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Large caps ready to take the lead

VIEWPOINT

By **ERIC B. PARNELL**

The stock market has experienced an unprecedented trend in recent years. While large cap stocks and small cap stocks usually trade market leadership back and forth every couple of years, small caps have been trouncing large caps for quite a while now. Over the last five calendar years from 2000 to 2005, small caps beat large caps each and every year and have racked up a total annualized returns difference of over 10 percent. And this trend of small cap leadership has continued through April 2006. Despite this seemingly endless winning streak, a variety of signs now suggest that large caps may finally be ready to take the lead.

Before going further, let's first explore exactly what defines a large cap stock and a small cap stock. Large caps are major companies that have a total market value that is generally greater than 5 billion dollars. Large cap companies include well-known names like General Electric, Microsoft and Procter & Gamble. Large cap performance is typically measured by the S&P 500 index. Small caps are more specialized companies that have a total market value that is generally less than 1 billion dollars. Examples include retailer Pier 1 Imports, chemical maker WD-40 and video recorder TiVo among many others. Small cap returns are usually measured by indices like the S&P 600 or the Russell 2000.

Small caps have outperformed large caps in recent years for several reasons. First, small cap companies tend to benefit more than large caps from strong consumer spending. When the U.S. headed into recession following the bursting of the tech bubble back in 2000, one key factor that helped keep the economy afloat was the fact that consumers continued to spend. And since the economy began to recover in 2003, consumer spending led the way. Second, small caps

typically rely on getting loans to expand their businesses. With interest rates as low as 1 percent in recent years, small cap companies have been able to get access to money at a historically low cost. Finally, small cap stocks were trading at prices that were bargains relative to their large cap counterparts.

Many of the factors helping small caps lead over large caps in recent years have just about run their course at this point. Many economists are anticipating that consumers are likely to cut back on spending due to high debt levels and a slowdown in the housing market. Also, interest rates have been rising sharply over the last 18 months, making it more expensive for companies and consumers to borrow money. Finally, the price discount of small caps versus large caps has now disappeared following the strong small cap run in recent years.

Large caps should receive an added tailwind against small caps for several additional reasons. First, large cap companies are generally more globally oriented and tend to benefit from growth overseas. While the U.S. has been the primary driving force for the world economy over the last decade, recent data has suggested that places such as Europe and Japan are picking up steam. Second, the U.S. dollar has been weakening relative to foreign currencies such as the European euro and the Japanese yen. A weaker dollar makes the products that large cap companies sell abroad more affordable to foreign buyers. This movement in exchange rates also boosts the profits that these large cap companies bring back to the U.S. Finally, large cap stocks are trading at some of the most attractive valuations since the early 1990s.

While many signals suggest that large caps are ready to take the lead from small caps, investors should still take a balanced approach when adjusting their portfolios. Attempting to time exactly when the leadership will change between large caps and small caps can be difficult. By maintaining a diversified portfolio that includes both large caps and small caps, you can help ensure that you always have an exposure to the stock segments that are leading the market at any point in time.

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