Lots of data here; you may find the highlights and notes helpful. Ray Randall

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# Small-Cap Stocks: Too Far Too Fast or Just the Beginning?

*By: James Solloway, CFA, Senior Portfolio Manager, Global Portfolio Strategies*


**Summary:**

- "Less-bad" indicators suggest the worst of the recession is over, boosting risk appetite and helping small-cap stocks to rally more than 50% from March lows, which SEI believes will prove to have marked the trough of the bear market.
- The dramatic recovery in share prices, while fairly extreme by historical standards, is not out of line for the early stages of a bear-market rebound, and SEI believes it is correctly anticipating an economic recovery. Declines in initial jobless claims and sharp improvement in manufacturing activity suggest "less bad" may lead to "more good" economic indicators.
- Data on money market versus equity exposure suggests investors in general are still slightly pessimistic, leaving room for more money to flow into equities as recovery comes. However, small-cap valuations are not cheap on an absolute basis or relative to large-cap stocks, and headwinds remain from continued financial stress.
- The makeup of the small-cap market presents good opportunities to benefit from stabilization in the financial system and economic recovery, given large weightings in the Financials, Consumer Discretionary and Industrials sectors. In SEI's view, some correction would not be surprising after a very strong run, but we believe the worst of the recession is over and credit conditions should continue to improve.


"Less bad is the new good" is the current mantra in the markets. This tagline reflects an economy where the decline is moderating, but the level of business activity remains very weak. While the economic data clearly point to a deceleration in the rate of decline compared to last year's final quarter and the first few months of 2009, it may take the rest of the year before there is conclusive evidence that a sustainable recovery has begun.

Investors nonetheless have responded enthusiastically to the possibility that the worst of the downturn has passed. In particular, stock markets around the world have bounced back smartly since early March, with the sharpest rebounds occurring in those markets and industry sectors that led on the way down. While this has been true of many areas of the financial markets, the substantial outperformance of small-cap stocks stands out as a particularly interesting example. Consider that the Russell 2000 Index of U.S. small-cap stocks advanced more than 50% from its closing low recorded on March 9 to its recent (June 1) high. Over this period, larger-cap stocks, as measured by the Russell 1000 stock index, rose 41%.

**It's Different This Time—No, Really!**

The magnitude of the rebound in riskier assets, including small-cap stocks, is certainly a welcomed, but surprising, development. At the bottom in late February/early March, several measures of investor sentiment deteriorated to extremely pessimistic readings, signaling that a reversal in trend was probably on the way. One such indicator is the ratio of total Rydex money market assets divided by Rydex long-only domestic and international equity-oriented mutual fund assets. Recently, money market assets shot up from 80% to more than 120% of equity-oriented mutual fund assets. Exhibit 1 highlights the movement. The peak coincided closely with the trough in equities as measured by the S&P 500 Index. This was a higher reading than the one that occurred at the November 2008 market low, and was the most pessimistic reading since the end of the last bear market in 2002/2003.

**Exhibit 1: Market Reversal?**

Source: Ned Davis Research

As one might expect, this ratio receded dramatically when the equity markets spiked higher. At a current value of about 60%, though, it is still above the mean reading of the past nine years and is back down only to levels that prevailed just as the financial crisis worsened last September. Other widely followed measures of sentiment (e.g. Ned Davis' Crowd Sentiment Poll, the American Association of Individual Investors' bulls vs. bears, Investors Intelligence Advisory Service bulls and bears and the NASDAQ short interest ratio) paint the same picture: extreme pessimism at the March lows followed by reversals to levels that can be considered neutral or still mildly pessimistic. Pessimism in these indicators can be seen as a contrarian indicator for the future direction of the equity markets, as the more money there is parked in money markets, the more fuel there is for any potential rally. This can be clearly seen in the strength of the recent rebound.

