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Time to Underweight Small-Caps?

Wednesday September 15, 4:48 pm ET

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Recently many market professionals have argued that in U.S. equities, the five-year run of small-cap outperformance has come to an end, and that large-cap stocks are poised to outperform. The implication is that ETF investors should reduce their exposure to small cap funds in favor of large cap ETFs.

Decisions of this nature should be based primarily on valuation analysis of the asset class. We believe it is appropriate to vary the level of exposure to an individual asset class if the data objectively show that the asset class has reached an extreme level of valuation, either on an absolute basis or relative to other asset classes, which represent alternative investment choices. This article examines what the evidence is currently telling us with respect to small-cap U.S. stocks.

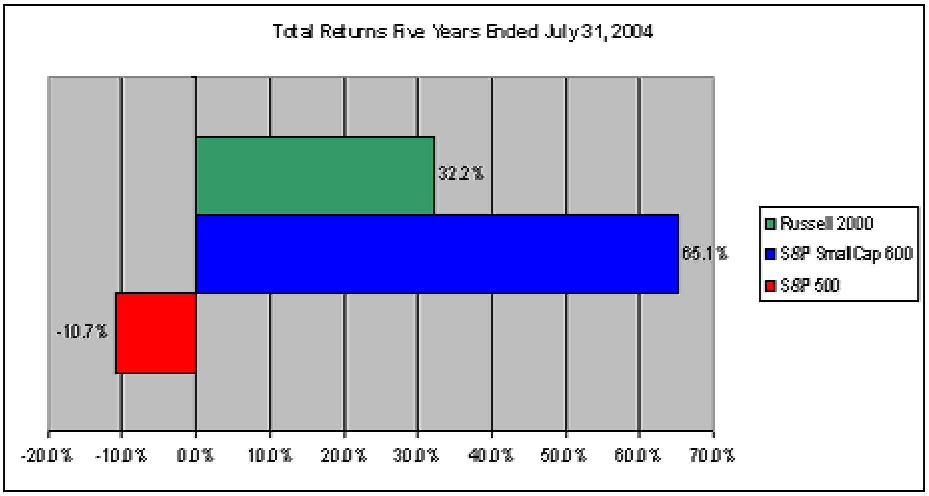
Small cap ETFs include iShares S&P SmallCap 600 Fund (AMEX:IJR - News) and the iShares Russell 2000 Fund (AMEX:IWM - News) as well as others that focus on value or growth sub-segments.

The current reservations about small-caps may stem from the sheer magnitude of their price outperformance over the past five years. As shown in the following table, the annualized returns of small-caps surpass those of large-caps by a wide margin on a one, three and five year basis.

Comparison of Annualized Returns Large Cap U.S. Stocks vs. Small Cap U.S. Stocks				
Asset Class	Index	Annualized Returns Through July 31, 2004 1 Year	3 Years	5 Years
U.S. Large Cap Stocks	S&P 500	13.2%	-1.5%	-2.3%
U.S. Small Cap Stocks	S&P SmallCap 600	21.5%	7.9%	10.6%
U.S. Small Cap Stocks	Russell 2000	17.1%	5.7%	5.7%

*Source: Ibbottson

Small-cap outperformance in recent years becomes even more dramatic when viewed on a total return rather than an annualized return basis. As shown in the next chart, an investment in the S&P SmallCap 600 five years ago would be worth 65% more today, while an investment in the S&P 500 would still be underwater.



