Will Small-Cap Stocks Lead the Way Back?

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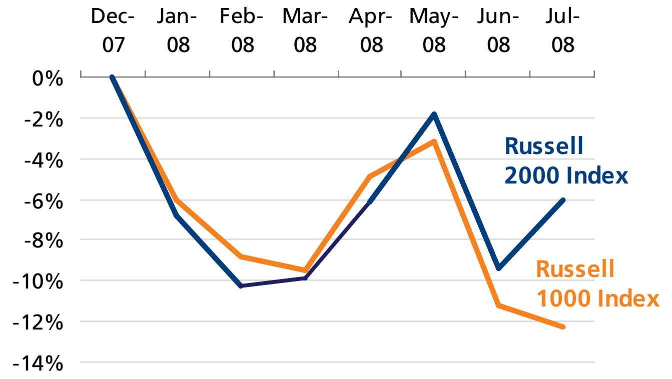
Given the recent downward revisions of U.S. real GDP growth for both fourth quarter 2007 and first quarter 2008, there seems little doubt that we will see a recession declaration some time in the near future, and indeed, some pundits suggest that the National Bureau of Economic Research will declare a recession soon after the November election. But as the experts ponder the technicalities, the fact is that for both U.S. industry and consumers alike, it sure feels like a recession. This is particularly so for small-cap stocks, as the everyday stresses of consumer sentiment, supply of credit and availability of free cash flow governs their success. Because of this greater exposure to domestic markets, during the first half of a recession, when investors often move to the relative safety of blue-chip stocks, small-cap stocks tend to be the hardest hit. Indeed, so far this year the market saw small-cap declines in excess of large-caps until the end of May.

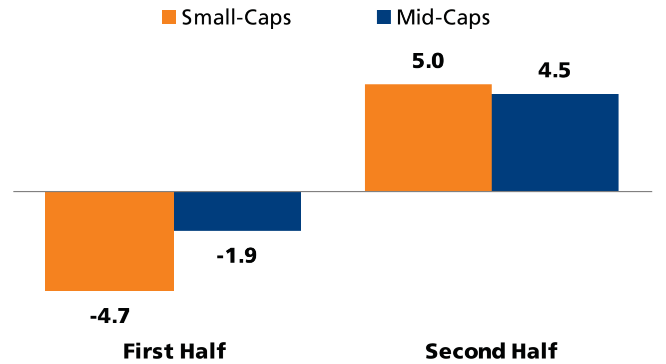
Monthly performance of Russell 2000 vs. Russell 1000 Index



Source: Frank Russell Company

While institutional investors tend to avoid market timing in favor of a diversified allocation approach, the current market turmoil has caused many pension funds to review the effectiveness of their allocations. Some are adding alternatives for return enhancement or, for the few that are fully funded, to reduce risk. Some are reducing domestic market bias, and many are changing the ratio between fixed income and equity. Perhaps the decision of whether or not to stay allocated or make a first allocation to small-cap stocks is less about benchmark performance than manager approach. History provides ample evidence that just as they will underperform in the first half of a recession, small-cap stocks will outperform in the second half of a recession on the back of rising consumer optimism.

Small- and mid-cap stocks lag during the first half of a recession, relative to large-caps



Source: Merril Lynch; Center for Research in Security Prices, University of Chicago Graduate School of Business

So, for pension funds reworking their allocations, even if a small-cap allocation can be assumed as part of a well-diversified portfolio, a couple of questions arise: Given significant market turbulence and no clear idea whether a recession will be short or protracted, is there a way for an active manager to smooth some of the turbulence and enable a fund to come out the other side with excess return? Then there's the question of value vs. growth. History suggests that value will do better in the first half of a recession and growth will do better on the way out, and certainly there is historical evidence that value holds up better overall in a downturn — will that be the case in 2008/09? And finally, if this is officially a recession, then what everyone wants to know is when will we know that it is over?

First, let's consider excess return. It is understood that small-cap stocks are more risky than large-cap stocks, and they produce higher returns accordingly. However, in times like these there is considerable opportunity for an active manager to minimize risk through bottom-up stock selection. Here are a few ideas:

Look at the financials of individual companies — This is the time when fundamental research pays off. While whole sectors might be flailing (as is the case with financials at the moment) strong fundamental research will allow discovery of a few specific stock positions that are well-placed to ride out the turbulence. A small-cap manager needs the research capabilities to identify companies with strong balance sheets, solid capitalization and minimal leverage. For instance, in the small-cap banking sector, mutual holding banks with strong deposit generation are good examples of a solid fundamental research opportunity.

