Good Things Come in Small Packages

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For many stock market investors, the first few years of the twenty-first century brought short-term pain and suffering. After a record bull market that produced 20%+ annual gains in the latter half of the Nineties, the first year of the new century ushered in a bear market that few expected. After a market plunge from 2000 through the end of 2002, many investors gave up and moved to conservative alternatives. Record cash flows into equity mutual funds in the first quarter of 2000 and out of equity mutual funds in the third quarter of 2002 reflected the short-term perspective of many investors. Then, as might be expected, a new bull market began in 2003 anticipating the implementation of President Bush's second major tax cut. The subsequent war in Iraq and run up in oil prices stymied the stock market advance and many market pundits proclaimed that the "market" was in a trading range and was unlikely to go higher in the near future. Does this story sound familiar? Well, it's not the whole story.

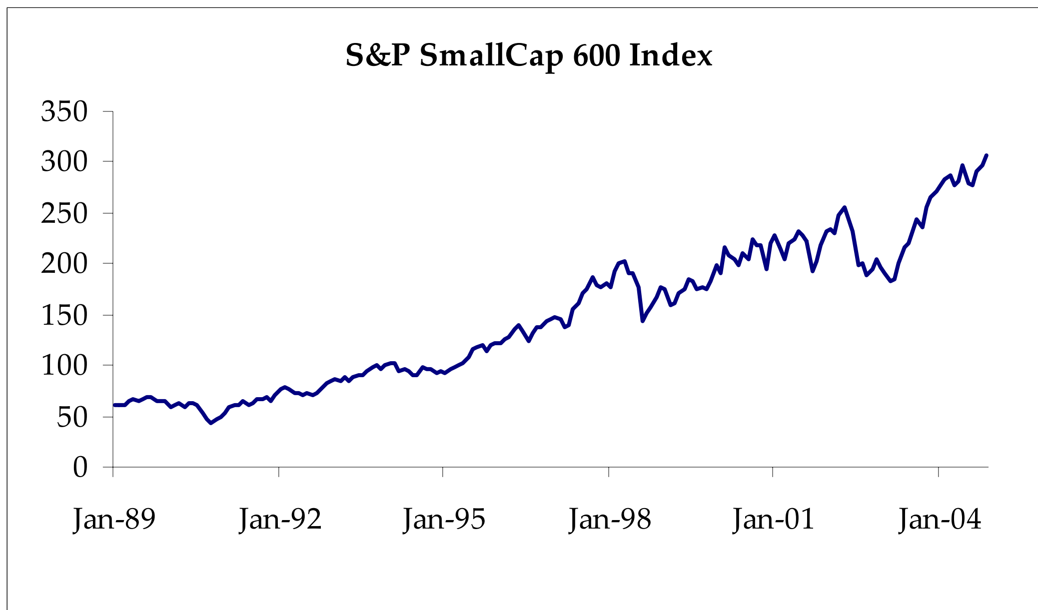
For most investors, the "market" is the S&P 500, an array of stocks that is ranked by total market value and whose performance is weighted by this market value. For most institutional investors, this is the only equity game that can be played because of the sheer weight of portfolio assets that must be invested in the market. The broad acceptance of index investing, i.e. passively buying mutual funds of stocks based on their market capitalization, may have something to do with leading people to believe that the stock market is in a wide trading range, given the performance of the grand daddy of all indices, the S&P 500.

Fortunately, the performance of the S&P 500 is only one interpretation of what the "market" is doing. I would like to rely on some of Larry Kudlow's economic analysis to justify the selection of another viable "market" index that tells a different story. During the recent presidential campaign when candidate Kerry's proposal to raise taxes on people earning over $200,000 a year, Larry pointed out that these so-called rich people were actually the people who were creating most of the jobs in this country. In other words, the real growth was taking place among small companies, not

large ones. If this analysis is correct then there should be another measure of stock market performance that gives us a different picture of what is really happening out there. Fortunately, there is such a measure.

The following chart tracks the performance of the S&P Small Cap 600 index. According to S&P, this index "was introduced in 1994 and is fast becoming the preferred small-cap index in the U.S. covering approximately 3% of the domestic equities market." As of September, the S&P Small Cap 600 consisted of 600 companies with an average market capitalization of $770 million. A careful analysis of this index reveals that we have been in a bull market as the recent price of this benchmark is at all-time highs. Statistically speaking, the index is up 10.6% year to date, 16.8% for the past year, 14.5% annually for the last three years and 12.0% for the past five years, as of October 31st (Exhibit #1). The index also tracks a long-term bullish trend, one that technicians will tell you forecasts continued good times for small cap stocks.

