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ELECTRONIC Q&A |  Online Exclusive

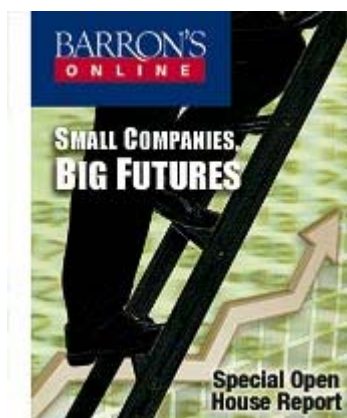
Ibbotson: Small Caps Still Have Big Bang

By JOHN KIMELMAN

Editor's Note: As part of our weeklong free Open House, Barron's Online begins a special series, "Small Companies, Big Futures." From Tuesday through Thursday, Weekday Trader, Electronic Q&A, Getting Technical and Hulbert on Markets will all look at how small stocks in general -- and some small companies in particular -- are likely to perform in the months and years ahead.

U.S. SMALL-CAP STOCKS HAVE OUTPACED their larger-cap counterparts for seven straight years.


And while many Wall Street investment strategists are predicting a comeback for the blue chips this year, renowned investment researcher Roger Ibbotson can easily see small caps winding up on top for the eighth year in a row.



"Small caps have tremendous momentum," says Ibbotson, the chairman and founder of Chicago-based Ibbotson Associates, which provides asset-allocation advice and tools to financial institutions. "Whatever they've been doing, they have a tendency to keep on doing."

Though small caps (whose market values are under \$2 billion) are more volatile than large caps (generally companies in the Standard & Poor's 500 index), Ibbotson points out that they have outperformed large-cap stocks by more than two percentage points a year over the last 80 years.

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Recently, Ibbotson, who moonlights as a finance professor at the Yale School of Management, spoke with Barron's Online about the prospects for small-cap stocks and how they can help investors' portfolios.

Barron's Online: *Explain the role that small caps play in an investor's portfolio.*

Ibbotson: Small stocks behave quite a bit differently than large stocks, and they tend to have over the long run higher returns. [Editor's Note: According to Ibbotson Associates, small caps have returned 12.6% a year over the past 80 years ending in 2005, whereas large caps have advanced 10.4% annually.] In general, small caps have had somewhat better earnings growth. And you're getting small

caps at a better price on average.

Q: *How much of an investor's stock portfolio should be composed of small-cap stocks?*

A: It might be about 25% of a total U.S. stock portfolio. But an aggressive investor could go [to] 50% or higher, though that would be risky.

Q: *How much riskier are small-cap stocks than large caps?*

A: When you put small caps into a portfolio actually, at the beginning it reduces your risk, because small stocks are great diversifiers from the rest of the portfolio.

It is only when you load up on them that it actually makes your portfolio more risky. So, if we are talking about 20% to 25% small caps, that's not increasing the risk of your portfolio.

Q: *Why have small caps outperformed blue chips over the last seven calendar years? They're even up against the big guys this year, despite the fact that most Wall Street investment strategists continue to call for large caps to stage a comeback, just as they did last year.*

A: Small caps have tremendous momentum. Whatever they've been doing, they have a tendency to keep on doing. There tends to be momentum overall in the market, but it is overwhelmingly in the small caps. And generally there have been long runs when small caps have beaten large caps, for example, from 1974 through 1983 was a 10-year run when small caps beat large caps every year.

Now, we are having this seven-year run, I guess there is a really good chance that small caps will outperform this year as well, so it might be the eighth year of the run. So, the momentum is there and runs tend to continue. But that has to end at some point.

Q: *Is this long-term outperformance by small-cap stocks in and of itself a reason to increase or decrease their weighting in a portfolio, or doesn't it matter?*

A: Well, generally because of the momentum when things are going well, I would say you would increase the weighting. But there are other things that make me less optimistic about small caps right now. And that's just basically that they have gone up so much that they are somewhat outrunning their earnings.

Ibbotson Asset-Allocation Models

Moderate Conservative Investor

Large-Cap U.S. Stocks	26%
Small-Cap U.S. Stocks	5%
International Stocks	11%
Bonds	37%
Cash Equivalent	21%

Moderate Aggressive Investor

Large-Cap U.S. stocks	43%
Small-Cap U.S. stocks	13%
International Stocks	22%
Bonds	17%
Cash Equivalent	5%

Q: *Implied in that answer is the assumption that investors can time the market and thus adjust their asset-allocation weightings based on hunches about the market's future direction.*

A: While I think it's tough to time markets, small caps is actually one of the areas that you have the most possibility of timing markets.

Q: *Because of the momentum?*

A: Yes. There is more momentum in small caps than any other area of the market that I have ever found.

Q: *You have said that most of an investor's return comes from asset-allocation decisions rather than individual stock-selection decisions. Indeed, other market analysts such as Gary Brinson have made this point. If that's so, doesn't it really behoove the average investor to focus on gaining exposure to different asset classes through low-cost funds as opposed to trying to pick individual stocks?*

A: I would say certainly that for the average investor it does.

Really the people who should focus on individual stock selections should be the true experts who know how to find stocks and buy them cheaply. But the average investor doesn't have that competitive

advantage actually.

Q: *Do you think that stocks are valued efficiently by the marketplace?*

A: Oh, I can definitely find lots of inefficiencies in the market, but I will say that when you were talking about that average investor again, that they might reasonably act as if markets are efficient and not try to buy the undervalued stock because they might end up buying the overvalued stock.

Q: *But what about small caps in particular? Even efficient-market proponents concede that the market for small-cap stocks is less efficient than it is for larger companies, thus providing greater opportunities for stockpickers.*

A: Yes, small caps are definitely going to be more inefficient, but it doesn't mean that even passive strategies may not work well in small-cap stocks, despite the fact that they are less efficient.

Q: *Should the average investor get his or her small-cap exposure through a small-cap index mutual fund or exchange-traded fund?*

A: In buying small caps, you want to try to buy relatively low-turnover funds, and they might include a broad-based small-cap fund that might include some mid-caps. That would enable them to be lower turnover. You don't necessarily want to get a portfolio of micro-cap funds, because they have higher turnovers and that leads to high taxes on realized capital gains.

But you would like to be able to hold these things for at least a year, because at least they become capital gains at that point. And you would like to [own] funds that tend to hold the stocks for at least a year.

Q: *Thank you.*

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