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Small-Cap Equity Performance Coming Out of a Recession

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An Opportunity in 2010 and Beyond

Extreme economic downturns — recessions — occur infrequently. When they do occur, they often leave investors uncertain as to how to best position the equity portion of their investment portfolios once a recovery appears imminent. The average investor has a general understanding of how companies overall are impacted by recessions, but may not be aware of the difference in how stocks of large- and small-sized companies react during different points in a recessionary cycle. Whereas, in normal economic times a fully diversified portfolio is considered by many to be the proper long-term structure for success, there are periods during and after a recession when opportunities may exist to advantageously under/ overweight certain capitalization ranges of the equity market.

While we have framed our analysis within the context of a recession, it is important to understand that the financial markets tend to lead at both the beginning and the end of an economic downturn/turnaround. For reference, the following table outlines the past five recessions. (Chart 1)

Chart 1

Start Date	End Date	Duration in Months	Contributing Factors
1/31/1980	7/31/1980	6	Fed's tight monetary policy to combat inflation; the 1979 oil crisis. The 80s' recessions are often referred to as the "double-dip" recession.
7/31/1981	11/30/1982	16	
7/31/1990	3/31/1991	8	Stock market crashed in 1987; S&L crisis; spike in oil price in the wake of the first Gulf war
3/31/2001	11/30/2001	8	Dot-com bubble burst; September 2001 terrorist attacks
12/31/2007	9/30/2009*	21	Housing market collapse; financial crisis

Source: National Bureau of Economic Research
*Note: End of Recession not yet officially declared by NBER

Smaller-Cap Stocks Lead the Way

We examined the returns of small-, mid- and large-cap stocks for the one-, three- and five-year periods beginning from each recession's mid-point, as defined by the National Bureau of Economic Research (NBER). It is important to note that we have assumed September 30, 2009 as the end date for the last recession, even though NBER has not yet officially called its conclusion. Historically, NBER has marked the end of a recession as the last quarter of a cycle with negative GDP growth or some time during the first quarter of a cycle with positive GDP growth.

With the exception of the five-year period associated with the 1981/1982 recession and the 1-year period associated with the 2008/2009 recession, small-cap stocks outperformed large-cap stocks following a recession. Mid-cap stocks, however, outperformed large-cap stocks following all of the recessions. (Chart 2)

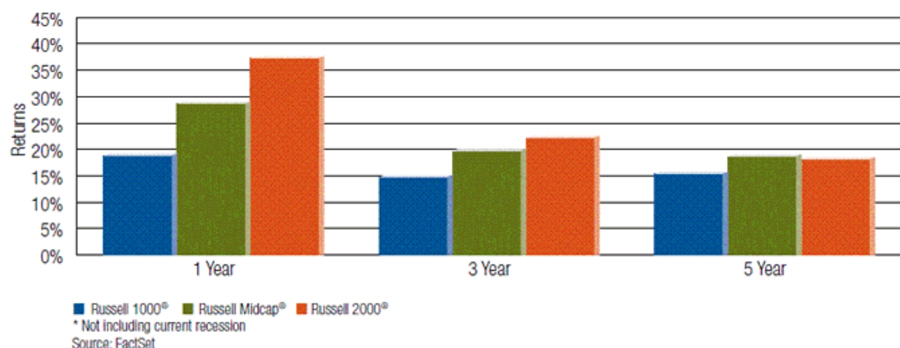
It is important to note that the smaller-cap stock underperformance exception that occurred after the 1981/1982 recession came after a long period of small-cap stock dominance over large-cap stocks. According to Morningstar/Ibbotson Associates' 2008 SBBI Yearbook, from 1971 through 1980, small-cap stocks returned 17.53%, substantially outperforming large-cap stocks, which returned 8.44%. Similarly, relative asset class performance during the downturn period for the 2008/2009 recession might explain the one-year performance exception. The Russell 2000® Index modestly outperformed the Russell 1000® Index from the start of the recession to its midpoint.

Evaluating the returns for the combined recessionary periods produces results similar to the performance for the individual recessions. This analysis accentuates the significance of the smaller-cap effect during the early part of the recovery period. (Chart 3)

Chart 2

	Recession Feb 1980 - July 1980			Recession Aug 1981 - Nov 1982			Recession Aug 1990 - Mar 1991			Recession Apr 2001- Nov 2001			Recession Dec 2007- Sept 2009		
	Returns for periods beginning April 30, 1980			Returns for periods beginning March 31, 1982			Returns for periods beginning November 30, 1990			Returns for periods beginning July 31, 2001			Returns for periods beginning September 30, 2009		
	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year
Russell 1000®	32.48%	21.56%	16.35%	44.41%	22.56%	25.76%	23.02%	17.37%	17.53%	-22.91%	-1.05%	3.45%	27.38%	n/a	n/a
Russell 2000®	66.35%	33.94%	20.76%	61.83%	23.39%	23.21%	40.54%	27.37%	21.30%	-17.96%	5.74%	8.99%	24.53%	n/a	n/a
Russell Midcap®	49.58%	27.36%	19.47%	49.66%	23.39%	26.02%	32.73%	23.73%	20.77%	-15.67%	5.87%	10.07%	38.59%	n/a	n/a
Russell 2000® outperformance vs Russell 1000®	33.87%	12.38%	4.40%	17.42%	0.83%	-2.55%	17.53%	10.00%	3.77%	4.95%	6.79%	5.54%	-2.85%	n/a	n/a
Russell Midcap® outperformance vs Russell 1000®	17.11%	5.80%	3.11%	5.25%	0.83%	0.26%	9.72%	6.36%	3.24%	7.23%	6.92%	6.62%	11.20%	n/a	n/a

