COVERING ALL YOUR BASES: DIVERSIFYING IN THE U.S. MARKETS

By Maria Crawford Scott

Firms of different market capitalizations behave differently—they have different risks, different mixes of industries and are in different stages of development, and that complementary behavior can significantly reduce risk for investors who diversify.

Investors have seen "the market" over the past few years attain unbelievable heights. Yet those who have been watching more closely have noticed that not all segments of the market have performed equally. For instance, in the past few years, the stocks of larger-capitalization companies have considerably outperformed those of smaller-capitalization companies.

The recent market segmentation has struck a nerve in some investors because it is the larger firms—generally thought of as more conservative and slower growth—that currently are outperforming. But there have been other times when larger firms have outperformed their smaller counterparts, as James Cloonan points out in this month's *AAII Journal* Matter of Opinion column on page 25. And as Cloonan points out in his article, the real lesson is the importance of diversification among firms with different market capitalizations within the U.S. stock market.

The market capitalization of a stock is simply its share price times the number of shares outstanding, and it serves as an indicator of firm size. At one end of the capitalization scale are corporate behemoths like Microsoft and General Electric, while at the other end are newly emerging start-up firms, the embryos of the corporate world. Firms of different market capitalizations behave differently—they have different risks, different mixes of industries, and are in different stages of development.

The best approach to reducing stock market risk is to invest in market segments that are affected by different kinds of factors. While one segment of the market may be down, the other segment may be less affected, providing higher returns over that period. The overall effect of combining these segments is to smooth return variations—and less variation means less risk. Segmenting the market based on firm size is advantageous because of the different behaviors of the segments.

STOCK MARKET SEGMENTS

The largest segment of the stock market measured by market capitalization consists of large, well-established companies. The Standard & Poor's 500 usually defines this group; it represents about 70% of the U.S. stock market. Most of these companies are well-known names: IBM, Ford, and AT&T, for instance. The stocks of these firms offer the potential for growth as well as some income, since they tend to pay cash dividends. These companies should form the core of every investor's U.S. stock portfolio.

The stocks of smaller U.S. companies, in general, have a greater potential for long-term growth than large, well-established companies.

However, they also have greater risks. In addition to the risks associated with stocks in general, the stocks of smaller firms have these further risks:

- There may be no yearly income stream, since they do not tend to pay dividends.
- Their returns tend to be more volatile, with many firms more prone to difficulties during economic downturns.
- Because they tend to be traded less often, these stocks tend to be less liquid, making buying and selling more difficult.

Maria Crawford Scott is editor of the AAII Journal.

While smaller-company stocks tend to be more volatile than the stocks of larger firms, studies indicate that their long-term returns have been higher. If you have a long-term horizon, the addition of small stocks to a core portfolio of larger firms can increase your overall stock portfolio return, if you are willing to take on the extra risk of larger return swings year to year.

Sandwiched in between the large-capitalization stocks and the small-capitalization stocks are the mid-cap stocks.

What advantage do mid caps bring to a portfolio? Mid-cap stocks have at times outperformed large-cap stocks, and have less risk than small-cap stocks. For investors wishing to diversify and cover all points in the stock market, mid-cap stocks fit the bill. For investors seeking higher returns but who are uncomfortable with the risk of small stocks, concentrating on mid caps may make sense.

What exactly is a mid-cap stock? Here, the distinctions start to blur—mid caps overlap at the extremes with large caps and small caps, but there are many different definitions of large capitalization and small capitalization.

Ibbotson Associates, a Chicago-based market research firm, uses the deciles of the New York Stock Exchange to help define ranges: mid caps are defined as deciles three through five, ranging in market capitalization from $950 million to $4.01 billion at the end of 1997; large caps are firms greater than $4.01 billion, and small caps are below $950 million (divided into low caps and, below $260 million, micro caps).

Other researchers use different cut-off points, but the important point is not to quibble over definitions, but to make sure that your investments include portions of each segment. A useful working range divides the large caps as above $4 billion, the small caps below $1 billion, and the mid caps in between.

DIVERSIFICATION

Allocating among these market segments can reduce the risk of your portfolio, ensuring your participation in the market segment that is currently outperforming.

Table 1 presents the average returns for mutual funds in each of these categories over the last 10 years. The annual return figures indicate the divergence in performance among the different segments, with small caps outperforming in some years, large caps outperforming in others, and even mid caps outperforming both small-cap stocks and large-cap stocks in one year.

