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How Much SMidCap Exposure?

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How Much SMidCap Exposure?

Small- to mid-cap stocks (smidcaps) have had an extended period of outperformance since 1999. The outsized returns delivered by this market cap segment have attracted considerable attention, and investors may wonder if it's too late to add exposure to smaller stocks. Below, we offer a few items for your consideration in determining how much exposure to smid-cap stocks one should maintain.

Asset Allocation

Historically, smaller stocks have higher expected return and higher risk than their large-cap counterparts. Because historically they do not carry a perfect correlation with large stocks, adding small caps to your portfolio may enhance return and reduce overall risk. Modern Portfolio Theory tells us an optimal portfolio is one which offers the best risk/return profile. Using that notion, an optimal mix may be 75% large-cap and 25% smid-cap stocks.

- Over the past 28 years, the small/midcap (*SMidCap*) Russell 2500 Index has posted an annualized return of 14.74%, versus the S&P 500's annualized return of 13.44%. (*For reference, the Russell 2000 Index has returned 13.38% per annum.*)

- The annual standard deviation of the Russell 2500 Index return over the same period is 17.77%, versus 14.87% for the S&P 500. (*For reference, the annualized standard deviation of the Russell 2000 is 19.30 %.*)

	Ann. Ret.	Ann. Risk
S&P 500	**13.44%**	**14.87%**
Russell 2500	**14.74%**	**17.77%**
Russell 2000	**13.38%**	**19.30%**

Source: Standard & Poors, Russell Mellon

- The Russell 2500 Index has a correlation with the S&P 500 of 0.86, and a near-perfect correlation of 0.99 with the Russell 2000:

	S&P 500	FR2000	FR2500
S&P 500	**1.00**		
Russell 2500	**0.86**	**1.00**	
Russell 2000	**0.80**	**0.99**	**1.00**

Source: Standard & Poors, Russell Mellon

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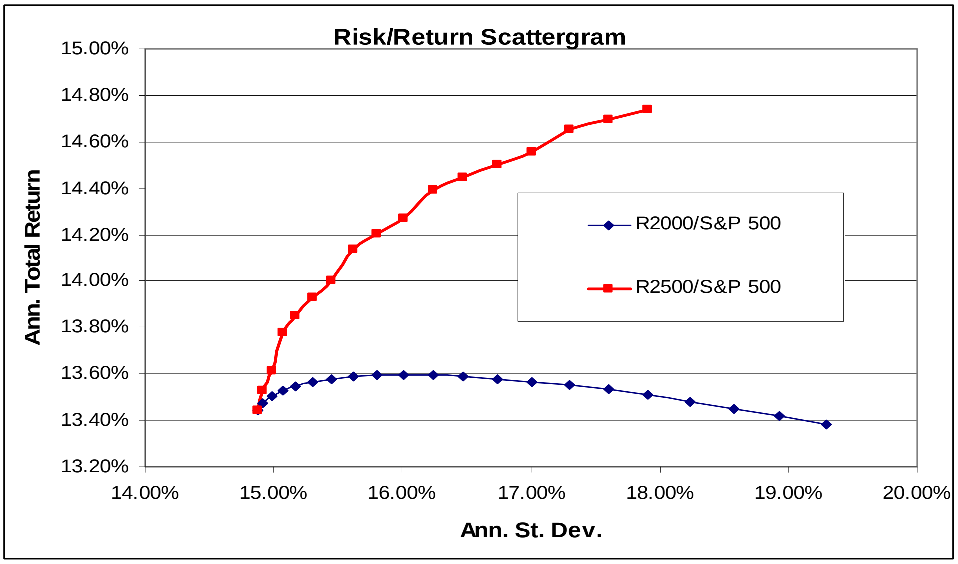
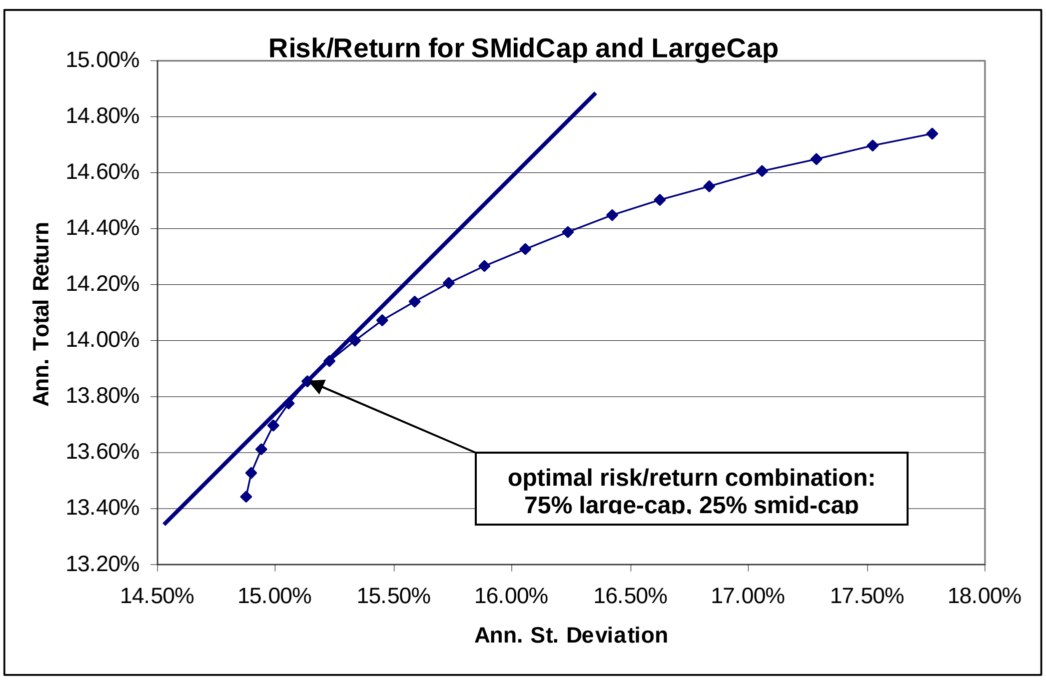
- Because of the Russell 2500 Index' returns and the benchmark's less-than-perfect correlation with the large-cap S&P 500 Index, a blended portfolio of large- and smid-cap stocks dominates both a pure large-cap portfolio and a blended portfolio of large-cap and small-cap stocks:



