SERVŌ WEALTH MANAGEMENT
Simplify Complexity

OCTOBER 2012

Factors in Focus

The Virtues of Small Cap and Value

by Eric D. Nelson, CFA

Last month we looked at our role as investors: *underwriters of capitalism*, holding thousands of stocks and bonds globally on a long-term basis, providing much needed funding to public companies around the world so they may continue to grow and innovate, producing products and services that help to improve our standard of living. And in return for providing this funding, we expect to earn attractive returns on our capital in line with the risks we have taken.

But when we look to the primary risks and expected return decisions associated with investing: how much to hold in stocks vs. bonds, small stocks vs. large stocks, and value companies vs. growth companies, the last two considerations are often ignored. Some investors assume that "tilting" a portfolio to smaller and more value oriented stocks is done only for the potential of sporadically higher returns, and others believe it is not necessary at all. A closer look will help to illustrate both a high degree of consistency across all dimensions of risk and return as well as an often ignored but significant benefit of smaller and more value-oriented stocks: additional portfolio diversification.

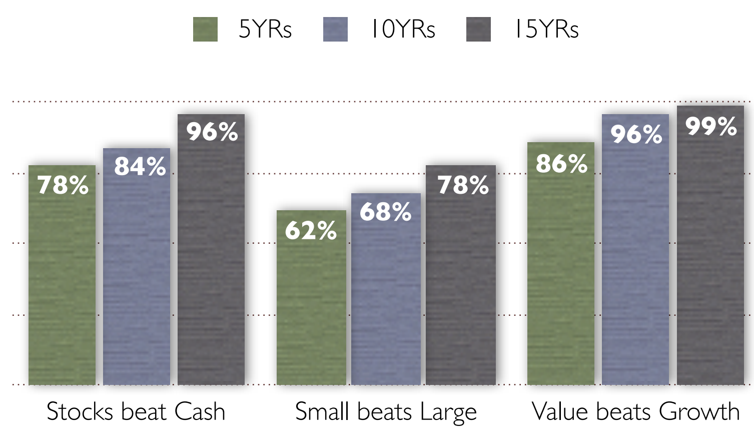
Risk is Usually Rewarded

Over as long a period as we can measure, investors have been rewarded for holding stocks in excess of risk-free cash investments with an additional return of 5.5% per year. Small stocks have generated a 2.4% per year return above large stocks. And finally, the lowest priced value stocks have earned a 4.0% per year greater return than the highest priced growth stocks. In each case the return was compensation for bearing extra risk. But how consistently have investors earned these higher returns? If the additional premiums were the result of an isolated period or two of exceptional results and long periods in-between with no advantage, the potentially higher returns may not be worth the long wait.

The evidence finds this is not the case.

As Chart 1 illustrates, over periods as short as 5 years, stocks beat cash almost 80% of the time, small stocks beat larger ones almost two-thirds of the time, and value beat growth almost 90% of the time. As the time horizon grows, so too does the persistence. So it appears markets "work" in that they properly reward us for taking investment risks. We aren't guaranteed a return over any given period of time, but the longer we stay with it, the more likely it is we will get what we deserve—on stocks, small cap, or value.

CHART 1: The Persistence of Stock, Size, and Value Returns (1928-2011)



Source: DFA Returns 2.0

The Long-Term Benefits of Diversification

The predictability of performance has grown with time. But as Chart 1 shows, even over periods as long as 15 years, all risks occasionally fail to generate a return. Fortunately for investors who want more long-term consistency, the periods where stocks fail to beat cash do not always coincide with the periods where small companies trail larger ones or value stocks underperform growth, and vice-versa. This means sometimes traditional stock indexes can be doing poorly but small and value companies are doing well, other times stock indexes are doing exceptional relative to

Past performance is not a guarantee of future results. Indexes are not available for direct investment and are used to convey broad economic principles. Their performance does not reflect the expenses associated with the management of an actual portfolio.

cash, but small and value companies are failing to outperform larger and more growth oriented companies.

Table 1 explores this tendency by looking at three distinct periods going back almost 50 years.

