Revisiting The Large/Small Division In Performance

One of the problems involved in discussing the performance differentials between large- and small-capitalization stocks is the temptation to get a cheap laugh from the "size matters" description. I refuse to do that, just as I refused back in December 2012 when I noted the most important factor for relative performance was the bull/bear state of the stock market and not long-term interest rates or the state of the dollar.

Let's update that analysis in light of the strong divergence between indices such as the large-capitalization S&P 100 (OEX) and the small-capitalization S&P 600 (SML). The analysis would not be materially different if I used the Russell 1000 and Russell 2000 indices, accessible via ETFs such as the iShares Russell 1000 (IWB) and Russell 2000 (IWM). As I write, the OEX and SML have returned 1.65% and -4.36% year-to-date, respectively.

As before, let's note some important distinctions between large- and small-capitalization issues. First, the large-capitalization issues have a significant advantage created by capitalization-weighted index funds such as the Standard & Poor's Depository Trust (SPY). Second, small-capitalization issues 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, you can explain the business model of an ExxonMobil (XOM) or a Merck (MRK) while holding a lit match; doing this while explaining assorted cloud-based schemes to sell genetic-based pharmaceuticals on a social network yet to make a dime would result in someone's burned fingers: Yours.

Relative Performance Maps

The two charts below depict the three-month total return differential between the OEX and the SML 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. OEX outperformance is depicted with green bubbles, SML outperformance is depicted with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the performance differential. The last datum used is highlighted in turquoise.

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
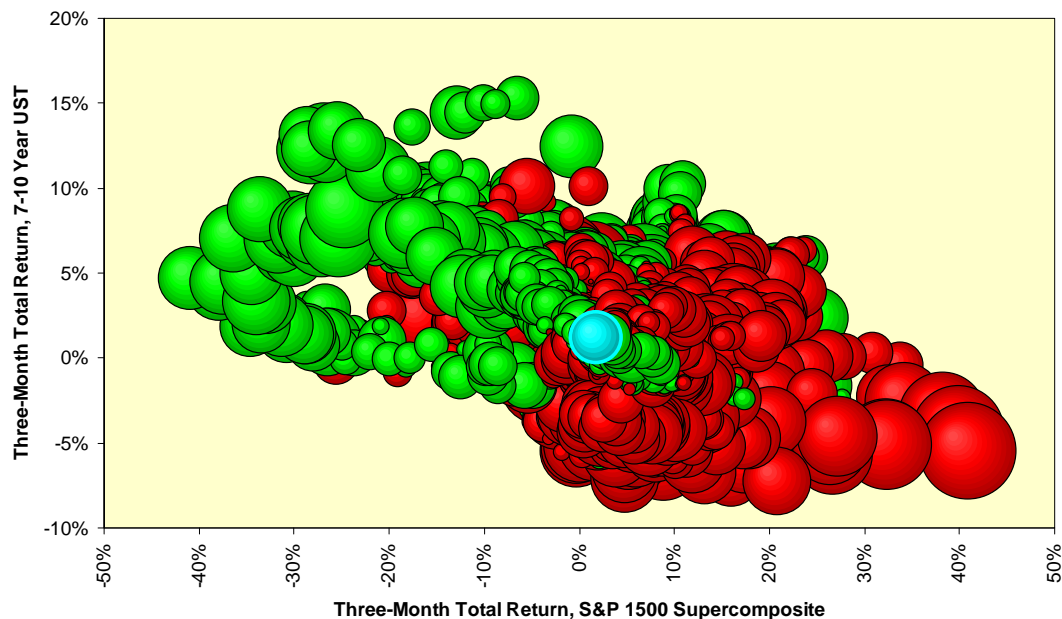
The next chart replaces 7-10 year Treasury returns with changes in the dollar. As the market shifts into a bearish phase and the dollar strengthens, large-capitalization issues outperform.

Relative Size And Performance:
Market State And U.S. Dollar
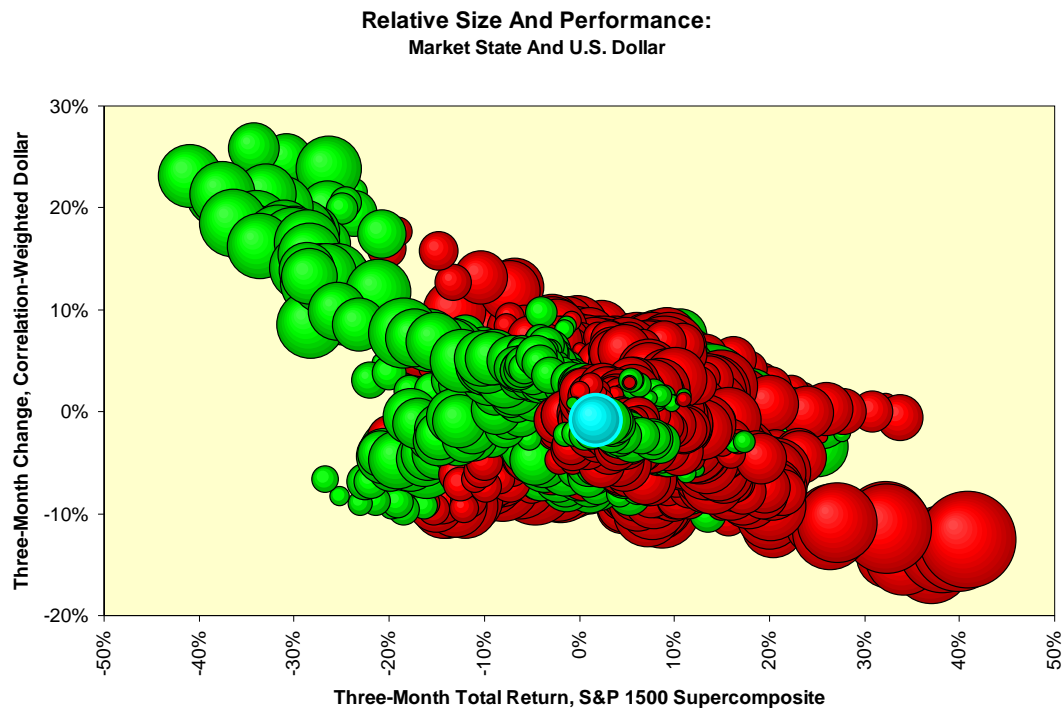
Where does this leave us at present? In both cases, either a general downturn in the broad market or a continuation of the 2014 trading range will maintain OEX outperformance. A continuation of the 7-10 year rally in Treasuries will favor OEX outpeformance as well, and as this rally seems to be associated with the current trading range in equities, that is sort of a twofer assessment. The dollar is far more problematic as it has been stuck in a three-year trading range and shows no strong predilection in either direction. A stronger greenback favors OEX outperformance and vice-versa.

So long as stocks remain in a defensively oriented trading range, the OEX will outperform the SML.