

SMALL-CAP STOCKS DOMINATE, BUT DIVERSIFICATION IS STILL THE RULE

By James B. Cloonan

Except for the last few years, the statistics over the long term favor small-cap stocks. But as the saying goes, "What have you done for me lately?"

While small-(micro) cap stocks still outperform large-cap stocks over the long run, for the first time they are not outperforming large-caps in the short to intermediate term. In the most recent five years, and particularly for 1998, the large caps are doing better.

While small caps showed tremendous advantage in the years 1991–1994, that has been overcome by the more recent superior performance of large caps. Since then, we should note, most of this large-cap advantage is due to the performance of a few giant companies.

In light of the performance of those market segments, how have the AAI experimental Beginner's and Intermediate Portfolios been faring?

As might be expected, for 1998 the Beginner's Portfolio and the Intermediate Portfolio are underperforming the S&P 500. At this mid-September writing, the S&P is up 4% since the beginning of the year, while the Intermediate Portfolio is down 16% and the Beginner's Portfolio is down 13%.

The Beginner's Portfolio was started in 1993 to examine and share the problems and procedures of managing a portfolio of small stocks using a consistent and relatively simple buy-and-hold approach in which adjustments are made quarterly. The portfolio focuses primarily on micro-cap stocks with low price-to-book ratios. [A complete description of the Beginner's Portfolio appeared in the May 1998 *AAII Journal*, and can be found in the *Journal* archives of the AAI Web site at www.aaii.com.]

The Intermediate Portfolio was started at the beginning of this year, and is similar to the Beginner's Portfolio, but adds some growth criteria and allows individuals to introduce their own qualitative criteria. [A complete description of the Intermediate Portfolio can be found in the February 1998 *Journal*, and in the *Journal* archives of the AAI Web site at www.aaii.com.]

Since both the Beginner's and Intermediate Portfolios have value as well as size criteria, it is interesting to see how they are performing relative to indexes with similar market capitalizations.

The Beginner's Portfolio, at –13%, is leading the micro caps, represented by the Dimensional Fund Advisors 9-10 Fund, which is at –20% since the beginning of the year.

The Intermediate Portfolio, which has a somewhat larger average market cap than the Beginner's Portfolio, is at –16% for 1998 as compared to the DFA 9-10 fund, at –20% and the Russell 2000 index, at –19%.

It appears that the value elements are helping, but the low market capitalization is not—at least so far in 1998.

Will the market continue to be dominated by the very large capitalization stocks in a few industries for much longer? No one knows, of course, but history would indicate that the phenomenon is cyclical. As was the case during the last period of dominance by the giants (1984–1987), the popularity of indexing fuels the continuing high performance of these stocks.

One thing is clear from studying the last few years: Diversification is desirable and necessary for any portfolio if year-to-year or five-year to five-year volatility is to be avoided. This means diversification over size, style, and industries as well as having a large number of stocks or funds.

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TABLE 1. STOCK MARKET DOMINANCE
(OUTPERFORMANCE OF AT LEAST 3 YEARS IN A ROW): 1926 TO 1998

Market Segment	Stock Market Dominance—Number of Years in Cycle:							
	10	9	8	7	6	5	4	3
Small Caps Dominant	1	0	1	0	1	0	1	1
Large Caps Dominant	0	0	0	0	0	0	2	3

Most Recent Cycles

1991–1994: Small-cap dominance

1995–1998: Large-cap dominance (assuming that large caps retain their 1998 lead)

Last 70 years

Number of years large caps outperformed: 30

Number of years small caps outperformed: 40

Last 25 years

Number of years large caps outperformed: 10

Number of years small caps outperformed: 15

Most Dramatic Outperformance

Small caps over large caps: 143% vs. 54% (1933)

Large caps over small caps: -8% vs. -51% (1929)

Total Return (Annualized) 1926 Through August 1998:

Large caps: 10.4%

Small caps: 12.3%

A 2% per year advantage means that an investment made in small-cap stocks 70 years ago would be worth about four times the same investment in large-cap stocks, ignoring taxes and assuming reinvestment of dividends).

As an indication of the cyclical dominance of large caps versus small caps, Table 1 indicates the number of times that there has been a cycle of dominance that lasted for more than two years. For instance, small caps have had a number of long cycles in which they outperformed large caps in each consecutive year: one cycle that lasted 10 years; one that lasted eight years; one that lasted six years; one that lasted four years; and one that lasted three years. In contrast, the large-cap cycles of dominance have been shorter-term: two cycles lasting four years, and three cycles lasting three years.

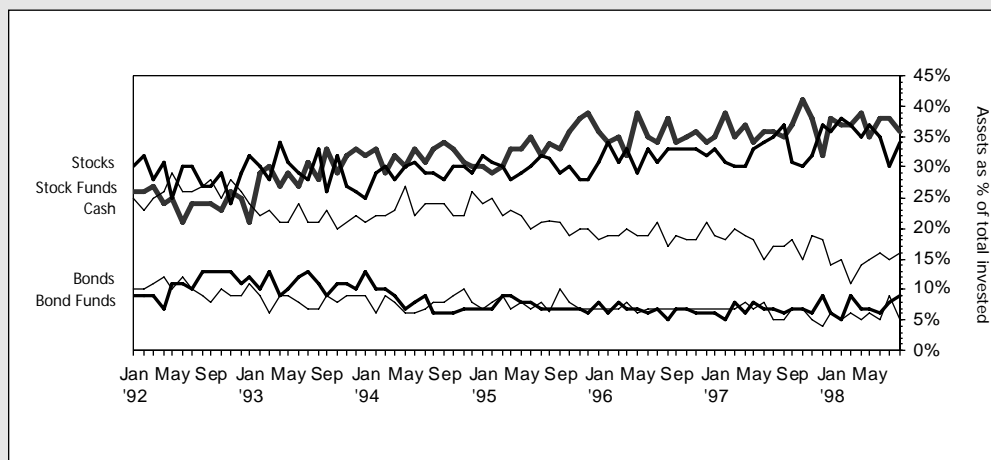
The table also provides other interesting statistics regarding the dominance of market segments.

As can be seen in the table, most of the figures favor small-cap stocks except those in the last 3½ years. But as the saying goes, “What have you done for me lately?”

Maybe lately will be the next 12 months. But do make sure you diversify. ♦

INVESTOR SURVEYS

AAIL ASSET ALLOCATION SURVEY



August 1998

Cash 16%
(+1%)

Stocks 34%
(+4%)

Stock Funds 36%
(-2%)

Bonds 5%
(-4%)

Bond Funds 9%
(+1%)

Figures in parentheses show difference from previous month.

The AAIL Asset Allocation Survey polls 600 members monthly on their current holdings among the five asset categories. Remember that these are averages of all members responding to the poll and not an investment guideline. Individual investors should vary their

portfolios to match personal circumstances and risk tolerances.

Survey results are available to members through the AAIL Web site at www.aail.com and the AAIL forum on America Online by the second business day of each month.