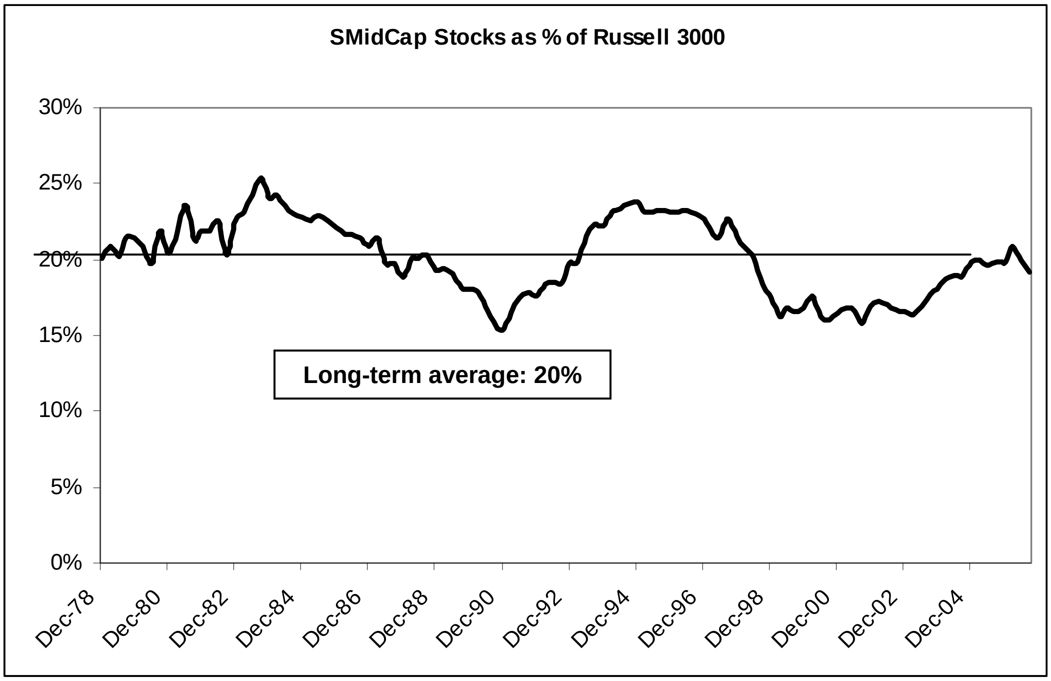
Source: Standard & Poors, Russell Mellon

