Capitalization And Relative Performance

There is no end to the endless debates over value versus growth, technical versus fundamental, trend-following versus mean-reverting or our subject here today, large versus small. First, let's stipulate the large-capitalization issues, especially members of indices underlying major mutual and exchange-traded funds such as the S&P 500, have a significant and indeed unnatural advantage: Index funds must own them.

Second, let's note the small-capitalization issues in indices such as the Russell 2000 and S&P 600 generally have higher price/earnings ratios, lower dividend yields and greater realized volatility. Investors have to pay more for these stocks, receive less back in the form of dividends and have to tolerate greater price swings.

Finally, while large-capitalization issues generally have lower growth prospects, the occasional meteor such as Apple in recent years notwithstanding, they make up for it by bringing business models proven to work to the table. When you buy an ExxonMobil or a Microsoft you do not have to contemplate whether the market will accept their business; that issue has been decided.

Drivers Of Relative Performance

Two potential drivers of relative performance based on capitalization are long-term interest rates and the dollar. Let's take the easy one first. The higher dividend yields of larger firms should make them more sensitive to changes in long-term rates.

The dollar-based division is more complex. Most investors assume and indeed have been told large multinational firms benefit from a weaker dollar as their overseas earnings are translated into a larger number of increasingly worthless pieces of paper; by similar logic, cutting a pizza into eight slices makes it more fattening than cutting it into six pieces. However, large firms' sales to overseas customers often are met by overseas production, and the larger the firm, the greater its capability of shifting its global supply chain around to cheaper zones of production. Smaller firms often have to export their goods and services from the U.S.; this is when a stronger dollar might make their sales less competitive.

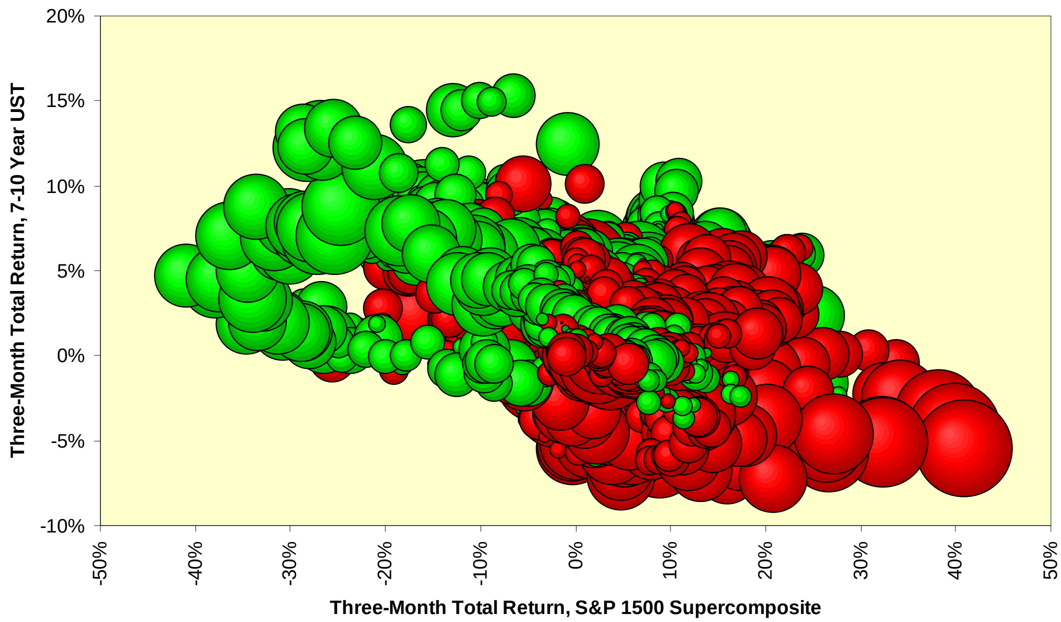
Finally and critically, bear markets and financial crises induce both movements into larger stocks in search of safety and into the dollar in search of global financial liquidity.

Zones Of Relative Performance

The two charts below depict the three-month total return differential between the S&P 100 (OEX) and the S&P 600 as a function of three-month total returns on the S&P 1500 Supercomposite and either 7-10 year Treasuries or the *Bloomberg* correlation-weighted dollar index. S&P 100 outperformance is depicted with green bubbles, S&P 600 outperformance is depicted with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the performance differential.

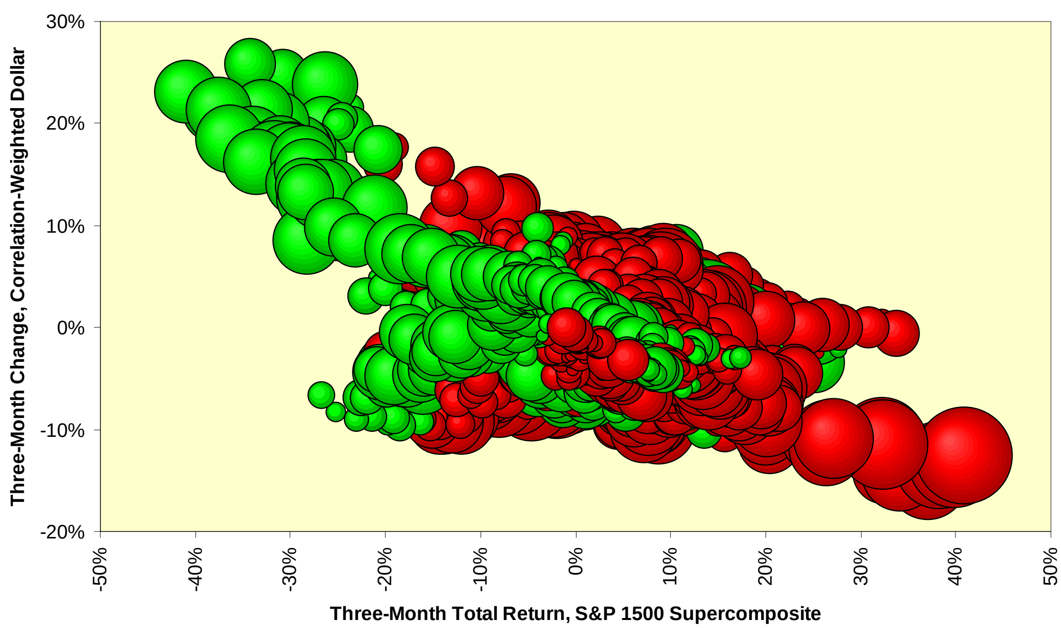
The first chart below confirms the relationship between OEX outperformance and long-term interest rates. As the stock market shifts into a bearish phase and long-term interest rates decline, investors flee into the perceived safety of larger-capitalization issues.

Relative Size And Performance:
Market State And 7-10 Year Treasuries



The second chart confirms the relationship between the dollar and OEX outperformance. As the market shifts into a bearish phase and the dollar strengthens, large-capitalization issues outperform.

Relative Size And Performance:
Market State And U.S. Dollar



The real driver of capitalization-based relative performance is the state of the market and how the "risk-on / risk-off" trade affects investor behavior. Large-capitalization outperformance appears to be more of a function of risk-aversion than of anything intrinsic to the issues themselves.