Stock Market Capitalization and Its Effect on Performance

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Historically, small capitalization stocks perform better than their larger counterparts—but at what cost? When analyzing companies suitable for investment, it behooves the investor to heed the warning signs of specific market caps. Below, the author identifies these warning signs, explains how to discern market caps, and tells how their nuances can increase return potential.

Benefit plans, as well as individual investors, can increase the potential return on their investments by learning to discern and detect "market caps"—the number and aggregate market value of the shares that public corporations have outstanding—as well as the caps' nuances.

Investing in different sized companies can have a profound effect on portfolio performance. However, there are significant differences among small-, mid-, and large-cap investing.

DEFINITIONS

Four of the terms that are frequently used in this article are defined as follows (these definitions were taken from SmartMoney.com):

- **Market Capitalization** (also known as *market value*): When measuring an individual stock, this refers to the number of shares a company has outstanding multiplied by the share price. When measuring a stock mutual fund, market capitalization refers to the median market capitalization (MMC) of all stocks owned by the mutual fund.

- **Large Capitalization** (large-cap): Stocks or stock mutual funds with a market capitalization over $10 billion.

- **Middle Capitalization** (mid-cap): Stocks or stock mutual funds with a market capitalization between $2 billion and $10 billion.

- **Small Capitalization** (small-cap): Stocks or stock mutual funds with a market cap under $2 billion.

CHARACTERISTICS OF LARGE-, MID-, AND SMALL-CAP STOCKS: INVESTMENT STYLES

Large-Cap Investing

Large-caps by far represent the largest market share of any of the three investment styles. Morningstar Principia Pro, a financial service providing performance and financial data on different types of investments with searching and ranking capabilities, indicates that 83 percent of the U.S. stock market is represented by large-caps. (See Chart 1.) This investment style includes investing in securities in the most stable companies. Mutual funds that invest in large-cap stocks often have a dual objective of capital growth and income (usually through dividend payments).

Mid-Cap Investing

Mid-caps represent 11 percent of the total U.S. stock market capitalization. Investing in mid-caps involves investments in both smaller companies that have grown in market capitalization size and former larger companies that have shrunk in market cap size. Mid-cap companies are attractive due to their faster growth rates while offering some of the stability often seen with large-cap companies.

Small-Cap Investing

Small-caps represent 6 percent of the U.S. stock market's total capitalization. High growth rates, high volatility, and high bankruptcy rates are characteristics of companies involved in this investment style. Small-cap mutual funds are higher-risk securities that offer a high potential return.

Chart 2 contains examples of companies involved in each style of investing.

Chart 1: Percentage of Total U.S. Stock Market Value as of 12/31/01

Large-Cap Stocks	83%
Mid-Cap Stocks	11%
Small-Cap Stocks	6%
Total	100%

Source: Morningstar

Chart 2: Examples of Companies in Each Investment Style

Large-Cap Stocks	Mid-Cap Stocks	Small-Cap Stocks
IBM	Federated Department Stores	Alpha Industries
Exxon Mobil	Clear Channel Communications	Ruby Tuesday
Citigroup	Cintas	Jack-in-the-Box
Microsoft	Bed, Bath & Beyond	Pier 1 Imports
General Electric	SunGard Data	Applebee's International

Source: Morningstar

Performance Comparison

I met with a trustee of a new 401(k) plan established by a group of physicians and suggested that the group add three mutual fund options to complete their plan menu: a mid-cap growth fund, a small-cap value fund, and a large-cap growth fund. At that time, the absolute return numbers on the mid-cap growth and large-cap growth did not look good. Both were down about 20 percent over the preceding 12 months (they did, however, outperform their peer group averages). The small-cap value was up 20 percent over this same time period.

The trustee reviewed my recommendation and asked, "Can't we just add the small value fund? Why would I add funds with negative returns?" I explained to him that during late 1999 and early 2000, when the mid-cap and large-cap funds were up over 50 percent and small-cap value was up only 5 percent, clients asked the opposite question: "Can't we just add the mid-cap and large-cap options?" The truth is that the stock market moves in cycles, with small-, mid-, and large-caps each outperforming one another at different time periods. Having all three styles helps to protect investors from chasing the latest market trend.

Chart 3 shows the performance, since 1991, of large-, mid-, and small-cap stocks. While the returns are close, small-caps have the edge over the past 11 years.

Chart 4 reviews the 30-year time period for years 1971 to 2000. Mid-caps are the winner for the 30-year period.