TABLE 1: The Diversification of Small Cap and Value Stocks (annualized returns)

Portfolio Mix	1965-1981	1982-1999	2000-9/2012	Total Period
S&P 500 Index	+6.3%	+18.5%	+1.7%	**+9.5%**
Cash	+6.7%	+6.2%	+2.2%	+5.3%
Diversified Stock Index	+12.0%	+18.3%	+6.6%	+12.9%
Diversified Balanced Index	+9.9%	+15.1%	+7.4%	**+11.2%**

*Source: DFA Returns 2.0; **Cash** = 1month t-bills; **Diversified Equity Index** = 30% S&P 500, 30% DFA US large value index, 40% DFA US small value index rebalanced annually; **Diversified Balanced Index** = 18% S&P 500, 18% DFA US large value index, 24% DFA US small value index, 40% 5YR T-Notes rebalanced annually*

From 1965-1981, we see a 17 year stretch where the large growth stock oriented S&P 500 Index failed to outperform cash. But this was offset by stronger returns from large and small value stocks included in the Diversified Stock Index, lifting it to a +12.0% return. And even with 40% in bonds, the Diversified Balanced Index that also included large and small value stocks still managed almost +10.0% per year.

The next 18 years were a mirror image of the previous 17. Stocks did exceptionally well, with the S&P 500 outperforming cash by over 12% per year—more than double its long term average. This time, the diversification of small and value stocks also worked in reverse, providing no additional return to the S&P 500. As such, the Diversified Stock Index underperformed the S&P 500 slightly, while the Diversified Balanced Index trailed it by over 3% per year. But with such an outstanding result for the stock market in general, most investors would admit additional "help" from small and value stocks wasn't necessary.

Finally, the last 13 years has looked similar to the first period. The S&P 500 has disappointed with only a 1.7% return, 0.5% less than cash. And once again, including large and small value stocks helped lift the Diversified Stock Index to a more satisfactory return, earning +6.6%—almost 5% more than the S&P 500. Bonds helped the Diversified Balanced Index even more, turning in a +7.4% result.

Taken as a whole we see that by concentrating one's investments in just the large cap growth stocks that dominate the S&P 500 index (or similar "Total Market Indexes"), one is prone to long periods of disappointing returns. But the investor who chooses instead to diversify more broadly, including large and small value stocks in their mix, and possibly even an allocation of 5YR bonds to lower risk, has found the ride to be noticeably smoother. So while small cap and value stocks are often thought of as additional (and optional) risks beyond those associated with simply investing in a large cap oriented fund like the S&P 500 or a Total Stock Index, it turns out that they also provide important diversification benefits during longer periods when the overall stock market is struggling to keep pace with even risk-less cash investments.

Higher Returns With Less Risk?

Finally, there is at least one other benefit of including small cap and value stocks in a diversified portfolio. Historically, doing so has meant that it isn't necessary to hold 100% in stocks to get the full return of the overall stock market. In the "Total Period" above (see **bold**) spanning more than four decades, we find that a portfolio that is only 60% in stocks, but includes an allocation to smaller and more value oriented companies, along with 40% in 5YR bonds was able to exceed the returns on the S&P 500 Index—an all-stock portfolio, with less overall risk. Including smaller and more value oriented stocks along with the S&P 500 provided significantly higher returns on the stock allocation of the Diversified Balanced Index. Also, the portfolio was rebalanced once per year as better performing investments were sold to buy underperforming investments to bring the allocation back in line. This meant that on occasion, some bonds were sold at appreciated values to buy more stocks that had fallen precipitously and represented even higher expected (and eventually realized) returns. This unique opportunity helped to offset what were much lower overall returns for bonds relative to stocks for the entire period.

Next month we will review how a balanced portfolio that includes small cap and value diversification across stocks and a modest allocation to 5YR bonds not only has produced favorable risk-adjusted returns, but has also proved to be a winning combination for retirees who want long-term portfolio growth and short-term liquidity for ongoing income and cash-flow needs.

SERVŌ | WEALTH MANAGEMENT
Simplify Complexity

Servō Wealth Management
3600 NW 138th Street; Suite 102
OKC, OK 73134
Phone: 405-418-8555
Fax: 405-728-2785
www.servowealth.com