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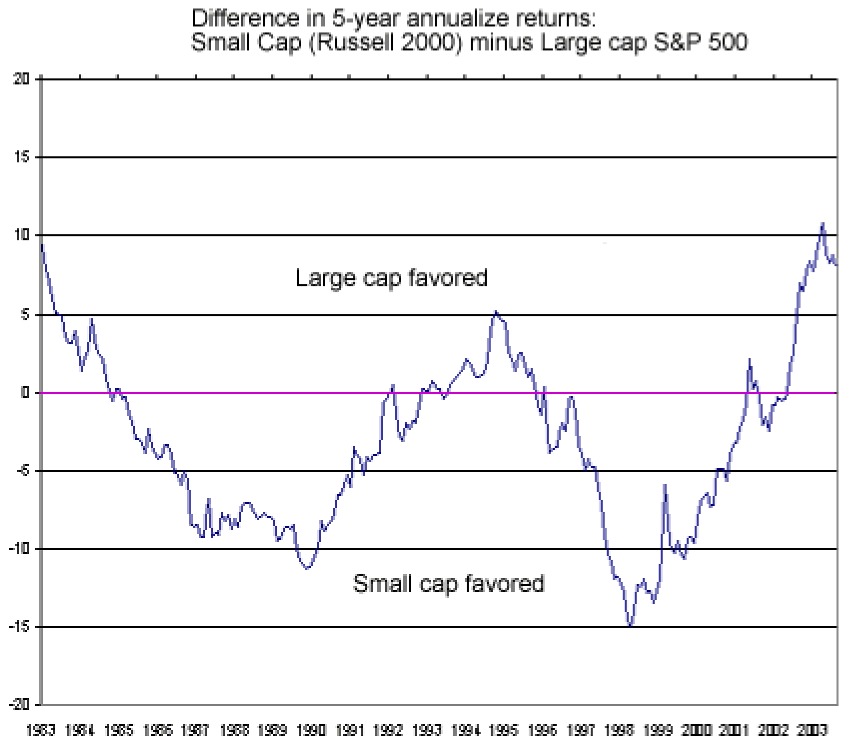
Based on this data, it is tempting to lock in profits on small-caps. Before rushing to the exits, however, it is well to consider that small-caps' recent run may have largely served to offset the long stretch of large-cap outperformance in the late 1990s. As shown in the next table, large caps outpaced small caps by as large a margin in the five years ended June 1999 as small caps have outperformed large caps in the past five years. As a result, on a ten-year basis, the annualized returns of the two asset classes are much closer together.

Comparison of Returns Large Cap U.S. Stocks vs. Small Cap U.S. Stocks				
		Annualized Returns		
Asset Class	Index	5 Years Ended 7/99	5 Years Ended 7/04	10 Years Ended 7/04
U.S. Large Cap Stocks	S&P 500	26.3%	-2.3%	11.1%
U.S. Small Cap Stocks	S&P SmallCap 600	16.1%	10.6%	13.3%
U.S. Small Cap Stocks	Russell 2000	14.4%	5.7%	10.0%

*Source: Ibbotson

Interestingly, the tendency for small-caps and large-caps to have alternating, multi-year periods of outperformance is not confined to the past decade. The next chart compares the difference in rolling five year annualized returns between large and small caps over the past 20 years. Over this longer period of time, four different relative performance cycles of similar duration are evident.



In addition to examining historical price performance, another useful tool to assess the relative attractiveness of these two asset classes is to measure their current valuations in reference to fundamental measures such as earnings, book value, and dividends. The next table presents this information and also shows how current valuation levels compare with valuation levels seen over the past ten years.

Valuation Comparison
Large Cap U.S. Stocks vs. Small Cap U.S. Stocks

Index	Price/ Earnings	Price/ Book	Dividend Yield
S&P 500 (1)	19.74	2.85	1.98%
S&P SmallCap 600 (1)	24.10	2.11	1.03%
Difference	(4.36)	0.74	0.95%
Median Difference (2)	(3.50)	1.10	0.92%
25th Percentile (Small Cap Overvalued) (2)	(8.02)	0.77	0.65%
75th Percentile (Small Cap Undervalued) (2)	2.01	1.85	1.14%

Source: Barra.com
(1) As of 8/31/04
(2) Data from 12/93-8/04

Based on the P/E and dividend yield data, the current "spread," or difference, between small-caps and large-caps is close to the median spread since 1994. Only the price-to-book data, where the current difference in P/B multiples is substantially less than the average spread over the past 10 years, suggests that small-caps are overvalued relative to large-caps.

So what is our conclusion based on all of the data presented above? The weight of the evidence suggests that the recent phase of small-cap outperformance is likely at or near an end. However, it does not appear that small-caps are extremely overvalued relative to large-caps. Small-caps' strong outperformance over the past five years appears to have been in large part a reaction to large-caps' unprecedented string of five consecutive years of 20%+ returns in the late 1990s. Accordingly, while it may be appropriate to underweight small-caps in an asset allocation, as of September 10, 2004, there does not appear to be sufficient justification to exit the asset class entirely.

J.D. Steinhilber is the founder of AgileInvesting.com, an investment advisory web site that recommends ETF-based portfolios.

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