

2009: the year when size mattered

By Tom Stevenson, 21 October 2009

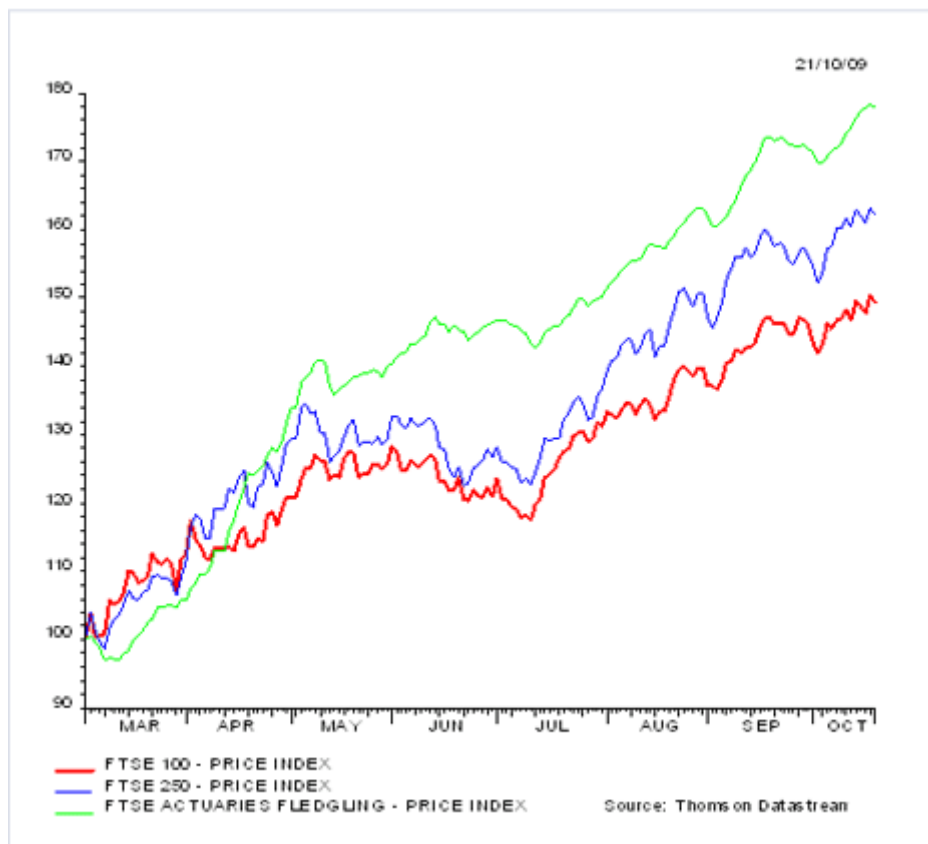
Small cap stocks have led the charge since March – is it time for the big boys to bounce back?

Since the market hit its low point in March, there has been a marked divergence between the performance of the largest and the smallest companies.

As the chart below shows, the FTSE 100 index of Britain's largest companies has risen by 49% since March 3. That's impressive but the FTSE 250 index of mid-cap stocks has gained 62% and the FTSE Fledgling index of the smallest companies listed on London's main market has done even better, rising by 78%.



"Smaller companies tend to be more cyclical than larger ones, harder hit by downturns and bigger beneficiaries of upswings." Tom Stevenson



There are good reasons why this should have happened. The market started rising in March because investors began to take a more optimistic view of the outlook for corporate earnings and became less worried about companies going bust as a result of the financial crisis.

In this environment, it is unsurprising that investors should have started to favour the cyclical companies that they thought would benefit most from easier conditions and which had been sold down most aggressively in the earlier market slide. Smaller companies tend to be more cyclical than larger ones, harder hit by downturns and bigger beneficiaries of upswings.

Research by Nomura shows an even more pronounced effect than this across Europe as a whole, where the companies making up the biggest quarter of stocks have risen by 40% since the market turned but the smallest quarter have risen by 93%.

The performance of smaller stocks tends to track what analysts are doing with their profit forecasts. As estimates are reined in, smaller companies underperform, but when upgrades are the order of the day then small stocks have their moment in the sun.

A year or so ago, most analysts were taking the red pen to their forecasts; now they are increasing their estimates on average, so the relative performance of smaller stocks is not all that surprising.

What next? Nomura's strategists looked at what happened in recent earnings cycles and calculated that on average small stocks kept up the running for a few months after estimates turned upwards but thereafter they started to fall behind the bigger stocks.

There are two main reasons for this. First, the underperformance of larger stocks in the early stages of the upturn means they become relatively cheap. And, in fact, larger stocks are cheaper than they have been compared to smaller stocks for 20 years or so.

The second reason is that economically sensitive consumer sectors like retail and leisure are more heavily represented among smaller stocks while the most defensive sectors like utilities and telecoms tend to be big stocks. As investors shift their attention from early beneficiaries of an upturn to companies that can grind out higher profits in a steadier environment, I believe they are likely to start looking harder at bigger, cheaper and more defensive stocks.

The sharp recovery from the market low has been called a "dash to trash" and, while not all smaller companies are low quality, the outperformance of small stocks fits with this appetite for riskier investments. This is a difficult environment for investors who focus their attention on fundamental valuations because often the least obviously attractive companies perform the best. I expect "normal service" to start resuming soon with big, robust defensive stocks having their day.

Source: Datastream, years from 30.09.04 to 30.09.09

	Sept 04 / Sept 05	Sept 05 / Sept 06	Sept 06 / Sept 07	Sept 07 / Sept 08	Sept 08 / Sept 09
FTSE 100	19.8%	8.8%	8.5%	-24.2%	4.7%
FTSE 250	26.8%	25.7%	10.4%	-28.5%	15.9%
FTSE ACTUARIES FLEDGLING	26.2%	10.6%	11.1%	-32.9%	35.5%

Please note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in Tom Stevenson's weekly column are his own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.