The Tortoise and The Hare: An Update

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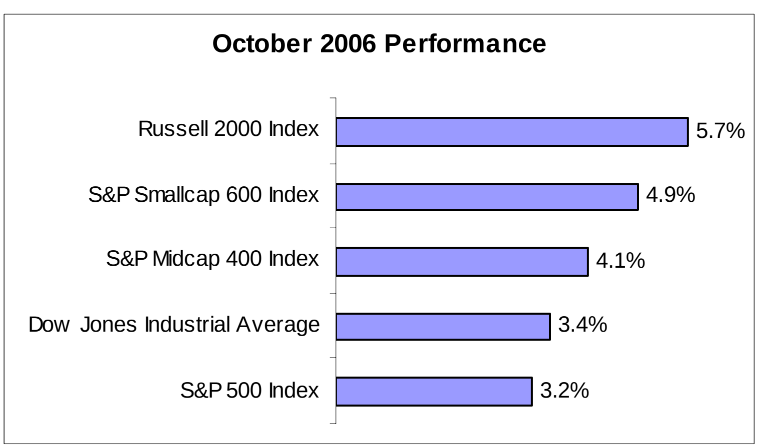
When the Dow Jones industrial average of just thirty large-capitalization stocks hit new highs above 12,000 recently, market pundits jumped on the bandwagon of predicting better large-cap stock performance. Over the past five years ended September 30th, small and mid-cap stocks outperformed the commonly used equity benchmark, the S&P 500 index. The cumulative returns were 102% for the S&P SmallCap 600, 85% for the S&P MidCap 400 and only 40% for the S&P 500. In other words, traditional index fund investors would have to experience more than a 150% increase in value just to catch up to the performance of the S&P SmallCap Index. As a result, the theory that you can't beat the index fell into disrepute as institutional managers who invested in mid-cap and small-cap stocks handily outperformed their large-cap brethren. The spurt to new highs in the DJIA gave many institutional investors, who had been stuck in the large-cap tortoises, new hope that the tide was changing. Then along came October.

While a one-month measure of investment performance does not make a trend, it can signal that there is still life left in the mid and small-cap stock universes. The Russell 2000 index, the benchmark for small-cap stocks, jumped almost six percent for the month almost doubling the 3% rise in both the S&P 500 index and the Dow Jones industrial average. The S&P SmallCap index surged almost 5% and the S&P MidCap 400 index also performed well with a gain of 4%.

Exhibit #1



Is there a fundamental reason why large-cap stocks, as a group, could continue to under perform other indices? The answer is yes —earnings growth. Most market observers will agree that earnings growth is the primary driver of stock prices. Standard & Poor's publishes the earnings for the indices that they have constructed facilitating comparisons among these indices from a fundamental perspective. The preliminary earnings estimates for this year and the estimated earnings for next year can be helpful in assessing the potential for these indices. The latest comparison of earnings for large, medium and small companies forecasts continued underperformance for large-cap stocks.

In 2004 and 2005, small-cap stock earnings growth easily beat the earnings growth of large-cap stocks. For 2006, preliminary earnings expectations indicate that both mid-size and small-size capitalization companies could outperform large capitalization stocks (see exhibit #2). Again in 2007, estimated earnings suggest that we will see a repeat of 2006. These changes are even more significant when they are measured on a cumulative basis.

