



C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

SMALL-CAP STRENGTH: RUNNING OUT OF FUEL OR SIGNALING FOR A BROADER PICK-UP?

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Small-Cap Strength

Running Out of Fuel or Signaling a Broader Pick-Up?

While the bears have savaged U.K. equities over the last three and a half years, small-caps have held up remarkably well, but the sector appears to be weakening. Since January 1999, the FTSE Small-Cap Index has returned -0.6%, compared to the FTSE 100's -25.0% and the All-Share's -20.4%. This is unusual, since small-cap equities tend to outperform most dramatically during the early stages of an economic expansion when the economy is moving out of recession, while underperforming large-caps before and during recessions because they are generally less well-equipped to weather economic contractions. In the late 1990s, however, the most egregious valuations were among relatively large issues, particularly in the telecoms and media sectors, while the United Kingdom did not experience the explosion in small-cap growth stocks seen in the United States.

Over the longer term, however, large-caps have significantly outperformed small-caps, with the FTSE 100 returning a cumulative 447.9% over the last 17 years compared to 289.3% for the FTSE Small-Cap Index (see Table A). There have been two periods during this stretch in which small-caps have shone: from January 1986 to January 1990, small-caps outperformed large-caps by a cumulative 18.1 percentage points (FTSE Small Cap, 117.0%, FTSE 100, 98.9%), while in the post-January 1999 rally they have bested large-caps by 21.7 points. The first of these two periods of relative strength lasted 49 months and the current one is 51 months old.

Negative Earnings

While small-caps have outperformed over the last three and a half years, most of the outperformance occurred in 1999 and 2000. In 1999, small-caps bested large-caps by 33.2 percentage points and in 2000 by 13.8 points. However, in 2001 and 2002, the FTSE 100 outperformed the Small-Cap index by 2.8 and 5.4 percentage points, while year-to-date 2003, small-caps have beat large-caps by 40 basis points.

Small-caps have managed to outshine large-caps largely due to their greater domestic focus, while the FTSE 100 is dominated by large multinational corporations, whose profits have decelerated sharply during this global slowdown. More specifically, the sectoral composition of the two indices is quite different, with cyclical issues more heavily represented in the small-cap than in the large-cap index (see Table B). For example, cyclical services comprise 28.2% of the FTSE Small-Cap Index, compared to 9.7% of the FTSE 100. Similarly, general industrials and basic industries combined constitute 12.8% of the small-cap market, and only 2.4% of the large-caps. Financials carry a similar weight in each index, 34.1% and 26.9%, (though the constituents are, of course, quite different). Information technology comprises 9.3% of the small-cap index, and 0.2% of the large-cap index.

Valuations: Equivocal Signals

From a valuation standpoint, small-caps were becoming increasingly pricey in the months before June 2002. The P/E of the FTSE Small-Cap climbed to 68.0, 2.5 standard deviations above its ten-year average of 21.1, while relative to

the FTSE 100, the index's multiple rose to 3.1, compared to its ten-year mean of 1.1 (see Tables C and D). Then earnings tumbled. It is somewhat disconcerting that since mid-2002 earnings for the FTSE Small-Caps have been in negative territory, which gives the index a negative P/E ratio. The electricity industry is the primary culprit behind these aggregate losses, though earnings in several other industries have fallen into the red as well, including steel, IT hardware, mining, telecom, household goods, and pharmaceuticals.

Despite negative earnings, the FTSE Small-Cap pays a hefty dividend yield of 3.2%, which is almost one standard deviation above its ten-year average of 3.0. However, payout rates for large-caps have grown even more attractive, which suggests that on the basis of this metric small-caps are actually slightly expensive compared to large-caps.

