

# The small-large cap cycle and other matters



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A glance at recent history shows that the relative performance of large- to small-cap stocks runs in cycles.

Of late, it has been the small caps that have shone. From the start of 2000 until 30 September 2005, US small caps returned 11.3% p.a. versus a minus 0.1% p.a. for their large cap counterparts. In Europe and the UK over the past three years or so, small caps outperformed their larger brethren by nearly 50% and about 20% respectively.

Six years previously, US large caps dominated investment returns. From 1994-1999, US large caps returned 23.9% p.a. versus 11.8% p.a. for small caps.

The interest in this analysis for share managers is that by analysing the economic situation when small caps outperformed (and vice versa) and then studying today's economic backdrop, they can predict with more certainty whether small or large caps will outperform in the near future.

So what, in general, was happening with the economic cycle when small caps did well in spurts over the past 25 years?

The results would show that small caps typically outperformed when an economy was coming out of a recession and entering a period of strong growth. During such times, consumer spending and housing prices were usually rising. In short, small caps did well when the economy started to thrive.

So, will today's US economy favour small or large caps? The latter it seems, if history is any guide.

The US economy now is one where the Federal Reserve has boosted the cash rate in 11 steps from 1% to 3.75% to slow the surge in housing prices, which prompted consumers to spend more.

And US real-estate prices appear to be peaking. Homes in the US are taking longer to sell and lumber prices have fallen 30% in the past five months or so (housing-price declines tend to follow six months after).

If what happened after house prices in the UK and Australia stalled recently is any indication, then consumer confidence and retail sales will struggle because people will feel poorer once home prices are struggling. The slowdown in consumer spending is expected to be magnified by soaring petrol prices which trims peoples' discretionary income.

As past analysis shows, any slowing in retail spending is likely to be especially felt in the economically sensitive small-cap asset class.

## **Think large and growth**

So the economic cycle tells us it doesn't seem a good time to go overweight US small caps. This decision is reinforced when you see that US small caps are trading near record premiums to large caps.



In recent months, US small caps have traded at 15.7% premium to large caps yet are forecasted to have zero growth in earnings in 2005 versus 19% for large caps. In the UK, small caps are now trading at a 15.6% premium to large caps on 2005 earnings, yet are only expected to see earnings growth of just 4.3% compared with 7.5% for large caps. European small caps have 2005 forward estimates of zero earnings growth compared with 8.5% for large caps.

US small caps will be under pressure if overall corporate margins narrow because they are more vulnerable to even modest disappointments in earnings.

In a slowing economic environment, and especially when equity markets are weaker, large caps generally offer better and more diversified returns. These companies usually generate sales in multiple markets and regions, thereby spreading their economic risk.

As well as favouring large caps, Perennial International also thinks it may be time to prefer growth to value stocks, which have done better over the past four years or so.

The excess valuations found at the late 1990s after five years of growth outperforming have been more than corrected. Quality companies with strong growth characteristics and high cash-flow returns can be bought today at valuations comparable with those of average companies.

Take Microsoft Corp. as an example. This high quality growth company is launching an unprecedented rollout of software products within the next 18 months: X-box, a new Office suite and its new operating system Longhorn. Yet in September the stock was trading at a 48% discount to its 10-year average even though it has a 12% long-term growth rate.

So with the global economy likely to slow in 2006 especially if oil stays around US\$60 a barrel as it was in early October, Perennial International thinks it's time to re-evaluate weightings to global large-cap growth stocks to ensure a more diversified return from international-share portfolios.

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