Exhibit #1



Using the S&P 500 index as the measure of the market's performance, traditional market pundits are wringing their hands over the expectation for a continuing range bound market. For the big institutions that are forced to

manage equity assets using large cap stocks, they are worrying as well. On the other hand, the investor who pays attention to Larry's economic analysis may very well find that investing in the small cap stock universe can provide bull market returns while the big cap stocks languish in a broad trading range.

The story that smaller is better is also reflected in a comparison between the standard-weighted index benchmark, the S&P 500 index with the unweighted S&P 500 index. Since the index is "weighted" by the market capitalization of the companies in the index, the performance of the largest companies far outweighs the performance of the smaller companies. To the best of my knowledge, there are virtually no equal weighted index funds or products because it would be difficult to invest sizeable sums of money equally across the benchmark since this strategy would require almost constant rebalancing. Since the beginning of 2000, the performance of the equal weighted index has been substantially better than the weighted index (Exhibit #2). The equal weighted index is hitting new all-time highs while the weighted index is still well below the all-time records set in early 2000. In other words, small capitalization stocks have done substantially better than large capitalization stocks since the beginning of the twenty-first century. When you compare the returns of smaller stocks going back five years (Exhibit #3), the out-performance is remarkable. Like I said, good things come in small packages. (For the record, past performance is no guarantee of future results.)

Exhibit #2

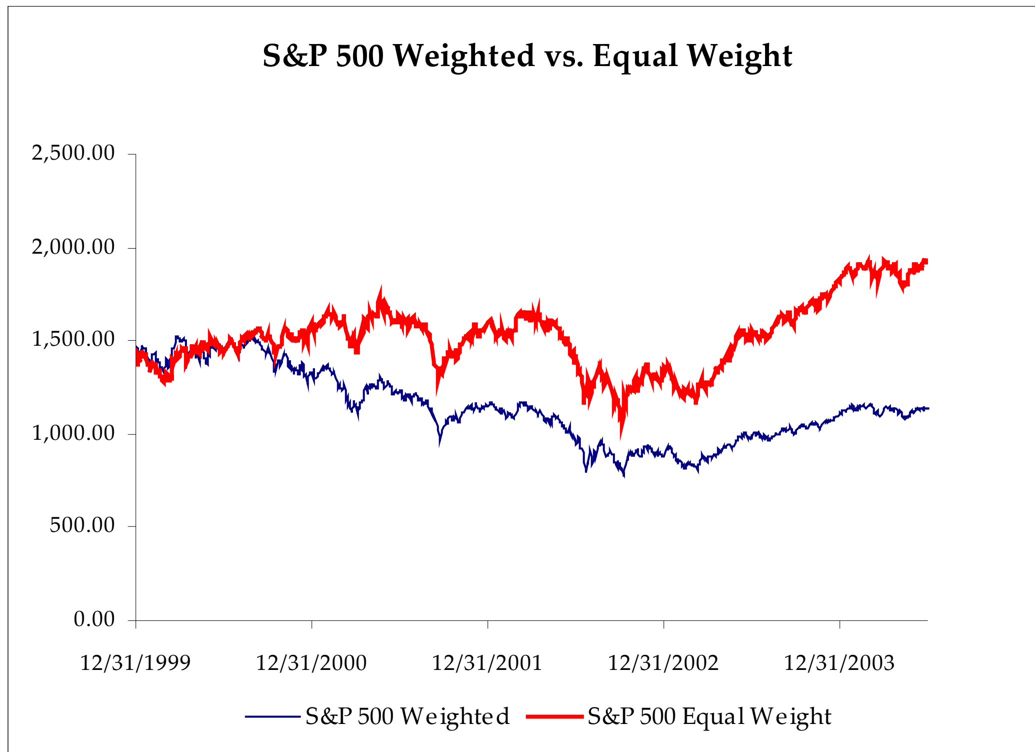


Exhibit #3

Comparative Performance through 10/29/04 (Multi-year data is annualized):

	YTD	**1 Yr.**	**3 Yr**	**5 Yr**
S&P 500	3.1%	9.4%	3.9%	-2.2%
S&P 500 Equal Weight	6.6%	14.5%	11.5%	7.0%
S&P MidCap 400	5.5%	11.0%	11.4%	9.8%
S&P SmallCap 600	10.6%	16.8%	14.5%	12.0%

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