Exhibit #2

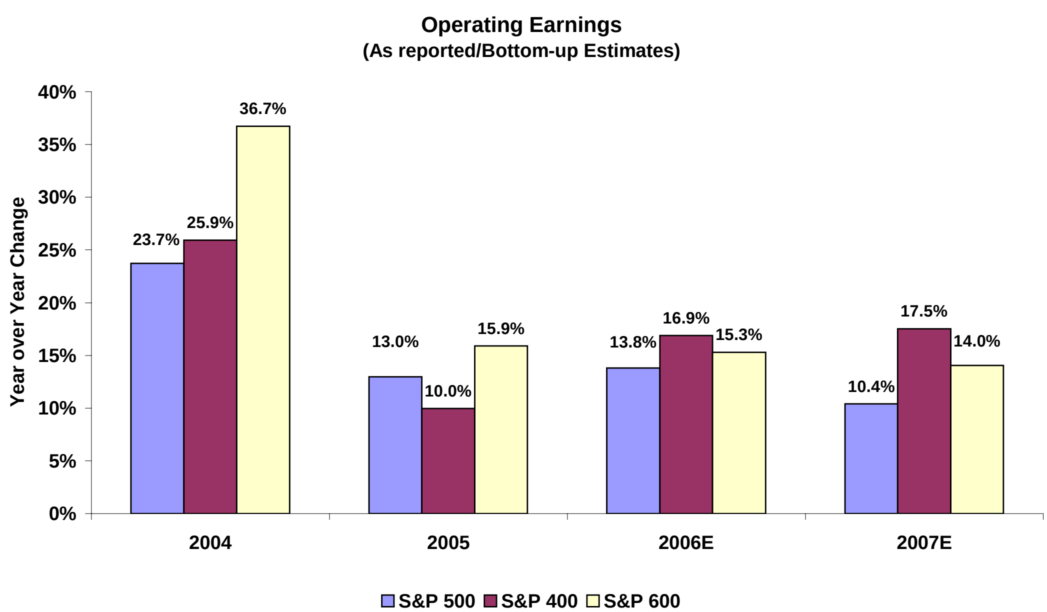


Exhibit #3 represents the cumulative growth in earnings for these three indices both actual and expected from 2004 through the end of 2007. The comparison reflects the superior fundamental attraction of the small-cap universe.

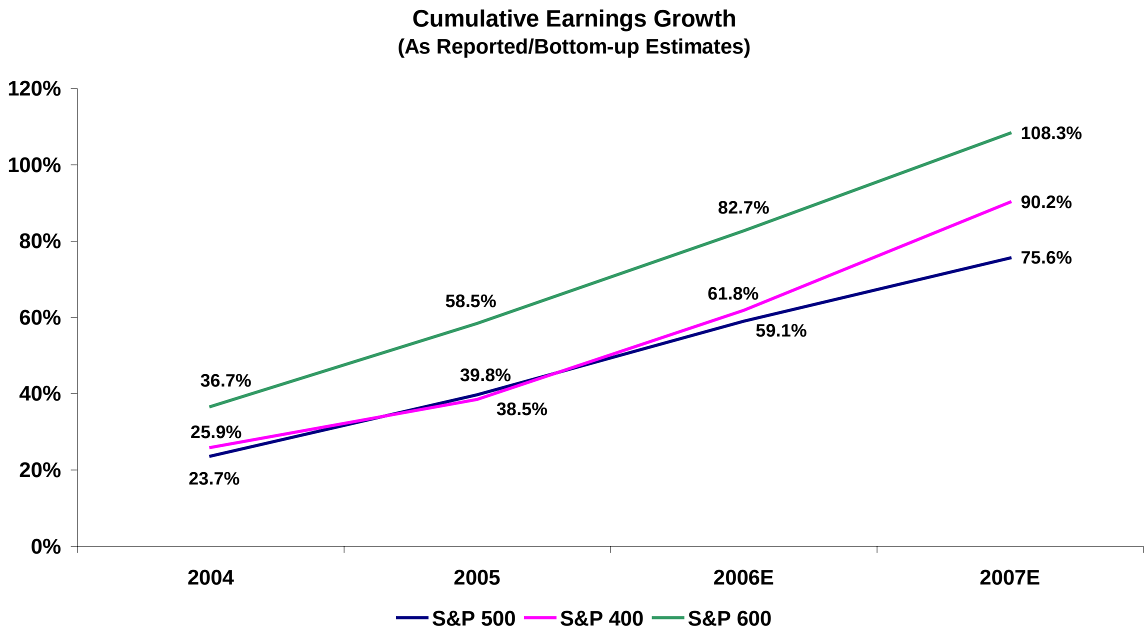


Exhibit #3

Another important factor contributing to small company attraction is the possibility that many of the growth companies in the small capitalization category will be acquisition candidates for cash rich companies. Investors owning small cap companies may find their portfolios benefiting from the takeover of one or more of their holdings at a sizeable premium over the current price of these stocks.

Investors who have been rewarded by owning small and mid-capitalization companies should have confidence that their investments will continue to do well. Institutional investors who are limited to investing in large-cap stocks may be surprised to see that the small-cap hare continues to outperform the large-cap tortoise.

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