stocks, was up 89.04%, far outpacing the S&P 500 index's 62.83% advance for the same period.

Small-cap investors have been amply rewarded. From March 2009 through July 2010, the total cumulative returns of small-cap funds were up a whopping 92.6%, according to fund tracker Lipper Inc. Mid-cap funds didn't do badly either, logging total returns of 81.3%. Large-cap funds returned 63.2% overall.

#### Small Cap's Big Fund Flows

Small caps have topped this year's charts as well. Since the beginning of 2010 through July, small-cap funds notched 4.04% in total returns, according to Lipper data, while mid-cap fund offerings rose 3.39%. By contrast, large-cap funds registered a negative 1.61% on a cumulative basis during that period.

Unsurprisingly, small-cap funds have collected the largest share of new money this year. Through the first seven months of this year, \$16.8 billion in new money poured into small-cap funds, reports Lipper, while \$7.2 billion went into mid-cap funds, and large-cap funds pulled in just \$4.1 billion from investors.

When investors were gaining confidence the economy will dodge a depression, the hardest hit small-cap stocks—some of the ones that earlier seemed most vulnerable—bounced back most. According to experts, however, this is the opposite of what one normally would have expected as the meltdown unfolded, when large-caps should have provided a safety net to cushion investors' losses.

That didn't happen, of course, and confidence in a recovery still remains dicey. "During the meltdown in 2008, investors were surprised that large caps didn't provide the protection that so many had assured that they would," says Jeff Tjornehoj, director of research at Lipper. "The reason was that they were such a large cornerstone in so many portfolios. The 'too-big-to-fail' philosophy hit them pretty hard. They seemed more vulnerable than people appreciated. As a consequence, people looked to small and mid caps to provide the opportunity for gains when the market started to come back."

#### Advisors Favor Small Caps

Can small caps keep the band playing going forward? Some advisors, managers and experts we spoke to believe small caps are overvalued and destined for a pullback. Others hold that the bull market in small caps still has legs.

Among the true believers is Ron Baron, veteran portfolio manager of the no-load Baron Growth Fund, with \$5.2 billion in assets. The fund has a 15-year average yearly performance of 10.93%, putting it in the top 3% of the Morningstar small-cap growth category. The fund has a three-year average turnover rate of 26%, one of the lowest in the industry, according to Morningstar.

Baron sees good opportunities for both small- and mid-cap stocks over the next 15 to 20 years, comparing the current market environment to the 17 years from 1982 to 1999, which he says were "phenomenal years for the market."

Reviewing the market's second-quarter performance this year, Baron says, "The correction in May and June shouldn't have happened. The excuse for it was the BP oil spill, the volcano eruption in Iceland disrupting air transport, the 'flash crash,' and the economic crisis in Europe, all of which conspired and took the stock market down sharply.

"What's happened is that the strongest stocks last year were the most leveraged, the most cyclical, and since then, those businesses that were least leveraged and the least cyclical did better in the second quarter.

"What's also interesting," he continues, "is that right now the Russell indexes for growth stocks are selling at much the same valuations as value stocks. Normally, growth stocks' valuations are much higher. So the less leveraged and cyclical companies are now doing better, and these are all descriptions of small and midsize growth companies. Everywhere you look there are tremendous opportunities."

Steve Salopek, portfolio manager for the ING Small Cap Opportunities Fund, also says the small-cap sector is well positioned at this time, with many companies available at attractive valuations. "Small caps tend to do well in cycles of low to moderate economic growth," he notes. Another factor helping the sector, he says, "is that larger companies have strong balance sheets, and in light of slower economic growth, may look to buy smaller companies as a way to grow their businesses." The ING Small Cap Opportunities Fund is up 7.85% through July 31, and the one-year return through the end of July is 21.96% (for the A shares).

Royce & Associates, which works exclusively with small caps and has \$30 billion under management, is a good proxy for the value investing style in the small-cap world. But at a time when growth investing seems to be in the driver's seat, some of Royce's funds have been hurt by the market's recent downturn. Nine-year-old Royce Value Plus Service, with \$2.9 billion in assets, suffered a second-quarter downturn of 8%, and year to date is up only 0.18%.

Still, the fund has outperformed the Russell 2000 for the five years ended July 31, and since its June 2001 inception, as the fund's manager, James A. "Chip" Skinner III, points out. Skinner is sanguine about the future. "The recent market pullback has created a good environment for finding value and growth in the same security," he says. "More companies have become attractively valued, and we've seen more companies that fit the selection criteria."

David Nadel, manager of the Royce Global Select Fund, sees the market's turbulence as part of the normal rotation cycle between small-cap and large-cap companies, and views it as a buying opportunity. "Typically, we don't put a lot of emphasis on any short-term performance period," says George, an 18-year veteran with Royce. "What we are doing now is trying to take advantage of current conditions with the expectation of generating solid returns over the next three to five years."