**Looking Over the Valley**

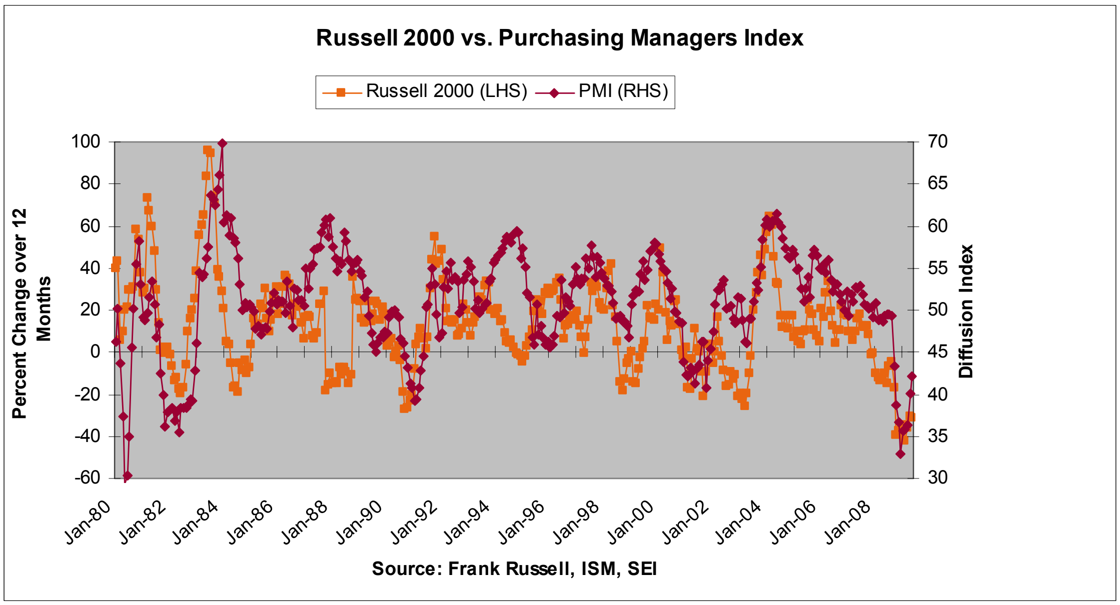
The February/March period was a time of maximum uncertainty. It was evident that the global economy was in rapid decline. The stress tests at the nation's biggest banks were just getting underway and there was little confidence that the stimulus measures that had been put in place were taking root. Let's fast forward to the present. Although there is still uncertainty about the timing and contours of recovery, there's a firming consensus that the economy should stabilize during the second half of the year and grow in more sustainable fashion in 2010. Robert J. Gordon, professor at Northwestern University and a member of the National Bureau of Economic Research Business Cycle Dating Committee (the organization that serves as the official arbiter of when U.S.

recessions begin and end), recently wrote a paper[1] suggesting that the economy could hit bottom as soon as May or June.

The stock market is itself a hypersensitive leading indicator of economic conditions, so it isn't surprising that stocks would bottom well before the recession ends. As we suggest, however, much of the run-up in recent months simply reflects a turn in sentiment. Risk aversion hit an extreme amid the intense uncertainty. "Less bad" was all that was needed to turn the markets around. This state of affairs can continue for a few months, but eventually "more good" must replace "less bad" as the catalyst. That's the difference between a bear-market rally and the start of a bona fide bull market.

Fortunately, "more good" is likely on its way. Professor Gordon keyed on initial unemployment claims in his paper as a timely and consistent indicator that has historically been nearly coincident with the end of recession. In Exhibit 2, we highlight another important indicator, The Institute for Supply Management purchasing managers index (PMI). We plot the PMI against the 12-month percentage change in the Russell 2000 Total Return Index. Excluding two notable exceptions (1987 and 1994-95), there is a decent correlation between the two variables, with sequential gains in the PMI associated with decelerating declines/accelerating improvement in the Russell 2000.

**Exhibit 2: Another Sign of Improvement**




The PMI actually hit bottom in December and registered a sizable increase in April. It increasingly looks as if the PMI itself is in the midst of a V-shaped recovery (or, to put it another way, conditions are turning less bad at a fairly rapid clip). We believe the behavior of the PMI is more than a statistical head-fake. The sharp declines in U.S. industrial production (down 12.5% over the 12 months to April and a stunning 16.4% seasonally adjusted annual rate since October) have led to a major inventory contraction. The conditions thus appear ripe for a stronger-than-expected rebound in business activity as companies reverse prior cutbacks and increase output to meet demand. This inventory wash-out has played out in even more dramatic fashion elsewhere in the world, laying the groundwork for a synchronized move to the upside.

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[1] "Green Shoot or Dead Twig: Can Unemployment Claims Predict the End of the American Recession," http://www.VoxEU.org/index.php?q=node/3524, May 1, 2009.

