A CONCESSION ON ‘SMALL CAPS’ AS MICRO CAPS STAGE A COMEBACK

By James B. Cloonan

Through much of 1999, it looked as if large-cap stocks would outperform, but the micro-cap stocks came back and beat the S&P 500 29.8% to 19.5% for the year. Thus, over the long term, micro-cap stocks continue to outperform large-cap stocks by 2% a year.

I am giving up the struggle to maintain the historical research use of the term “small-cap” stocks. Except for a few academics, the investment community today uses “small cap” to describe companies that have a market value of up to $1 billion to $2 billion. This is the range of the Russell 2000 index, considered by many to be the official small-cap index.

However, the original research on small-cap stocks was done on the lowest 20% of stocks ranked by capitalization on the New York Stock Exchange. This research found that small caps historically produced returns that were not only higher than larger-cap stocks, but greater than would be expected given the greater levels of risk. Subsequent research that tended to confirm the small-cap effect used NYSE stocks to determine the capitalization ranges, but did not require that stocks be traded on the NYSE.

And that is still the capitalization range used by academic researchers today when examining the “small stock effect.” At current market valuations, this would include stocks with capitalizations of up to only about $220 million.

However, the non-academic popular jargon for these smaller-than-small caps is “micro-cap” stocks. And so I surrender to this usage, and will now refer to them either as micro caps or as 9-10 stocks, indicating they have capitalizations that would equal the ninth through tenth decile (lowest 20%) of NYSE stocks.

Now that the terms are cleared up, what about performance? In the October 1998 *AAII Journal*, I pointed out that large-cap stocks, represented by the S&P 500, were about to outperform micro-cap stocks for the fourth straight year—the maximum number of consecutive years that large caps had outperformed micro caps since 1930. Micro-cap stocks, on the other hand, had outperformed large caps in 40 of 70 years, with the length of outperformance extending as long as 10 years in a row.

Through much of 1999, it looked as if large-caps would break their record and outperform for the fifth year in a row. However, micro-caps (as measured by the DFA 9-10 Small Cap Index Fund) came back and beat the S&P 500 29.8% to 19.5% for the year. Thus, over the long term, micro-caps continue to outperform large caps by 2% a year, which means that over a 36-year savings period, an initial investment in a micro-cap portfolio would be double the same investment in a large-cap portfolio.

The Russell 2000, now called small cap but really moving into mid cap, also edged out the S&P 500, 19.6% to 19.5%.

Across the board, from micro-cap to large-cap, growth stocks outperformed value stocks significantly. This situation has continued for a number of years now, and probably will continue as long as tech stocks remain dominant (since almost all tech stocks are growth and not value).

The yearly pattern of micro caps versus large caps doesn’t provide any indication of how micro caps will fare next year compared to their big brothers. Also, although it is an election year, historically this factor has not impacted relative performance.

As always, diversification across stock categories is the best approach, but hopefully the re-emergence of micro-cap superiority will stop individual investors from giving up on them completely. ◆

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