Chart 5 goes back to 1926. Note that the mid-cap stock data does not date that far back. The data compares large- and small-cap stock returns as well as risk levels (as measured by standard deviation).

Over the long term, small-caps have outperformed large caps 1.80 percent by taking greater risk.

Chart 3: Large-, Mid-, and Small-Cap Equities Annual Returns

Year	Large-Cap	Mid-Cap	Small-Cap
1991	30.46%	20.95%	46.05%
1992	7.80%	11.48%	18.41%
1993	10.14%	13.55%	18.91%
1994	1.25%	-3.78%	-4.99%
1995	37.56%	30.67%	29.88%
1996	22.98%	18.91%	21.09%
1997	33.26%	32.33%	26.07%
1998	28.41%	19.77%	-1.38%
1999	20.48%	15.53%	11.31%
2000	-7.99%	18.49%	10.73%
2001	-12.22%	-0.41%	5.90%
Average Annual Return	**15.65%**	**16.14%**	**16.54%**

Source: Standard & Poor's and Barra Indices

Chart 4: Historical Performance 1971 to 2000

	Large-Cap	Mid-Cap	Small-Cap
Average Annual Return	14.5%	15.7%	14.9%
Highest Calendar-Year Return	37.6%	56.6%	61.8%
Lowest Calendar-Year Return	-26.4%	-26.6%	-34.4%

Source: Center for Research in Security Prices

Chart 5: Large-Cap vs. Small-Cap 1926-2001

	Large-Cap	Small-Cap
Average Annual Return	10.70%	12.50%
Standard Deviation	20.20%	33.20%

Warning Signs When Investing in Large-, Mid-, and Small-Cap Stocks

Investing in different capitalization styles requires the diligent monitoring of stocks because the investment markets are in a state of fluctuation. It is important to note that an investor's original investment allocation among small-, mid-, and large-caps can be changed with no action on the investor's part. Here are three warning signs to be aware of:

Style Drift

Occasionally, a stock or mutual fund will "drift" or change its market-cap style. Style drift can occur purposefully or inadvertently. For instance, in August of 2001, the Franklin/Templeton Mutual Fund Group announced that the Franklin Small-Cap Growth Fund was changing. Previously, the fund had focused on investing in stocks with market caps under $2 billion, thus warranting the "small-cap" fund moniker. However, the fund was attracting billions of dollars in assets and was having a hard time buying small-cap stocks. As a consequence, the fund—

renamed the Franklin Small-Mid Cap Growth Fund—is able to buy stocks with up to $10 billion in market cap (mid-cap stocks).

For individual stocks, circumstances such as growth or decline can cause style drift. Kmart is an example of this. Five years ago, Kmart had a large-cap capitalization of over $18 billion. Now the retail giant's capitalization is $782.5 million, making it a small-cap stock.

Change in Portfolio's Investment Allocation Due to Market Performance

Fluctuations in the market will, over time, change a portfolio's allocations.

Example: An investor has the following investment allocation:

Large-Cap	30%
Mid-Cap	30%
Small-Cap	40%

During the next year, the market-cap sectors perform this way:

Large-cap is up 10%.
Mid-cap is down 20%.
Small-cap is up 30%.

At the end of the year, the investor's allocation is now:

Large-Cap:	30.3%
Mid-Cap:	22.0%
Small-Cap:	47.7%

If an investor wants to maintain the original allocation, he or she needs to "rebalance" the account. Investors should rebalance at least annually to keep their original goals intact.

Fund Name Does Not Accurately Reflect Current Holdings

The last warning sign to watch out for is misleading mutual fund names during large-cap outperformance cycles (such as the late 1990s). I have seen small-cap mutual funds where the top holdings are filled with large-cap stocks, such as Cisco Systems and Microsoft (this was prevalent during the late 1990s' stock boom). During times when small-cap stocks dominate large-caps, mutual fund managers will occasionally try to increase returns by buying stock in smaller companies. When evaluating funds, it is important to monitor the holdings of the funds to make sure the fund is investing the way the fund name implies (i.e., small-cap, large-cap).

CONCLUSION

A sound investment portfolio will consist of all three market capitalization styles: large-, mid-, and small-cap. Because the styles go through cycles where one style outperforms the others (and vice versa), an investor needs to watch the allocation and rebalance his or her account on a periodic basis (at least annually). When investing in mutual funds, an investor also needs to investigate to make sure that the large-, mid-, or small-cap fund selected is actually consistent with the fund's stated objectives. ✲

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