The 10-year average return indicates that small caps retain a slight performance edge over this particular 10-year period. The bear return figures illustrate the higher risk of smaller firms, which had losses greater than either the mid caps or large caps. The bull return figure reflects the recent outperformance of large-cap stocks over the bull market period.

The last two rows in Table 1 illustrate the benefits of diversifying among the various segments. The first of these two rows shows a conservative combination of the three categories, consisting of 80% invested in large caps, 10% in mid caps, and 10% in small-cap funds. The second shows a more aggressive combination of 50% invested in large caps, 25% in mid caps, and 25% in small caps. There are, of course, an endless array of combinations; these are presented only as examples.

The yearly return figures for these two portfolios compared to the individual market segments provide an indication of the benefits of a mixture. The two combination portfolios had less individual yearly losses and lower bear market losses than the worst-performing segment. They also performed better than the worst-performing segments during bull markets. And both portfolios

TABLE 1. DIVERSIFYING IN THE U.S. STOCK MARKET: ANNUAL RETURNS FOR THE PAST DECADE

Category	1997 (%)	1996 (%)	1995 (%)	1994 (%)	1993 (%)	1992 (%)	1991 (%)	1990 (%)	1989 (%)	1988 (%)	10-yr Avg. (%)	Bull Market* (%)	Bear Market** (%)
Large-Cap Funds	30.4	21.1	33.3	–0.4	10.9	8.9	34.5	–4.0	27.8	17.0	17.2	151.8	–6.5
Mid-Cap Funds	22.9	19.1	32.4	1.2	19.2	12.4	42.1	–4.2	24.7	15.7	17.8	133.8	–7.9
Small-Cap Funds	19.1	19.0	30.7	0.2	16.2	13.7	49.5	–7.3	25.0	19.4	17.6	109.6	–9.0
Portfolios:													
Conservative (80%/10%/10%)	28.5	20.7	33.0	–0.2	12.3	9.7	36.8	–4.4	27.2	17.1	17.3	145.8	–6.9
Aggressive (50%/25%/25%)	25.7	20.1	32.4	0.2	14.3	11.0	40.2	–4.9	26.3	17.3	17.5	136.8	–7.5

** Bull market: July 1, 1994, through June 30, 1998*

***Bear market: February 1, 1994, through June 30, 1994*

Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 17th edition, published annually by AAII.

did better over the 10-year period than the worst-performing market segment, but with lower annual risk.

What about the overall returns? The cycles that favor one market segment over another can extend over long time periods. The most recent 10-year period slightly favored mid-cap firms. In hindsight, it is clear that over this time period, an investor with more committed to this segment, in this instance the aggressive investor, would have outperformed the more conservative individual. However, it is the uncertainty concerning these patterns that creates risk; by diversifying among these various market segments, you are reducing the risk that you will guess the pattern incorrectly.

GUIDELINES FOR ALLOCATING

There really are no hard-and-fast rules for allocating among market segments. The allocation decision within these market segments depends on your risk profile: your risk tolerance, return needs (growth and income), and time horizon. There are many different combinations that can match an individual's profile, and everyone's profile differs. The final decision must rest on your own judgment and what you are most comfortable with.

Here, however, are some thoughts to consider:

- Keep in mind the goals of diversifying among market segments. The various market segments move in different cycles; one may do much better than another over certain time periods. Diversifying reduces the risk that you will guess incorrectly which market segment will do well in the near future.
- A core position consists of roughly a 50% commitment, or at least the largest single commitment, and the most conservative segment should serve as a core. Using this approach, the largest commitment of a portfolio would be invested in the stocks of large-cap firms.
- At least 10% of a portfolio must be committed to a market segment to have a meaningful effect. Using this approach, at least 10% of a stock portfolio would be invested in small-firm stocks or mid-cap stocks.
- If you want to be completely diversified in U.S. stocks to reduce portfolio risk and to participate in the potential growth of mid-cap stocks, then you should include mid caps in your portfolio unless your large-cap and small-cap holdings stretch their capitalization ranges and no hole in the middle exists.
- Alternatively, if you are invested in large-cap stocks and want to be more aggressive, but are leery of the volatility of small caps, mid-cap stocks may fulfill some of that growth goal without taking on the substantial risk of small caps.
- Don't become overly concerned with precise definitions, but use this range as a rough guide: large-cap stocks are greater than $4 billion, mid-cap stocks are between $1 billion and $4 billion, and small-cap stocks are those below $1 billion.
- If you are a mutual fund investor, make sure you carefully read the prospectus to determine the capitalization range in which the mutual fund managers you have hired are operating. Size does matter. ✦