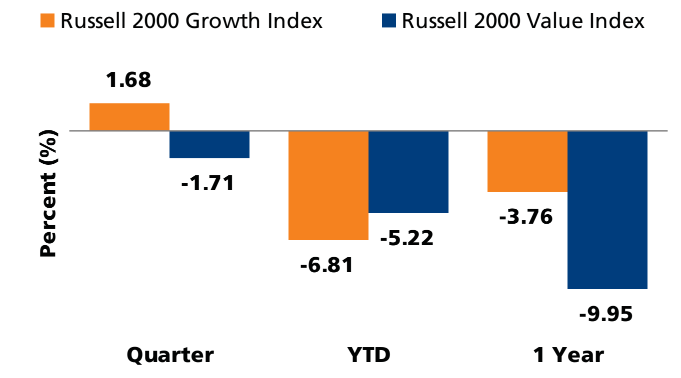
Ensure ongoing access to capital — This is extremely important to companies in today's environment because, as a recession deepens, capital will be pulled away, seriously impeding a company's ability to grow. Therefore, well-capitalized companies have a better chance of riding out a crisis. We get nervous when cash as a percentage of market capitalization drops below 10%. In many companies where balance sheets are strong, with high cash balances (over 15%) and low debt levels, we are seeing high cash flow growth, and, even though the companies that were most highly levered during the private equity heyday have now left the market, we are still seeing significant bifurcation of companies in relation to their debt levels.

Consider valuation — In this market more than a PE ratio is needed to make a forward growth estimate, especially given that the forward PE data is notoriously incomplete and over 200 small-cap companies offer no PE estimates at all. Price to book and price to sales are significantly more important, and these and other metrics need to be applied not just to specific companies, but to their competitors and the other important companies along their distribution channel.

Avoid sector bets — One area where small-cap managers can get into trouble is with large sector bets. In this environment, sector bets can change quickly and overweight positions, which appeared to be paying off in the short-term, drop precipitously once the over-zealous market bet is identified as lacking fundamental strength. Similarly, conventional wisdom for this environment might be that a defensive position in health care would be a good choice; after all, people always get sick. However, a closer review of this sector shows that tight credit will cause spending cuts and increased patient defaults in small hospitals. So in this market, where valuations tend to become compressed, investors will find pockets of opportunity by focusing on underlying company fundamentals rather than depending on past history or macro sector themes.

This logic also applies to growth vs. value. While there is a place for both styles in a well-diversified allocation, there is no reason to assume that value will outperform growth overall in this environment simply because it has in the past. Given the 34% weight for the financial sector in the Russell 2000 Value Index and the current distress in this sector, it is not surprising that valuations are currently much more attractive for growth stocks vs. their value counterparts, and earnings as well have held up better for growth stocks.

Value vs. Growth performance (as of 7/31/08)



Source: Frank Russell Company

Which brings us to our final question: When will it be over? Certainly, no one will hold up a sign when the recession is over, or tell us when it is safe to get back in the water, and as we have already seen, basing our expectations on past history can sometimes be deceiving. For example, after the dip in March we saw a significant recovery and much speculation whether this was the small-cap up-tick that would lead us into the second half and eventually out of the recession. However, the March gains turned out to be short-lived, and were generally attributed to the short-term benefit of the government's tax rebates and the Fed rate cuts rather anything sustainable. So, whether the recession will go on to be "W" shaped or prolonged, few dare to speculate. Typically, the end of the recession is when the Fed, seeing no further need to buoy the economy, stops cutting interest rates. And yet today, the threat of rising inflation weighing against the need for credit remediation suggests that, although the Fed seems to have stopped cutting rates, the economy is not going anywhere in a hurry.

While none of us has the proverbial crystal ball, and many things suggest that this downturn is different from past events, in a certain way it is not. Markets are cyclical and no matter how much we like the good times, the market needs downturns to identify companies with unsustainable business models. Those who have spent many years in the market know that, despite its inherent difficulties, downturns or even recessions present some of the market's best opportunities to make money. So, this is a market to beware of generalizations and keep an eye on the details, especially on your small-cap stocks; they are the barometer of consumer sentiment…and just as small-caps epitomize the markets' woes at the beginning of a recession, they will offer the first sign of the light at the end of the tunnel.