## Have We Really Come All That Far?

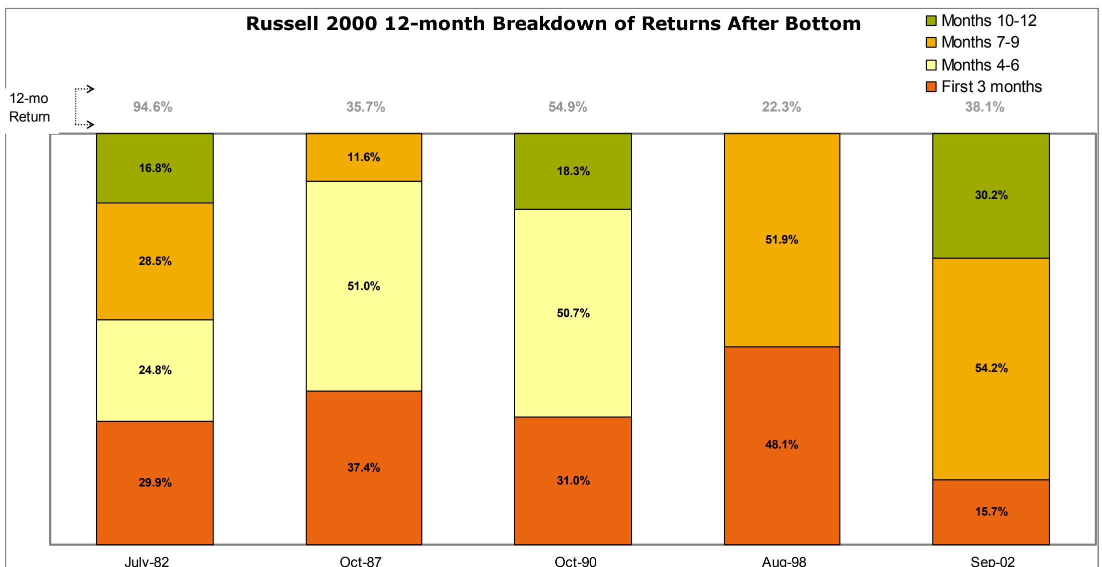
As we noted earlier, the Russell 2000 has climbed more than 50% from its early-March low, and the Russell 1000 has risen approximately 40%. Is it possible that a snapback in the economy is already fully reflected in share prices and that the equity market's performance will fade back toward the bear-market lows? Actually, we think that it's quite likely that equity prices could hit a bump or two. That noted, we think it's wise, however, to keep the market's recent climb in context. The Russell 2000 is up about 5% from the start of the year and remains about 35% below its year-ago reading. The Russell 1000 is more than 5% above its beginning-of-the-year level and about 30% below the levels that prevailed this time last year. Given the improved news flow, a rebound slightly above the level of five months ago does not appear excessive.

## Baby Bulls Seldom Travel in a Straight Line

Exhibits 3 and 4 track the performance of the Russell 2000 and Russell 1000 during the first year of a new cyclical upswing. The Russell data encompasses five distinct bull markets following market declines of at least 20%. Bear market troughs were established in July 1982, October/November 1987, October 1990, August 1998 and September 2002. The evidence suggests that the first three months of a new bull market is a dynamic period and captures a bigger-than-average share of the first-year's gain. But it hardly captures all of the appreciation that occurs during the entire first year of a new bull run.