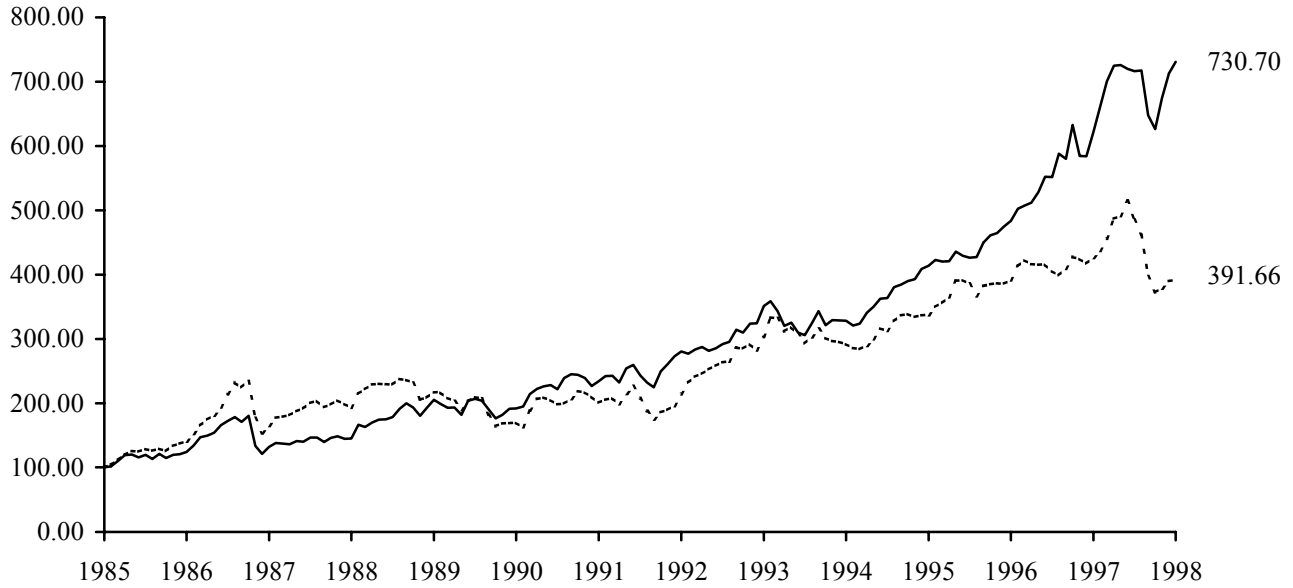
From a diversification standpoint, small-caps have not particularly enhanced investors' risk-return profile in recent years (see Table E). Rolling 36-month correlations of the FTSE Small-Cap Index with the FTSE 100 have risen to 0.80, up from 0.40 as recently as July 1998.

As investors increasingly shop for earnings stability and yield, it would seem unlikely that small-caps could continue to outperform larger-cap issues unless the latter were selling at significantly higher valuations. Since this is no longer the case, we think investors should not extrapolate the relative advantage enjoyed by small-caps into the future, even if they believe that an improving economy will favour higher-beta equities.

