

## **Does Small Cap Investing Still Make Sense?**

During calendar year 1998 and the first quarter of 1999 the performance of broadly diversified portfolios suffered by comparison to the Standard and Poor's 500 Stock Index. This is not unusual. This should happen every time the Standard and Poor's 500 has above-average performance. However, this period was unusual in terms of the magnitude of the difference. The magnitude of the difference was unusual due in large part to the fact that small cap stocks under-performed large cap stocks by 35%. There has been only one other year since 1925 in which small cap under-performed large cap by more than 30%; that was 1929!

In the first quarter of 1999, small cap stocks under-performed large cap by another 13%. Small cap has lagged large cap by close to 50% over the last 15 months!

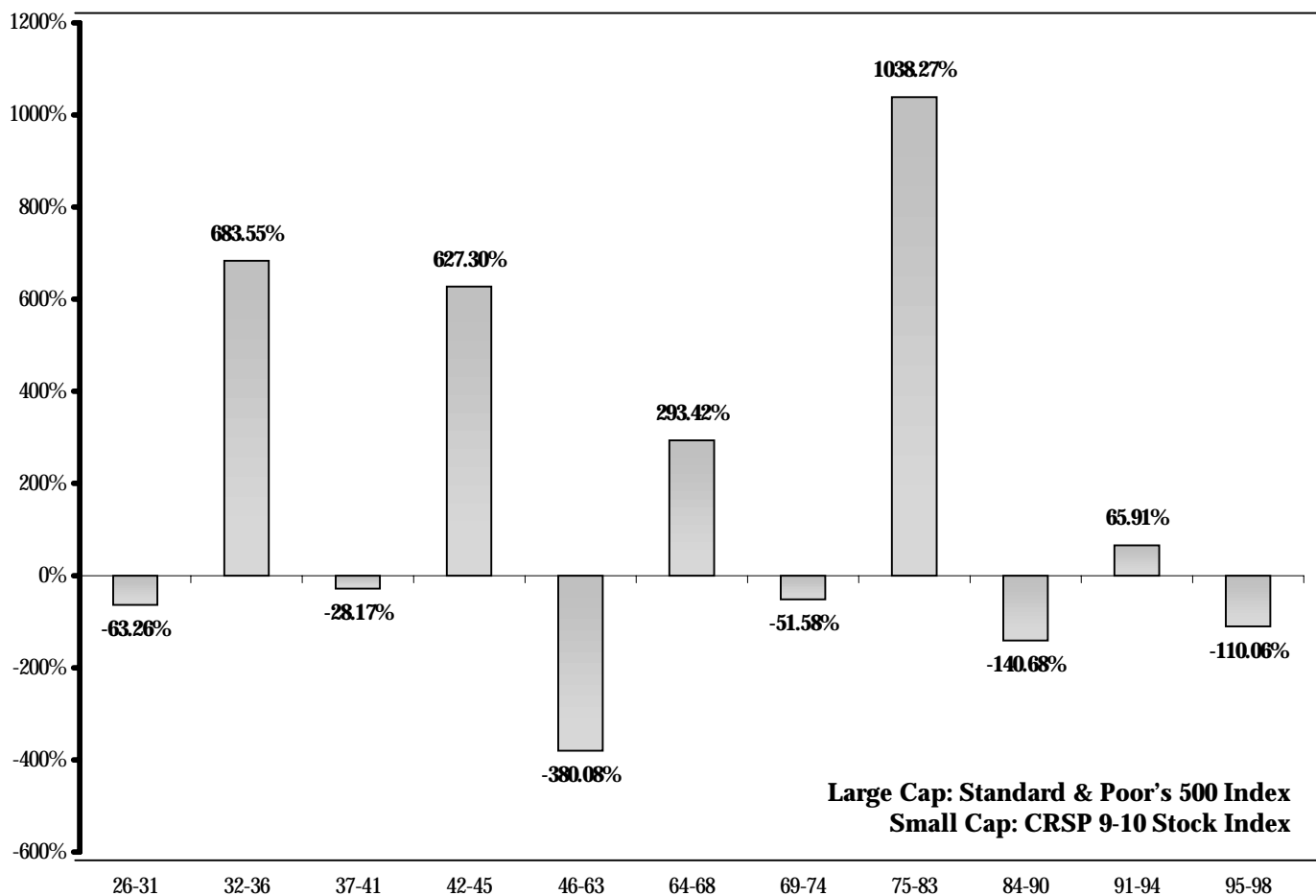
The question now is what should we do about it. The disparity between globally diversified portfolios and the S&P 500 stock index has caused us to reconsider our global strategy. While there is nothing we can do about the past, we must go forward and make decisions that will maximize the probability that we will have good performance in the future. So the question is: should we continue to invest in small cap stocks? Or better yet, will small cap stocks have better performance than large cap stocks in the future?

Nobody knows the answer to question number two – will small cap stocks have better performance than large cap stocks. But by the same token, nobody knows the answer to the converse of question number two - will large cap have better performance than small cap? Therefore the answer to question number one - should we continue to invest in small cap stocks? – is a matter of placing hedged bets in the face of uncertainty.

So does the fact that large cap stocks have beat small cap by 50% over the past 15 months and 110% over the past 51 months mean that small cap stocks no longer offer attractive investment possibilities? It is very tempting to abandon small cap stocks in favor of large and chase the extraordinary returns that have been achieved there.

However, were we reviewing this decision in early 1984, we would have faced the mirror image of the quandary that now frustrates us. Small cap stocks beat large cap every year from 1975 through 1983. Investors who excluded large cap at that time excluded the best performing asset class from 1984 through present. The following chart shows the divergence between small cap and large cap stock performance for various periods between 1926 and 1998.

## Cumulative Total Return Advantage of Small Cap Over Large Cap for Various Periods from 1926 through 1998



Does that mean that the run for large cap will end and small cap will take over soon just as the run for small ended in 1984 and large took over? Not necessarily, but it does mean that a few bad years do not erase the case for small cap. The same people who were chasing the hot small cap stocks in the 80's are probably chasing the large cap stocks now. Even if they got into these areas in time to catch some of the return, most of them probably had disappointing overall results.

A long-term investment strategy is built out of decades of investment results. A short period of unusual results does not have a meaningful impact on the long-term data. Admittedly, it has a significant impact on short-term results, but even that significance will fade in time. The stock market crash of 1987 was an extraordinarily significant event at the time, but now it is merely an historic blip. So, too, will the small cap divergence of the late 90's seem insignificant a decade from now.