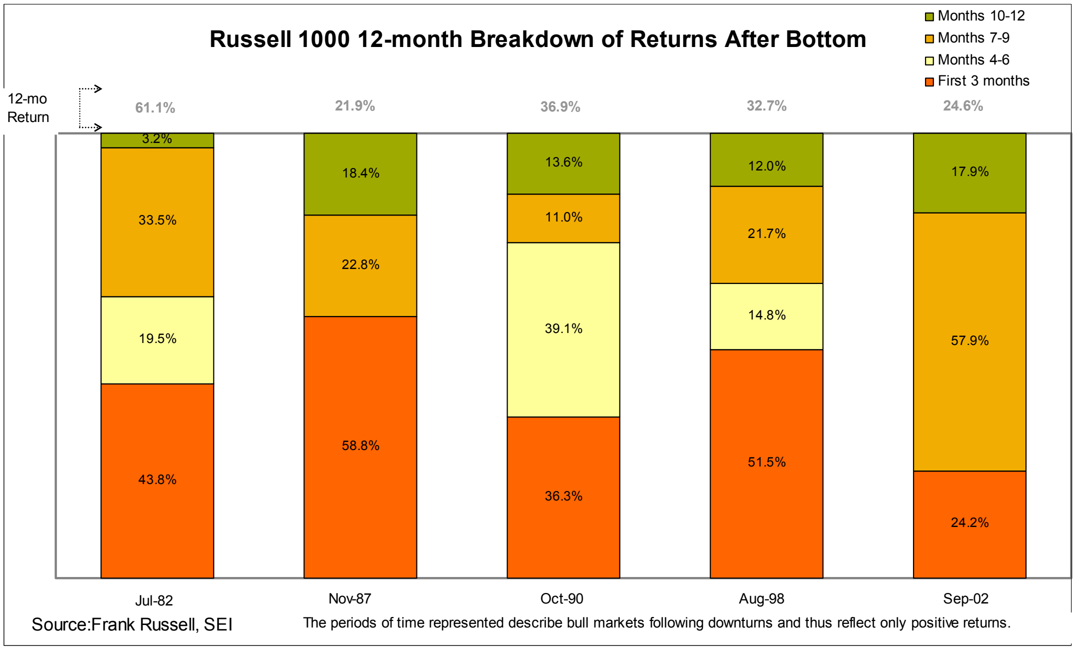
On average, the first three months of appreciation in the Russell 2000 captured an average of 32% of the total gain that takes place in the first 12 months. The Russell 1000, on the other hand, tends to have a larger portion of the gain accounted for in the first three months, an average of 43%. In order to review a larger sample size, we conducted the same exercise with data provided by Ibbotson Associates going back 60 years. The Ibbotson data showed that 37% of the first-year's appreciation in small-cap stocks was recorded in the first three months. The comparable figure for large cap stocks was 35%.

### Exhibit 3: First Year of Bull Markets in Russell 2000



Source: Frank Russell, SEI
The periods of time represented describe bull markets following downturns and thus reflect only positive returns.

**Exhibit 4: First Year of Bull Markets in Russell 1000**



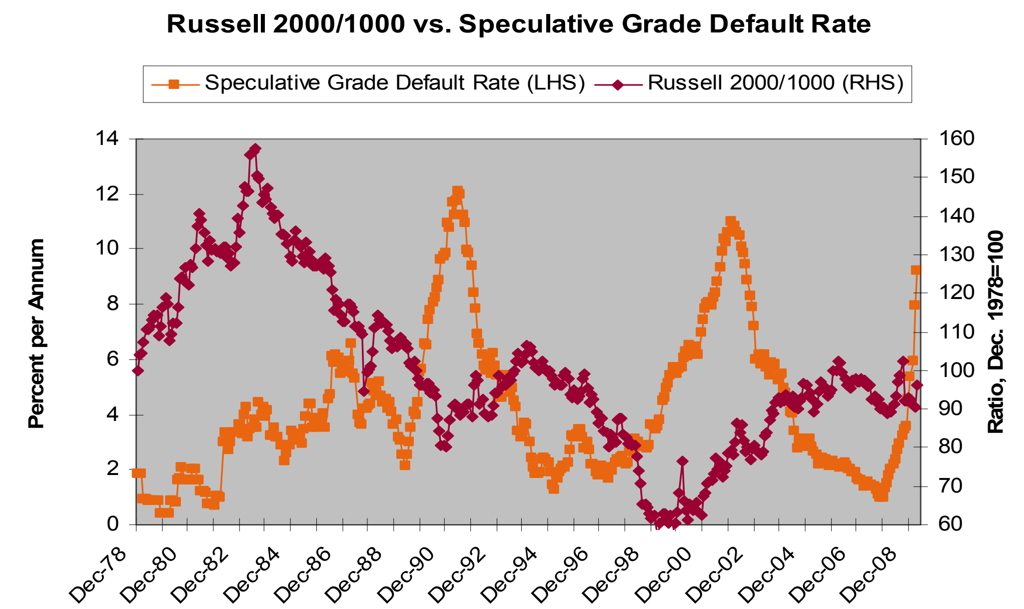

The type of bear market that precedes the recovery also seems to matter. The biggest initial market jumps in the first year of a bull market occurred after the August-October 1987 market collapse and the July-August 1998 crash. In both cases, these market declines were more a function of market dislocations rather than fundamental economic events. The U.S. economy remained relatively strong during these two periods. Since the fundamental underpinnings of the stock market were in good shape, equity prices could "normalize" faster. Bull markets associated with recoveries from recession generally have larger first-year gains, spread more evenly through the year.

