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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- The Russell 2000 is the generally accepted benchmark of small stock performance
- There is virtually no relationship between stock market returns from one year to the next.

The Importance of Small Cap Stocks

Asset diversity should be the objective of any investment strategy. There is little dispute here. The real dilemma is determining the components of a diversified portfolio. Which assets should be included in a portfolio to achieve the best return for the desired amount of risk? This article will address a subset of that problem: How does one achieve efficient returns from domestic equities?

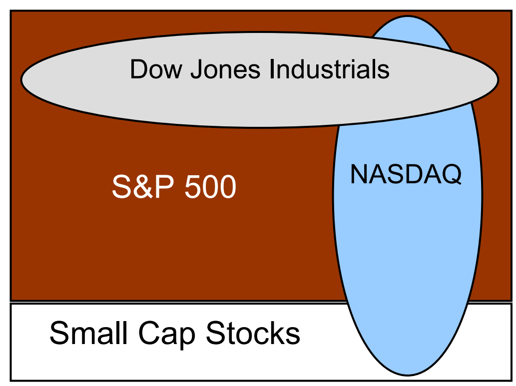
Every day, financial news networks report the results of the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite Index. Despite their popularity, none of these indices represent an efficient investment in the US equity markets.

The NASDAQ began trading only 30 years ago and gained prominence in the late 1990s with the emergence of numerous hi-tech stocks within its membership. Despite some recent rebalancing by the NASD, nearly two thirds of its market capitalization remains in technology. It does not represent the domestic market as a whole and is substantially more volatile.

The Dow Jones average is comprised of 30 stocks chosen to fairly represent the major industries driving the US economy. There are no rigorous criteria for inclusion, Dow Jones makes reasonable selections but 30 stocks cannot capture all the drivers of value in today's marketplace. The 30 stocks currently selected have an aggregate market capitalization of only $2.9 trillion. The entire US market trades at a market capitalization of $10.5 trillion. Consequently, the Dow Jones Industrial average doesn't correlate highly with overall market movement.

More promising is the S&P 500. It is composed of roughly the 500 largest stocks in the US market. That amounts to 80% of the aggregate domestic market by tradable value and includes almost all of the major public companies. It is a reasonable proxy for domestic investing and is superior to most portfolios of retail investors. By custom, smaller stocks are omitted from its consideration.

All the foregoing indices lack representation of small cap stocks. The chart below illustrates the rather uneven coverage of the investable domestic market .



Does investment in small stocks really add anything from a diversification standpoint. The empirical evidence indicates that it does. Not only have small cap stocks outperformed the S&P 500 since 1926 but the character of that performance strongly suggests that they are an asset class that brings unique benefits to an investment portfolio.

The Center for Research in Security

Small Cap Stocks (continued)

Prices (CRSP) ordered the domestic equity market into ten groups or deciles of stocks in descending size. The first decile corresponds closely to the S&P 500 while the tenth decile is comprised of the smallest stocks. When the three-year returns of these stock deciles are examined since 1927, an interesting phenomenon emerges. The best and worst performing decile is drawn from either the largest stocks or the smallest stocks almost 75% of the time! That's more than three times the expectation given random chance. There appear to be two factors driving returns: a large cap factor and a small cap factor. The returns of stock deciles of intermediate size are just combinations of the two.

"Small stocks enjoy market returns that are independent from the large stock indices most commonly discussed in the financial media."

Small stocks enjoy market returns that are independent from the large stock indices most commonly discussed in the financial media. Any investment portfolio should include such exposure to reduce its overall risk. There are a few ways to go about this.

A simple tax-efficient solution is to invest in an equity fund that includes positions in these smaller stocks as well as the more well known names. One example is the Total Stock Market Index Fund offered by the Vanguard group. With annual expenses of less than 0.20%, the fund takes positions in nearly 4000 stocks.

"The annual returns of the smallest two deciles of stocks have outpaced the S&P 500 12.47% to 10.21% since 1926."

There may be ways to add value relative to this simple, yet effective, approach. Recalling the performance of the various deciles of stocks, there appears to be only two factors driving returns. Either very large or very small stocks pace the market. As such, it may suffice to invest in very small stocks as a compliment to the largest decile corresponding to the S&P 500. Indeed, the empirical evidence suggests that prominent representation of very small stocks should enhance portfolio returns over the long term. The annual returns of the smallest two deciles of stocks have outpaced the S&P 500 12.47% to 10.21% since 1926.

Very small stocks or "microcap" stocks from the ninth and tenth deciles comprise equity in companies worth less than about $500 million. These are not household names and they offer greater returns because of greater inherent risks. They have higher borrowing costs and greater likelihood of bankruptcy.

If an investor wished to exploit a "barbell" strategy of investing in very large and very small stocks, a question emerges as to the relative weightings of these two asset classes. The S&P 500 subsumes more than 80% of the total market and is necessarily is a better gauge of overall economic activity. As their name suggests, microcap stocks comprise only a tiny fraction of the investable market. Yet their portfolio characteristics argue for an outsized weighting. My personal view is that any "barbell" investment strategy of large and microcap stocks should be comprised of 20% to 30% in the smaller names.