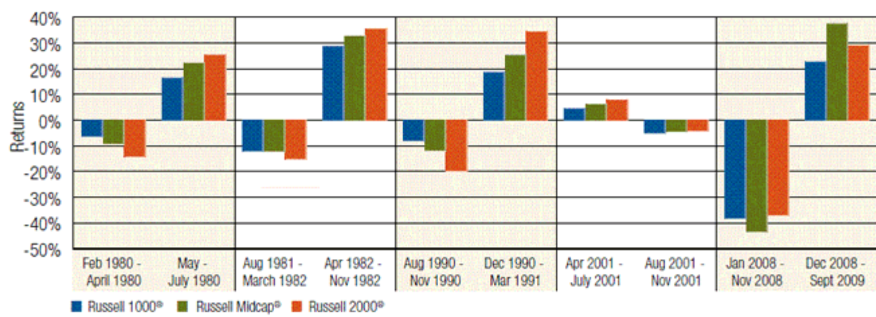
Source: National Bureau of Economic Research & FactSet



Small- and Mid-Cap Performance During Recessions

As you might expect, smaller-cap stocks often suffer disproportionately during the first half of the official recessionary period but then bounce back very strongly on a relative basis in the second half compared to large-cap stocks. (Chart 4)

When the entire recession is accounted for, the data shows that small-cap stocks have outperformed their large-cap counterparts during three of the past five recessions, while mid-cap stocks have outperformed their large-cap counterparts in each of the past five recessions.



Explaining the Smaller-Cap Effect

Fundamentals

Has the relative outperformance of smaller-cap stocks for the periods coming out of recessions been an anomaly during the past 30 years, or is it the result of factors unique to small- and mid-cap stocks? We would argue that many fundamental factors support a case for small- and mid-cap stock outperformance coming out of a downturn. First, in order to adjust to an environment moving from contraction to expansion, a company needs to be nimble. To that end, small- and midsized companies are generally better able to quickly add to their work forces and ramp up production in anticipation of an improvement in the economy. According to Giuseppe Moscarini, an economist at Yale University and Fabien Postel-Vinay of the University of Bristol, employment growth at small firms is faster than at larger companies early in the recovery period because small firms are able to capitalize on the slack labor market typically associated with this point in the business cycle. As a result, small- and mid-sized firms are better able to take advantage of the environment and produce stronger gains in both revenue and earnings. Second, small caps generally experience steeper declines early in a recession due to a flight to safety that naturally occurs, resulting in oversold conditions and under-valued small- and mid-cap stocks. Third, smaller companies tend to get a performance boost when mergers and acquisitions activity increases, which is common toward the end of a recession when valuations become more attractive and larger companies look for ways to grow their businesses.

Risk

In general, small- and mid-cap stocks are riskier (i.e. have higher price volatility) than their large-cap brethren for a variety of reasons, including less consistent earnings, reduced liquidity, more concentrated product lineup, and a scarcity of information available

to investors. Wall Street coverage is thinner for small- and mid-sized companies than it is for larger companies and the media does not report on these firms on a regular basis. Assuming the market is reasonably efficient, small and mid-cap stocks should outperform their large-cap counterparts over time and that performance advantage will typically be magnified when investors anticipate a recovery and thus are willing to assume higher levels of risk. The linear upward progression in historical risk levels across the capitalization spectrum is shown below. (Chart 5)

Chart 5: Annualized Standard Deviation - Periods ending April 30, 2010

Index	Since July 2000	20 Years	30 Years
Russell 1000®	16.25%	15.11%	15.63%
Russell MidCap®	18.65%	16.77%	17.12%
Russell 2000®	20.81%	19.46%	19.78%
Russell Microcap®	21.92%	n/a	n/a

Source: FactSet

Looking Ahead

As the data in this paper suggest, small and mid-cap stocks tend to perform very well compared to large-cap stocks when investors expect an economic recovery. Furthermore, that outsized performance tends to extend well into the recovery period. In addition, the severity of the declines in prices and related valuation levels that preceded the turning point can influence the duration and magnitude of the rebound in equity prices. Every cycle is different but historically sharp recoveries follow severe downturns.

Many investors are cautious about committing capital during the recessionary period as well as in the early part of the recovery. Unfortunately, this caution can result in missed opportunities to capitalize on the rebound in prices. As prices continue to rise during the recovery period, investors often regret not taking advantage of the dislocations in the market. No one has a crystal ball, but if past relationships hold true, then equities should continue to move higher as the economy rebounds, with small- and mid-cap stocks capturing a disproportionate share of the gains. While it is difficult to pinpoint how long the smaller-cap advantage will last, there are a few indicators that may shed some light on the future. First, low interest rates typically benefit bonds but also have a positive effect on stocks. The perception that the Federal Reserve will be on hold with respect to short-term rates for some time should have a positive effect on stocks, especially the smaller ones. Second, continued strength in the merger and acquisitions area would have a disproportionately positive impact on smaller companies. Third, an improvement on the earnings front may also provide an additional boost to small- and mid-cap stocks.

As investors mull over what to do about their investment programs during the recovery period, there are a few universal considerations they should evaluate:

- While we do not know when the performance advantage for small- and mid-cap stocks will dissipate during a recovery period, we do know that smaller companies have greater variability of returns, but it is this risk for which investors are compensated over the long term.
- While it makes good sense from a diversification standpoint for most investors to have at least a market-like weighting in small- and mid-cap stocks, investors with a higher risk tolerance may want to consider the benefits of overweighting small- and mid-cap stocks during periods when the economy is coming out of a recession.
- Since it is generally accepted that asset allocation is the key determinate of performance, having the appropriate asset mix is crucial. During turbulent periods, portfolio weightings tend to drift away from investors' normal targets (either unintentionally or by design), leaving them with a less-than-optimal mix of holdings.

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