Disciplined Growth Investors

The Way Wealth Is Built

SMALL CAP STOCKS AS A DEFINITIVE STRATEGY

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The issue has been raised as to whether investing in small cap stocks makes sense as a category of equity investing. Historic return data for the S&P 500, the Russell 2000, and market cap weighted performance for the period prior to the inception of the Russell 2000 have been used to examine this issue. Here are some facts to consider in examining the issue on small caps versus large caps:

Over a long time period (25+ years) small caps have provided a return of about 14% while large caps provided about 11%.

Over intermediate time periods (5-15 years) the return for one capitalization category can differ significantly from its long-term norm. A view of the future may be gained from observing these deviations.

Over intermediate periods (5-15 years) one category is favored over the other.

Time Period	Favored Capitalization Category
1974 to 1982	Small Cap Stocks
1983 to 1990	Large Cap Stocks
1991 to 1994	Small Cap Stocks
1995 to Present	Large Cap Stocks

HERE ARE THE PRESENT CONDITIONS:

Recent returns by large cap stocks are far above their long-term norms. Over the past four years ending 9/30/98 large cap stocks have earned 24.5% compounded. This has lifted the compound annual return for the large cap stocks over intermediate periods (5-15 years) to rates far above historic norms. For this period the annual compound return has ranged between 14.2% (last eleven years) and 19.2% (last eight years). During no intermediate trailing period (5-15 years) in the last 15 years ending 9/30/98 did large cap stocks earn a compound return less than the historical average.

Recent returns by small cap stocks are well below their long-term norms. Over the past four years ending 9/30/98 small cap stocks have returned 10.8% compounded. This period of underperformance has pulled down the intermediate return below historic returns. For the last 5-15 years small cap stocks have ranged between 9.0% (last eleven years) and 12.8% (last six years). Only during one period (last eight years) did the small caps exceed their long-term return (15.9%).

The performance of large cap stocks has exceeded their fundamental progress. Presently the S&P 500 is selling at record high levels of price-earnings ratio, price-book ratio, and price-sales ratio. The S&P 500 also sells at record low levels of dividend yield.

The lagging performance of the small caps has caused them to sell at the largest relative valuation discounts to the large caps in at least 25 years. Based on our direct fundamental work, including balance sheet analysis, a large number of small cap stocks sell at the lowest absolute valuations seen during the last 25 years.

The trailing one-year performance spread between the S&P 500 and the Russell 2000 for the period ended 8/31/98 was the widest in the 20-year history of the Russell index and only slightly less than the performance spread in 1974.

There are currently no significant legal, tax, or political issues that would favor large cap stocks over small caps or vice versa. However, the recent decision by the Federal Reserve Board to officially ease monetary policy should favor small caps. Historically, monetary easing has favored small caps versus large caps for the twelve months following the Fed cutting interest rates.

OBSERVATIONS REGARDING THE LIKELY RETURNS FROM SMALL CAPS:

The relative performance of small caps over the last year is extreme. The last period of similar extremes (1974) preceded the best relative and absolute performance for small caps in the past 25 years.

All investors must make some assumptions about the future in order to arrive at a disciplined strategy. Our working assumption is that a prudent strategy assumes reversion to the mean. In other words, a prudent forecast would assume that the S&P 500 would be likely to revert to its long term 11% compound return. Likewise, small caps would also return to their 14% long-term return.

A prudent strategy also requires that a crosscheck of the output of a "reversion to the mean" forecast to verify its reasonableness.

REVERSION TO THE MEAN:

S&P 500

In order to develop an intermediate forecast of the returns likely from the S&P 500, we assumed that the S&P 500 would migrate from its return of the last 5-15 years to a 20-year return of 11%. For example, the S&P 500 returned 17.3% over the past ten years. If large caps were to return to their long-term average of 11%, the S&P 500 returns would have to drop to 5.1% per year for the next 10 years. By applying this same methodology over the last 5-15 years historic returns, the range of future returns over the next 5-15 years for the S&P 500 would be –3.7% to 8.2%. The average of these returns was 4.2%.

As a crosscheck of the forecast we looked at the likely movement of the P/E ratio for the S&P 500. The current P/E of the S&P 500 is approximately 26x. We assumed the P/E ratio would revert to a more normal 18 times in 10 years. (This multiple reflects a low inflation environment. This level is well above the P/E of 6x during the high-inflation period of the early 1980's.) We also assumed that earnings per share and dividends would grow at 6%. With a beginning current yield of 1.5% the 10-year return from the S&P 500 would be 3.9% per year.

Russell 2000

We assumed the Russell 2000 would migrate to its norm of 14%. Using the last 5-15 years data, the Russell would earn a compound return of 12.8% to 27.5% over the next 5-15 years. The average return was 18.10%.

A crosscheck of our valuation work suggests very high future returns. We examined the returns from small caps following 1974, the last period of extreme performance divergence between small caps and large caps. We found that from 1975 until 1982, small caps earned 30.6% per year.

ABOUT DISCIPLINED GROWTH INVESTORS

Disciplined Growth Investors is a registered investment advisor specializing in the management of small and mid cap growth equity portfolios. Our clients are institutions and high net-worth individuals. We are completely independent and 100% owned by our employees.

Our investment process is designed to exploit the ever-present inefficiencies that exist in the financial markets especially in the assessment of individual securities. Our investment research is fundamental and seeks to discover stocks of well managed companies engaged in attractive businesses. Our investment style of "Growth at a Reasonable Price" employs both growth and valuation criteria in security selection. We then apply proven portfolio management disciplines to achieve success for our clients.

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