

SIZE MATTERS, AND SO DO VALUES

TWO OF THE BIGGEST DRIVERS OF STOCK performance are size and valuation. In fact, a given stock's style is often the biggest driver of its performance. A key to doing well in the stock market is determining what style is in favor and which ones are out of favor. In my April column, for example, I recommended investing in small-cap growth stocks. Through April until September's close, the iShares Russell 2000 Growth exchange traded fund (IWO), which tracks that small-cap index, has risen 37.49 percent. That's more than double the strong 17.42 percent gain registered by the widely followed S&P 500, a larger-cap stock index.

SMALL AND BIG, GROWTH AND VALUE

For the purposes of investing, you only really need to be concerned with four styles – big-cap growth, big-cap value, small-cap growth and small-cap value. Don't worry about mid-cap stocks, since they tend to trail big stocks when they do well, as they are too small, and, conversely, trail small stocks when they do well, as they are too big. I'm also going to ignore micro-cap stocks, those that are too small to warrant almost any attention. Taking a company's share price and multiplying that by the number of shares will generate a company's market capitalization or its dollar size.

Companies with higher valuations are considered growth stocks, while those with low valuations are value stocks.

For example, semiconductor equipment company Ultratech (UTEK), with a market capitalization of less than \$1 billion and shares priced at more than 8x last quarter's sales at the end of September, is a small-cap growth stock. On the other hand, Exxon Mobil (XOM), with a market capitalization of around \$250 billion and shares priced at less than 2x sales, is a large-cap value stock. Grouping stocks by their size and valuation shows that there are prolonged and predictable periods where a given style outperforms others.

STYLE CYCLES

Was I just lucky to advise investing in small-cap growth stocks as they began delivering a blistering six-month return of 37 percent, or was I paying attention to some facts that most people ignore? I'm not that lucky, so let's look at the facts. Data from Ibbotson Associates shows that small stocks have outperformed big stocks in the 12 months following every recession since World War II. When you dig further into the historical data, you find that small-value stocks tend to hold up better during bear markets than other styles, while small-growth stocks typically lead the market higher for about the first third of a bull market.

So far, this market cycle is behaving in a typical fashion. Not only is small-cap growth leading other styles off the March bottom, but from the year 2000 until the end of 2002, the Bara small-cap value index actually rose about 17 percent, even while the large-cap-dominated S&P 500 declined around 40 percent. If we look further back, we see that large-cap growth stocks were the best place to be in the late 1990s, as they led other styles. Typically, large stocks do best in the latter stages of a bull market, so the time will come when I will recommend moving out of small stocks and into large ones.

Exchange traded funds are an ideal way to take advantage of the stock market's style cycles. At the beginning of this year, my firm allocated large positions of the iShares Russell 2000 Growth (IWO) to our investors. Instead of having to research thousands of small-growth stocks and try to separate the wheat from the chaff (no small feat, as Enron demonstrated even well-covered big-cap stocks can hold nasty surprises), we simply use the exchange traded fund to buy the whole index and gain exposure to several hundred stocks in one fell swoop. We thereby reduce stock-specific risk, while still gaining the performance advantage if we select the right style – a strategy that can also work for you. ☺

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