In the five baby bulls we highlighted in Exhibits 3 and 4, the Russell 2000 outperformed the Russell 1000 Total Return Index in the first year of recovery on each occasion except for the August 1998-99 experience. The average out-performance of those four occasions amounted to nearly 20 percentage points. The current rally's out-performance is about half of that amount. The Ibbotson data (which suffers from a survivor bias that favors the small-cap index, given a larger proportion of small-cap stocks that went bust and are thus not included in the data) indicates that small-cap stocks have outperformed large caps in seven of the last eight recoveries, with an average out-performance in those seven instances of almost 23 percentage points. The historic data thus suggest that small caps tend to perform relatively well at the start of a new bull market.

Historical trends notwithstanding, we would continue to advise ample diversification across the market capitalization spectrum. There are a few wrinkles in the current cycle that argue against an aggressive exposure to small-cap stocks relative to large. First, credit conditions remain problematic for smaller, less financially secure companies. Granted, the easing of the credit crunch has been behind the rebound in equity performance and investors' willingness to venture into riskier areas once again. But the financial stress is still very real.

Exhibit 5 compares the relative performance of the Russell 2000/1000 with Moody's Speculative-Grade Default Rate (below investment grade). The default rate is climbing very rapidly, and will likely exceed the previous two peaks recorded in 1983 and 2001. Although a rising default rate did not impede the Russell 2000's recovery earlier this decade, the multi-year deterioration in the default rate during the 1980s coincided with a long decline in relative small-cap performance. Until there are more signs that credit conditions are easing up for smaller companies, the rising default rate should be viewed as a potential headwind for small-cap equity performance.

**Exhibit 5: Financial Stress is a Headwind**



Sources: Frank Russell, Moody's, SEI

Valuation is another consideration that suggests a more balanced view of the relative prospects of small caps versus large. Steven DeSanctis, Small-Cap Strategist for Bank of America-Merrill Lynch, recently compared large and small stocks on the basis of five different valuation metrics – trailing Price to Earnings (P/E), expected P/E, price-to-book, price-to-sales and P/E-to-growth, as seen in Exhibit 6. As of April, the Russell 2000 was trading at an absolute premium valuation versus the Russell 1000 on a trailing and forward normalized P/E basis. Only the price-to-book ratio, though, is trading at a discount relative to its long-term average value (extending back to the first quarter of 1979). We emphasize that these comparisons suggest a more balanced view, not a bearish one toward small cap stocks. These valuation metrics may be higher than the long-term average, but they are not in super-expensive territory.