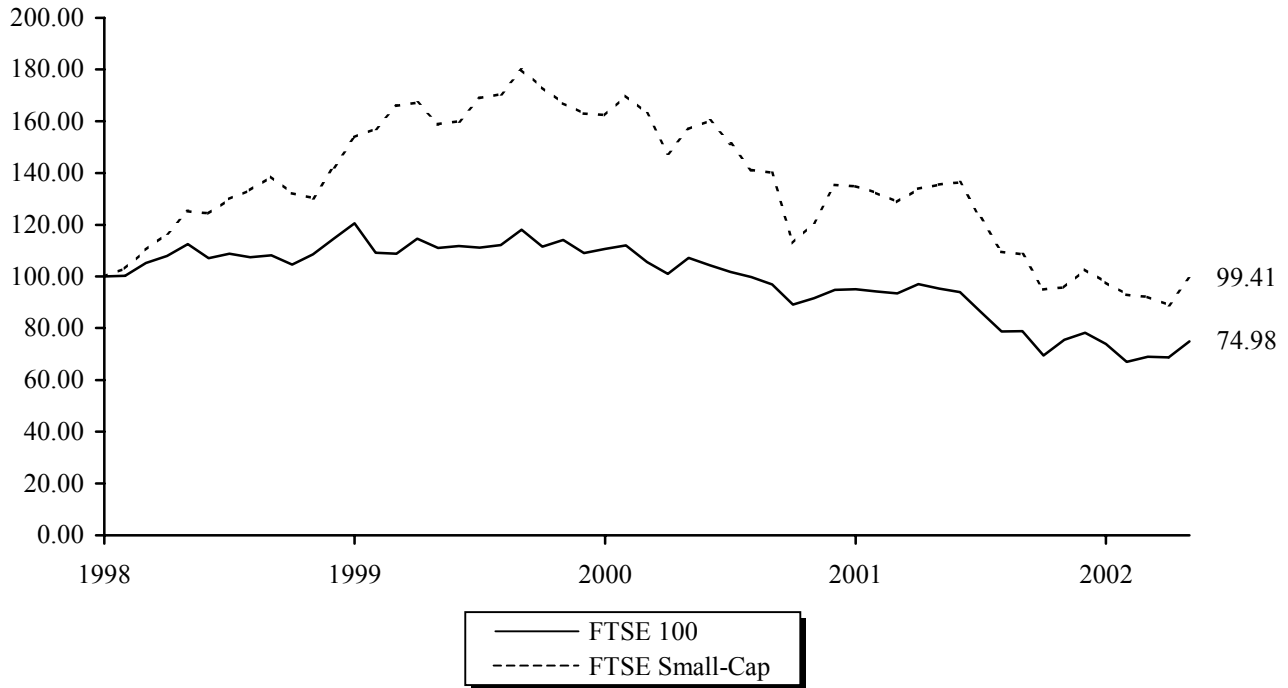
Table A

FTSE 100 VERSUS FTSE SMALL-CAP: CUMULATIVE WEALTH

1 January 1986 - 31 December 1998
(31 December 1985 = £100)



1 January 1999 - 30 April 2003
