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## EUROPEAN MARKET COMMENT

### SMALL-CAP EQUITIES: ARE THEY WORTH THE RISK?

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Robert Lang  
Rowan Harmer

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## Small-Cap Equities: Are They Worth the Risk?

Small-cap equities in the United Kingdom have had a difficult 18 years. Since the FTSE SmallCap Index's inception in 1986, not only has it been the United Kingdom's most volatile major equity index, it has also posted inferior inflation-adjusted returns. Since 1986, the index's real average annual compound return (AACR) was 6.36%, slightly below real AACRs of the FTSE All-Share (7.00%) and FTSE 100 (6.92%), while its 19.15 annualized standard deviation exceeds the 16.87 level posted by both the FTSE All-Share and FTSE 100 (see Table A). The 18-year Sharpe ratio of the small-cap index is 0.08, which is below that of the FTSE All-Share and FTSE 100 (0.13). Based on this evidence, it appears, at least at first glance, as if U.K. investors should avoid small-cap equities.

However, investors should not build their assumptions about future returns on historical performance figures. Even a time period as long as 18 years is too short by several decades to warrant extrapolating any conclusions. In the United States, by comparison, small- and large-cap equities exhibited a similar relative performance pattern as in the United Kingdom: that is, from January 1986 to March 2004, the Russell 2000® Index of small-cap stocks underperformed the Russell Top 200® on a risk-return basis.<sup>1</sup> However, changing the beginning and end points of the calculation yields an entirely different conclusion. From 1979 to 1986, the Russell 2000® outperformed the Russell Top 200® on an absolute and risk-adjusted basis, with Sharpe ratios of 0.31 for the Russell Top 200® and 0.48 for the Russell 2000®.

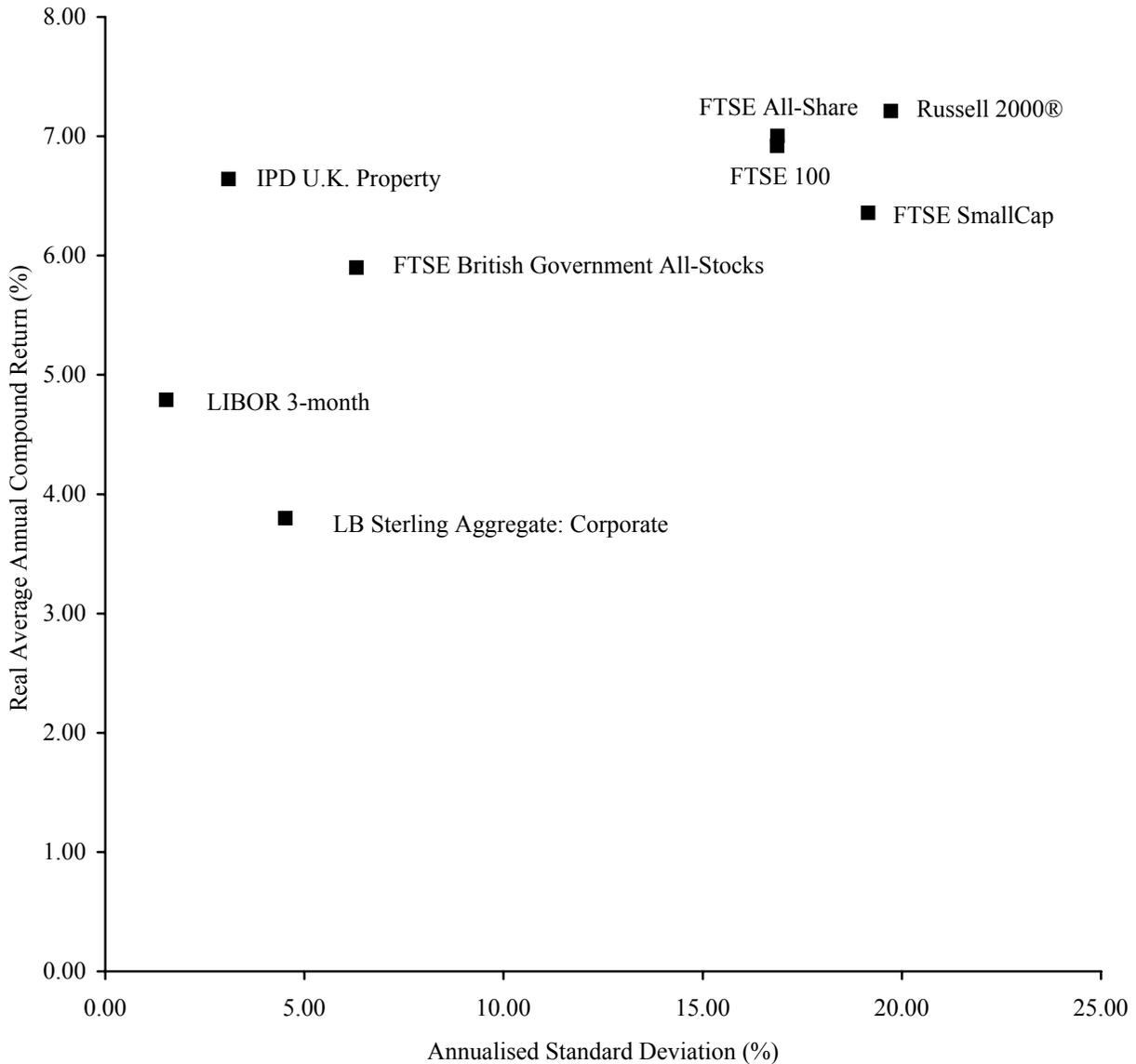
While we would not recommend a policy allocation to small-cap stocks, as they are too similar to larger-cap shares to warrant a distinct allocation, we would recommend overweighting and underweighting small-cap shares relative to their neutral market weights when valuations are compellingly cheap. Over the last decade, periods of relatively high valuations for small-caps were generally followed by periods of relative underperformance. Currently, small-caps are quite expensive relative to their own history, as well as to the FTSE 100.

Investors should not avoid small-cap equities simply because they have underperformed over the last 18 years. However, given relative valuations today, we would recommend underweighting small-caps until valuations improve. Over the long term, we would expect small-cap shares to outperform at times, particularly following periods of relatively low valuations and we would expect skilled managers to be able to provide alpha in this relatively inefficient market sector.

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<sup>1</sup> The Russell Top 200® Index posted a real AACR of 8.70%, compared to the Russell 2000®, 7.19%. However, the small-cap index was more volatile over this time period (standard deviations of the Russell Top 200® and Russell 2000® were 16.05 and 19.68) while their respective Sharpe ratios were 0.41 and 0.26.

Table A

**RISK AND RETURN COMPARISON FOR VARIOUS REAL INDICES****1 January 1986 - 29 February 2004**

Sources: Investment Property Databank, Lehman Brothers, Inc., and Thomson Datastream.

Notes: The Lehman Brothers Sterling Aggregate: Corporate Bond Index data starts in January 1999. Investment Property Databank data starts in January 1987. All data denominated in pounds sterling except for the Russell 2000®, which is denominated in U.S. dollars.