- Finally, given the above, we search for the optimal blend of large-cap and smid-cap stocks. The scattergram below identifies the risk and return profiles of large-cap and smid-cap blends, with the smid-cap exposure increasing from 0% to 100% in increments of 5%:



Source: Standard & Poors, Russell Mellon

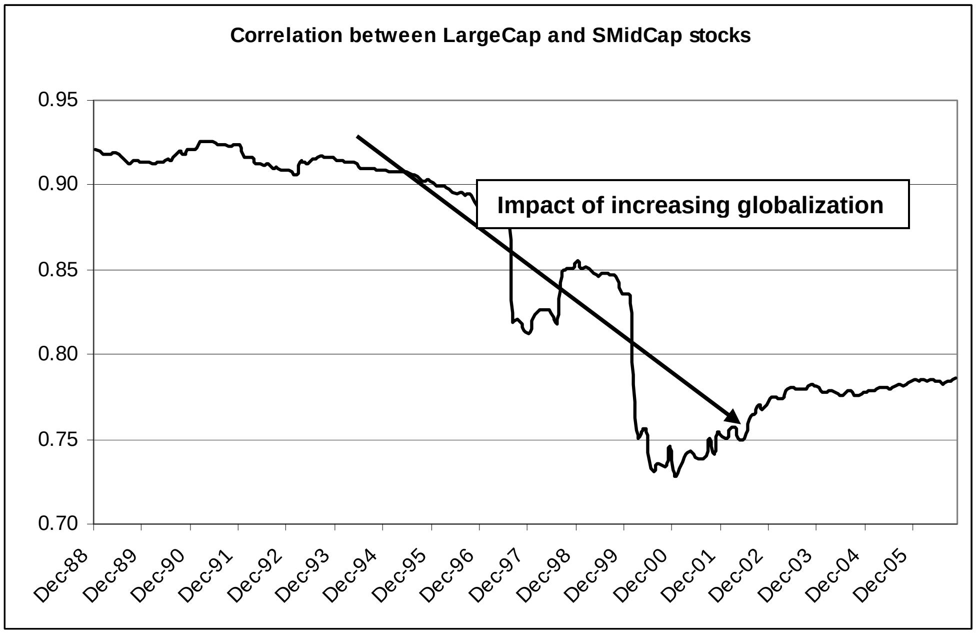
The Efficient Market Hypothesis, meanwhile, tells us that we should use market exposure as our guideline in determining proper exposure to an asset class. We measured the total market capitalization of the Russell 3000 Index and the Russell 2500 Index over the past 112 quarters. By dividing the latter into the former, we can determine what percentage of the Russell 3000 consists of smid-cap stocks. Employing this approach, we arrive at a similar conclusion of the optimal smid-cap allocation:



Source: Russell Mellon

Increasing Benefits of Diversification

As globalization increases, performance of larger stocks and smaller stocks may diverge, as large companies derive significant revenue from overseas, small stocks significantly less. Above, we referenced the fact that over the past 28 years, the correlation between the S&P 500 and the Russell 2500 Index is 0.86. However, as the global economy becomes increasingly integrated, this correlation is generally decreasing. As such, the benefits of diversifying among large- and smid-cap stocks may be increasing:



Source: Standard & Poors, Russell Mellon

Benefits of Neglect

There has been considerable research regarding the performance of "neglected", or under-followed, firms. Lower levels of analyst coverage are associated with higher returns, regardless of firm size. Several theories have been put forth to explain this effect. Investors may be willing to pay a higher price for stocks which have a recognized "brand", despite the fact that future returns may be lower. Another theory is that news may be incorporated less slowly for under-followed stocks, and thus they are more prone to the impact of long-term price momentum. A third theory posits that less-followed firms are simply less-efficiently priced (and more volatile), and therefore may offer higher returns. Under each of these theories, neglected stocks outperform stocks with greater analyst coverage.

Average Analysts' Coverage	
S&P 500	**15.4**
Russell 2500	**6.4**

Source: Standard & Poors, Russell Mellon, IBES

Reports also indicate that on average, while only 32.6% of all large-cap managers have trumped the S&P 500, 40.8% of all mid-cap managers topped the S&P 400, and 49.5% of all small-cap managers beat the S&P 600. This confirms the notion that small- and mid-cap cap stocks are less efficiently priced than their large-cap counterparts.

