

Giants or Dwarves?

"If I have seen further it is by standing on the shoulders of Giants." - Isaac Newton

"If I have not seen as far as others, it is because giants were standing on my shoulders." - Hal Abelson, professor of computer science and engineering

"If I have seen farther than others, it is because I have been surrounded by dwarves." - attributed to Murray Gell-Mann, professor of physics

You do not have to be able to see very far to know that certain investors have done well in the past few years by standing on the shoulders of dwarves. Over the six calendar years through 2005, the Standard & Poor's 500 index of large company stocks lost more than six percent, while the Russell 2000 index of small company stocks earned over 43 percent. The Russell 2000 index hit an all-time high this May, while large stocks are still far short of the highs they hit in 2000. Last year was the first year since 1998 that large stocks had a (slightly) better performance than small stocks, after six straight years of small company stocks beating large company stocks.

Investors have noticed and poured new money into small company stocks. As usual in investing, money follows past performance. Should you join the flight from giants to pursue dwarves? At Sigma, we tilted client portfolios towards small company stocks for many years. Despite their current popularity, however, we do not believe the run of superior small company stock performance will continue. Why?

First, consider valuation – always a good starting point for analyzing investments. Over almost three decades, the Russell 2000 index of small company stocks has, on average, sold at roughly the same forward price/earnings ratio as the Russell 1000 index of large company stocks. The late 1990s were not kind to small stocks, though, and they sold at a discount of more than 20 percent relative to large stocks. At the end of May 2006, however, small stocks were selling at a 16 percent relative premium. The bull market in small company stocks versus large company stocks has made them expensive.

A second problem for smaller companies is interest rates. Ned Davis Research, Inc. has calculated the performance of both large and small company stocks following the six times since the mid-1920s that the Federal Reserve has increased the discount rate to six percent. On average, such a rise has been bad news for smaller stocks in the following three and six month periods. The Federal Reserve hiked the discount rate to six percent in early May.

“We live forward, but we only think backward.”
~ Soren Kierkegaard

Finally, small company stocks are overdue for a correction after their multi-year winning performance. The pendulum swings both ways. We believe that investor demand, not business fundamentals, was the primary driver of the good performance by small

stocks in late 2005 and early 2006. The Russell 2000 index represents only about a tenth of the total U.S. stock market capitalization. Into this small pool, investors have dumped buckets of new investment money. Small company managers have used the new money to bid up the prices of the stocks. Many experienced small company managers have reacted to this deluge by not accepting new investments. Of the managers still accepting money, we are skeptical that they can continue their hot performance with the much larger amount of money they are now managing.

A warning about investing based on logic, however – it can be emotionally trying in the short-run. Small stocks were cheap at the end of 1997, but it did not matter. In 1998, the Russell 2000 index fell two percent while the S&P 500 index rose over 28 percent. This had nothing to do with reality – in terms of business fundamentals, small companies were doing better than large companies. With a 30 percent gap in stock market returns, though, you can talk logic all you want, but it will likely fall upon deaf ears. Most investors ignored relative valuations then and joined the crowd throwing money at large company stocks, only to miss the big bull move by small company stocks that was just starting.

Investors expect the market dwarves to continue to produce giant returns. As usual, investors are extrapolating the past into the future, assuming that tomorrow will always be like today. We are perhaps not as smart as those quoted at the beginning of this newsletter (certainly not the first), but if you would like help from a firm trying to think forward rather than backward, call us at 503-419-3938 or check us on the web at www.sigmainvestment.com.