(31 December 1998 = £100)

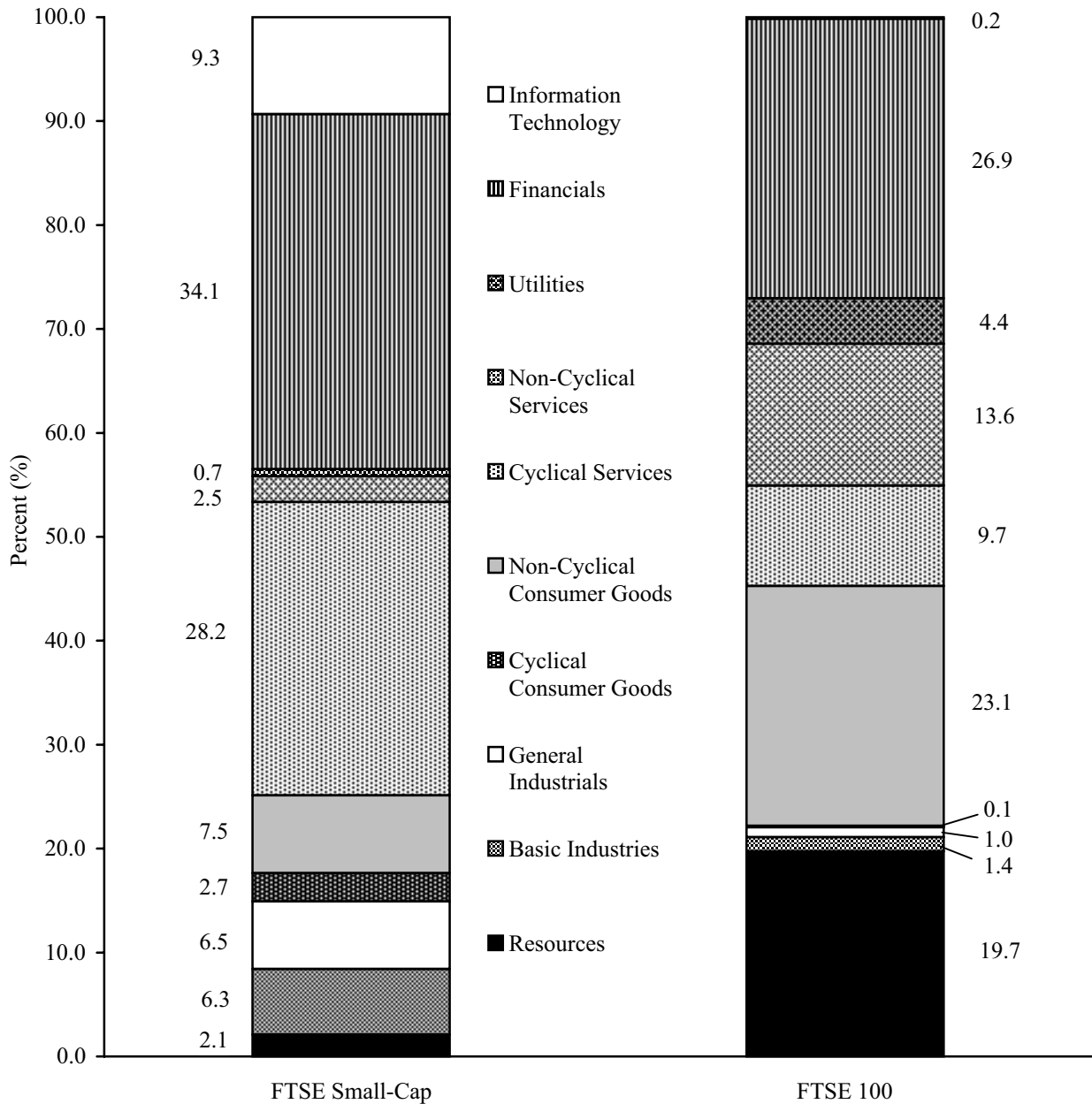


Source: Thomson Datastream.

Table B

FTSE SMALL-CAP VERSUS FTSE 100: ECONOMIC GROUP ALLOCATION

As of 30 April 2003



Source: FTSE International.