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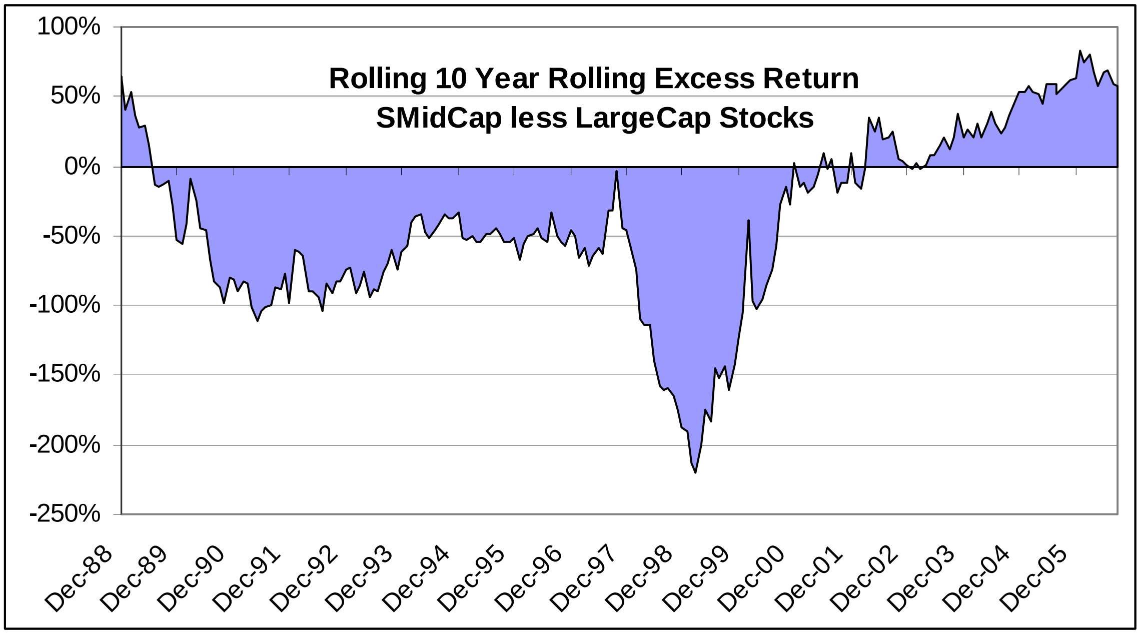
Size Rotation

As presented below, the performance swings between large-cap outperformance and small-cap outperformance can be significant in magnitude. While smid-caps have outperformed significantly over the past 6-7 years, the magnitude of their outperformance is not nearly equal to the magnitude and duration of outperformance recorded by large-caps during the 90's.



Source: Russell Mellon

Loss Likelihood and Time Decay

We've already shown that when viewed separately, smid-cap stocks are slightly more risky than large-cap stocks. We've also shown that combining smid-caps with large-caps may lead to a better risk/return profile for investors. Another way of potentially decreasing the risk of smid-cap stocks is through increasing the holding period. While smid-caps have greater risk, they may also have greater return potential. Thus, by increasing the duration of the holding period, the greater return potential slowly overwhelms the impact of higher volatility/greater risk.

Loss Probability:	S&P 500	FR2500
1 Year	10.9%	11.2%
3 Year	10.4%	3.7%
5 Year	12.0%	0.7%
10 Year	0.0%	0.0%

January 1978 – November 2006; past results do not ensure future results.

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Conclusion

We've presented a case as to why your smid-cap exposure may be better than small-cap exposure, and why smid-cap exposure of 20-25% may be appropriate for suitable investors. We framed our reasoning in a risk/return discussion. While some may believe it's too late to gain exposure to this segment of the US equity market, many investors generally do not carry 20-25% of their domestic stock allocation in small and mid-cap stocks. We believe that the diversification benefits of smid-cap exposure increase with time, and that the current length and magnitude of smid-cap outperformance falls well within observed norms. We also believe that while some believe stand-alone exposure to smid-cap stocks is too risky, even that risk may be mitigated with a sufficiently long holding period.

[i] *Pradhuman, Satya D., Merrill Lynch, Asset Allocation – Update on Framing the Size Dilemna, January 17, 2006.*

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