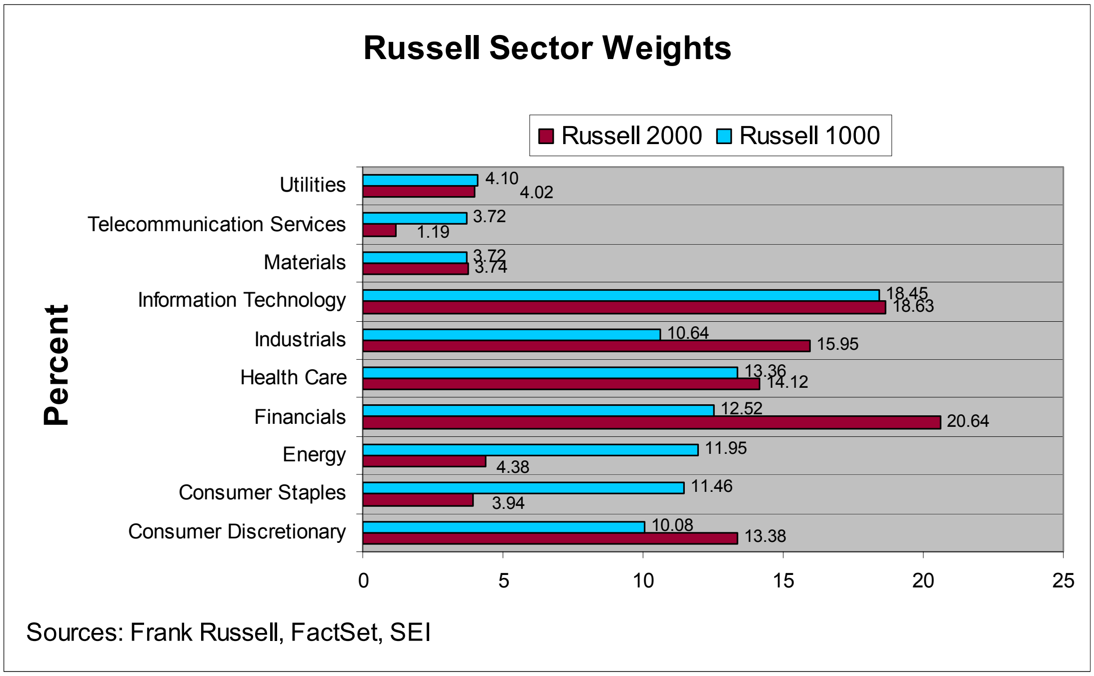
**Exhibit 6: A Look at the Statistics**

| As of 4/30/09 | Russell 2000 | Russell 1000 | Russell 2000/1000 | Russell 2000/1000 Long-Term Average |
|---|---|---|---|---|
| **Trailing P/E** | 14.48 | 12.35 | 1.17 | 1.02 |
| **Forward P/E (I/B/E/S)** | 15.01 | 13.44 | 1.12 | 1.04 |
| **P/E-to-Growth** | 1.15 | 1.36 | 0.85 | 0.81 |
| **Price/Book** | 1.46 | 1.93 | 0.76 | 0.81 |
| **Price/Sales** | 0.79 | 0.9 | 0.88 | 0.82 |

Another way to examine the relative merits of small caps versus large is to compare the sector weights. Exhibit 7 highlights important differences between the two indices. The Russell 2000 Index, for example, has more than 20% of its market weight concentrated in the financial sector. In contrast, the financial weighting in the Russell 1000 is down to 12.5%. The strong performance of the financial sector since the start of the rally has evidently been a big factor behind the sharper gains in the small-cap index. The higher weight in the consumer discretionary sector has also been helpful versus the Russell 1000.

Continued financial repair and recovery in the economy should bode well for the Russell 2000. A pick-up in the industrial sector (a third area where the Russell 2000 has a much larger weight than the Russell 1000) could be an important source of performance in the months ahead. Meanwhile, the Russell 1000 could be held back by the large relative weight in consumer staples (11.5% versus 3.9% for the Russell 2000), although the relative overweight in energy (12% versus 4.4%) would provide an offset in an improving economy.

**Exhibit 7: Russell 2000's Advantageous Sector Weightings?**




**Keep Those Rally Caps On**

To repeat one more time, it's reasonable to expect some correction following the sharp climb off the early March lows. The path of the stock market can be erratic during a bearish-to-bullish reversal – and with good reason. It's hard to know when an economic upturn will take hold, much less determine its strength and durability. Let's use the current travails of the auto industry as an example. The shutdown in production facilities and in dealerships conceivably could push initial unemployment claims to a new high and interrupt and/or delay the recovery. Signs of renewed weakness —even if they are well-telegraphed and well-contained—could have a negative impact on investor confidence.

We would argue, however, that such reversals are more likely to be temporary than not. During the past four bull-market recoveries, the Russell 2000 suffered at least one quarter of decline. In the last recovery phase (starting at the trough in September 2002), both the Russell 1000 and Russell 2000 suffered a relapse during the December 2002-February 2003 period of about 10% owing to investor uncertainty regarding the economy and worries surrounding the impending conflict with Iraq. The relapse surely did not feel good at the time, but in introspect it provided a good opportunity to increase exposure to equities.

**Outlook**

SEI's view is that the worst of the recession is behind us and that credit conditions will continue to improve. The strong global policy response, both fiscal and monetary, really does appear to be gaining traction. As "less bad" news turns into "more good" news, investors should continue their move into riskier assets. But setbacks are inevitable and will correspond with investors' perceptions regarding the outlook for economic activity and corporate profitability. There may be no need to chase after stocks this very day, but buying on pullbacks strikes us as a reasonable tactic, with the goal of increasing equity exposure over time.

We think small-cap stocks are in a position to continue to outpace the recovery in large- cap stocks, although it's not clear how substantial the extent of out-performance will be from this point. Small-cap stocks experienced a multi-year period of out-performance from 2000 to 2006, and are trading at somewhat more expensive levels than large caps by a variety of valuation metrics. Nonetheless, the composition of the Russell 2000 Index, with a concentration in the financial, industrial and consumer discretionary sectors, should help the index outperform its larger-cap counterparts, assuming the financial crisis eases and the economy enters a sustainable recovery in the next six months or so.

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