On the international front, Nadel sees current opportunities in such markets as Switzerland, Austria, Canada, Germany and South Africa. While the fund has limited exposure in Greece and Italy, "we are beginning to warm up again to the latter, given the prevalence of its strong brands," Nadel says. Outside of Western Europe, Eastern Europe is beginning to look more attractive, as well as parts of the Middle East, he adds.

#### Jeremy Grantham's Challenge To The Market

Not everybody is enthusiastic about small companies, though. In his latest quarterly report, market guru Jeremy Grantham, the chief investment strategist for asset manager GMO and a perennial bear, claims low interest rates, driven by the Federal Reserve and its chairman Ben Bernanke, are encouraging speculators to invest in aggressive investments—specifically lower quality and smaller companies.

Grantham thinks this has reversed the normal pattern. In March 2009, as the stock market rally got under way, small caps should have been inexpensive relative to the S&P 500, he writes. But they weren't.

"The continuing low rates and the Bernanke 'put' have allowed the undertow of speculation or aggressive investing to continue so that, uniquely to this cycle, both lower quality and smaller companies are winning in a down year." Remarkably, he says, both speculative and small stocks that were overpriced on January 1 have beaten the blue chips year to date.

Because of his prescience in predicting the financial crisis, Grantham's views carry a lot of weight. Wealth manager Aaron Skloff, CEO of Skloff Financial Group in Berkeley Heights, N.J., disagrees, however. Skloff maintains Grantham is discounting "the positive impact a U.S recovery will have on smaller companies."

"Many smaller companies derive the majority of their revenue domestically," says Skloff. "Avoiding the meltdown of currencies around the world, including the euro, has enhanced their revenue recovery—particularly since the beginning of 2010. The U.S. is showing the greatest economic recovery of the three developed countries [the U.S., Europe and Japan], further enhancing the prospects for small-cap stocks."

"Furthermore," adds Skloff, "when banks resume lending to smaller companies that have been shut out of the financing loop, the smaller companies will be able to seize business opportunities that have been out of their grasp since the recession began."

Advisors such as Owen Murray, director of investment research at Horizon Advisors LLC, an RIA in Houston managing \$150 million, also see more growth potential today in small caps than they do in large caps. "A problem we run into, however," says Murray, "is that small caps generally have limited capacity. So funds with good managers are typically closed to new investors."

Horizon Advisors uses the Baron Growth Fund, the Royce Pennsylvania Mutual Fund, the Royce Premier Service Fund, the Turner Emerging Growth Fund and the American Century Small Cap Value Fund in its clients' portfolios.

Truepoint Inc., an RIA in Cincinnati that manages \$850 million, is keeping its powder dry in the small-cap space, according to Bradley A. Reed, a CFA and the senior manager of investment advisory services. "Since the small-cap space has performed well relative to the large-cap space recently, we have not been adding to our positions," says Reed.

Reed favors the DFA Targeted Value Fund, which he describes as "passively managed, but not a complete index fund." He also favors its sister vehicle, the DFA Small Cap Value Fund.

Year to date through July, the DFA Targeted Value Fund has returned 6.38%, while for the trailing 12 months it returned 27.14%.

Other advisors believe small-cap stocks are overvalued and have reduced their exposure in the sector. The Trust Company of the South, based in Burlington, N.C., cut back clients' positions in small-cap funds from 15% to 11% earlier this year, and may trim further, says Dan Tolomay, the chief investment officer.

Tolomay is looking for big caps to eventually outshine their smaller brethren. "If economic growth continues to be sluggish," he says, "the industry dominance of large caps should help them to grow earnings in challenging environments. Bigger firms are also more exposed to rapidly growing international markets."

Lewis J. Altfest, the principal of Altfest Personal Wealth Management in New York, with \$600 million under management, cut his firm's small-cap allocations to 6% of clients' portfolios some time ago. "We think there are better opportunities in larger company growth funds at a reasonable price," he says.

Right now, momentum seems to favor small-cap stocks over their large-cap counterparts. Will the pendulum swing back to large caps soon?

"Small caps do seem to have more momentum," says Lipper's Tjornehoj. "I don't expect large-caps to take over soon. There will come a day, but that seems far off to me."

Bruce W. Fraser, a veteran financial writer based in New York, specializes in writing about wealth management, financial planning, investments, small companies, and green environment issues. He is a frequent contributor to Financial Advisor magazine. He may be reached at [frasernyc@aol.com](mailto:frasernyc@aol.com). Visit him at [www.bwfraser.com/home](http://www.bwfraser.com/home).