

SMALL-CAP STOCKS AND RECESSIONS

History seems to indicate that small-cap stocks frequently have outperformed larger stocks as the economy recovers from a recession.

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Although institutional investors typically maintain a strategic asset allocation based on long-term performance expectations, they might try to capitalize on shorter term anomalies through tactical shifts in asset mixes. Timing these shifts is difficult, so investors are keenly interested to understand any patterns in performance that appear to persist over time and which may be exploited for tactical purposes.

A number of studies have examined the performance patterns of stocks of different capitalization ranges as the U.S. economy enters and passes through recessionary periods. As several of these studies have noted, small-cap stocks historically have tended to outperform larger stocks in the later stages of the recession and well into the recovery period. As the “Stock

Performance and Recessionary Periods” chart on page 23 shows, this outperformance followed a period of superior returns from larger stocks immediately before and during the first part of the recession. Observations of the last four recessionary periods (those ending in 1980, 1982, 1991 and 2001) and of small-cap stock returns appear to support this view.

A Closer Look at History

We used recessionary periods as defined by The National Bureau of Economic Research (NBER), which determines when recessions in the United States officially “begin” and “end.” NBER has recognized 32 recessionary periods since 1857. On average, these recessions lasted 17 months. In more recent decades — between 1945 through the last officially recognized event in 2001 — the 10 recessions lasted an average of only 10

months. For the entire period, recessions occurred every 4.7 years on average, but since 1945 the average was 6.3 years. As of this writing, the duration and depth of the current recession were unknown. However, although the trend has been toward fewer and shorter recessions since the end of World War II, it is already certain this will not hold true for the deep downturn we currently are experiencing.

The Russell 1000 and Russell 2000 indices served as proxies for large and small stocks. In the four most recent recessions, comparing returns for the last three months of the recession and the first nine months of the recovery shows small-caps on average outperformed large-caps by slightly more than 22%.

Such observations need to be used with caution to avoid confusing correlation with causality, but still can be informative. Each recession is different, and the current one has introduced extreme levels of volatility in equity markets overall. Other factors that need to be considered include traditional valuation measures and credit conditions.

The Difference in Performance

Intuitively, small-cap stocks are more sensitive to both good and bad economic expectations. Typically, small-cap stocks are more richly priced (higher valuation ratios), more highly leveraged (more debt) and tend to have more volatile performance histories. The higher P/E valuations have tended to react more sharply when earnings expectations shift from pessimism to optimism as recoveries begin. Higher leverage has become a

drag as interest rates increase, and provided a lift as rates dropped. Companies with greater dependence on debt tend to suffer as credit tightens, but benefit as credit loosens. Riskier small-cap stocks, early in their life cycles, have suffered when the market seeks quality, but quickly attracted attention once investors feel more comfortable taking more risk.

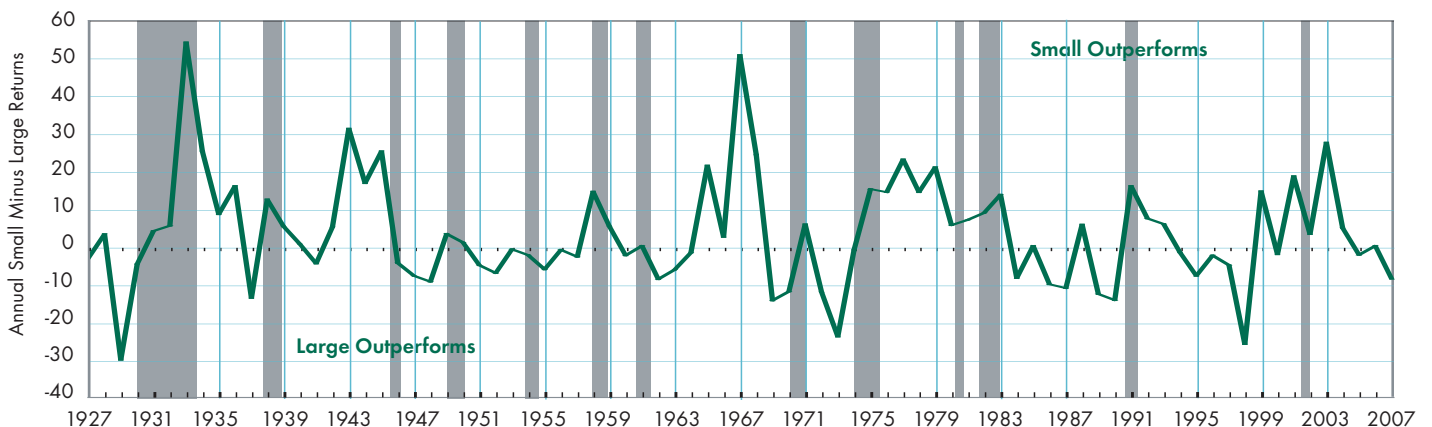
A robust diversification plan can benefit from the inclusion of small-cap stocks in an equity portfolio. Still, the question is: Are small-caps poised for a period of outperformance as, over time, we move through this phase of the business cycle? At this point, the answer isn't clear. In addition to uncertainty about the current recession, current small-cap valuations relative to large-caps are still above long-term averages, although they are modestly more attractive on an absolute basis. Expectations for earnings growth in small-caps, however, remain higher than in large-caps. More favorable debt conditions — signaled by decreasing high-yield spreads, for example — would also help confidence in small-cap investment.

As in any investment decision, careful attention to market conditions and risk are critical to the investor's overall success, particularly so in these volatile times. ♦

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Stock Performance and Recessionary Periods

History shows that small-cap stocks tended to outperform larger stocks as recessions near their end and economic recovery begins.



Note: Recessionary periods indicated by gray bars. Past performance does not guarantee future results.

Source: Northern Trust