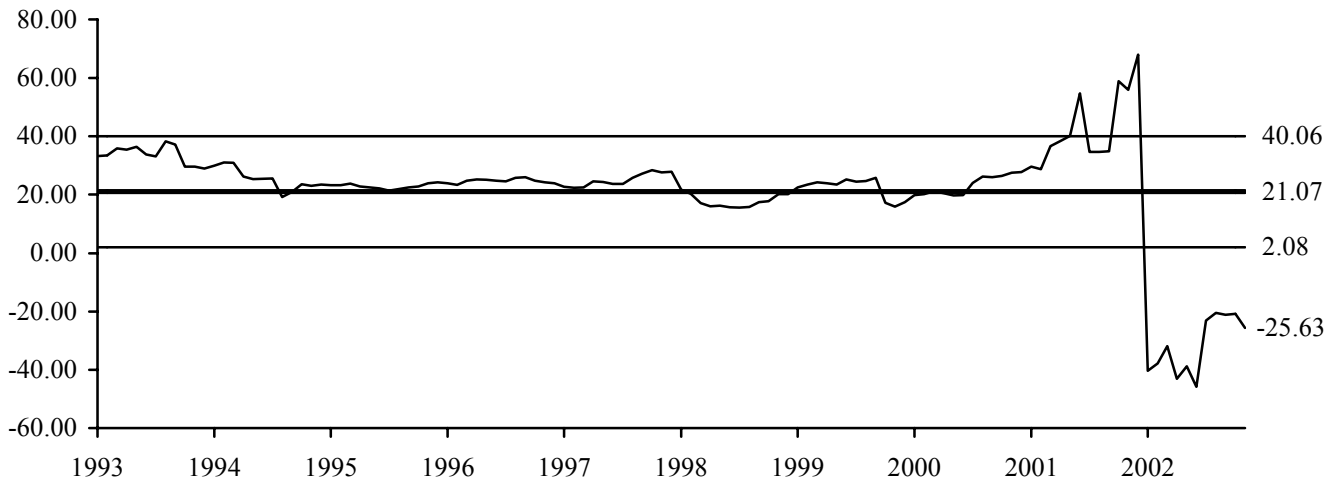
Table C

GLOBAL EQUITY MARKET VALUATIONS

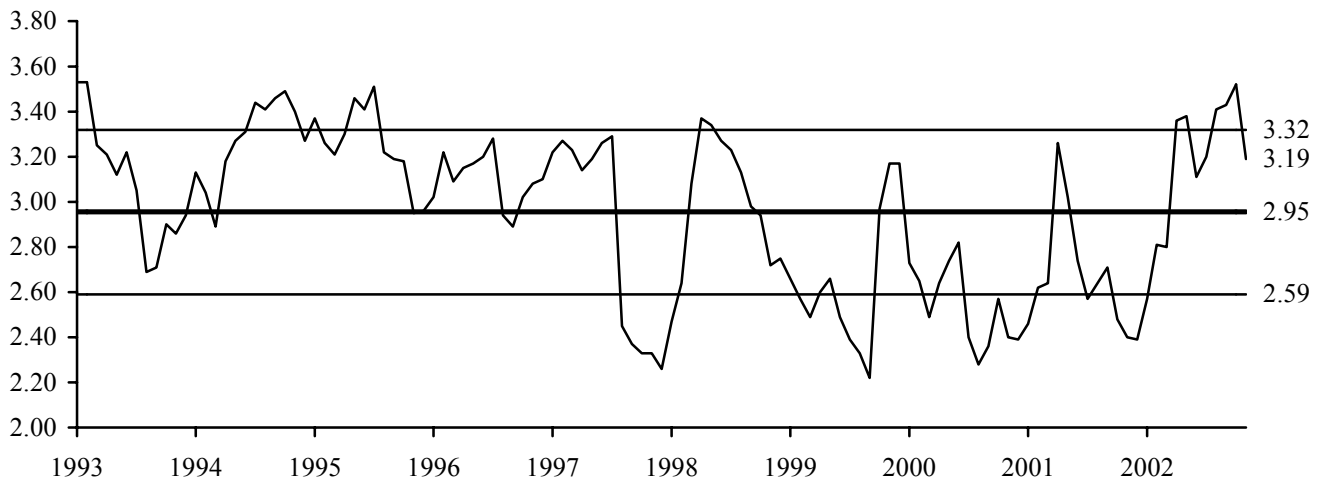
FTSE Small-Cap

1 June 1993 - 30 April 2003

Price-Earnings



Dividend Yield (%)



— Mean
 — One Standard Deviation

Source: Thomson Datastream.

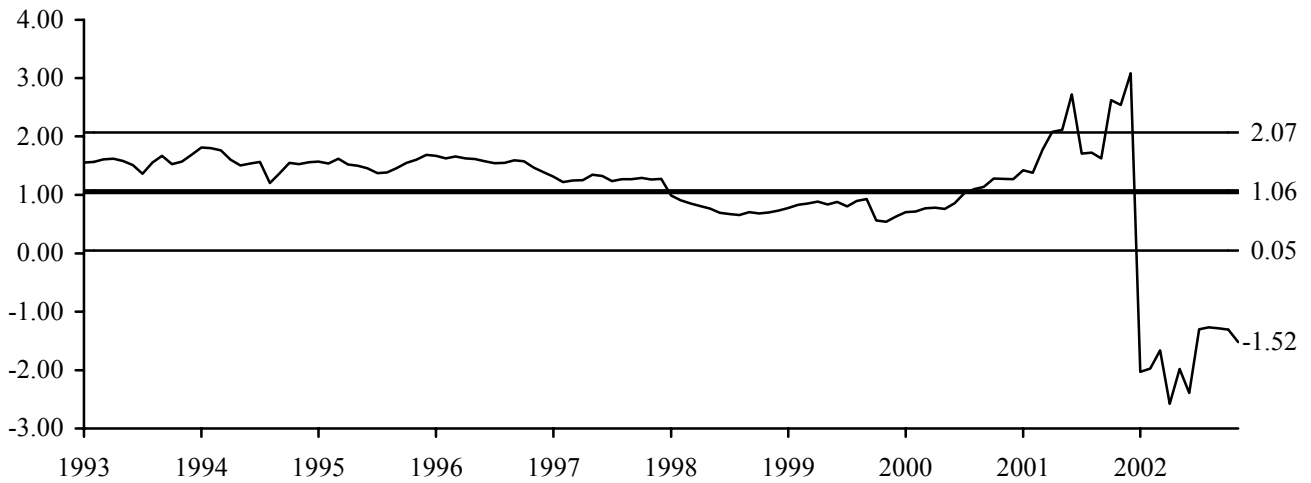
Table D

GLOBAL EQUITY MARKET VALUATIONS

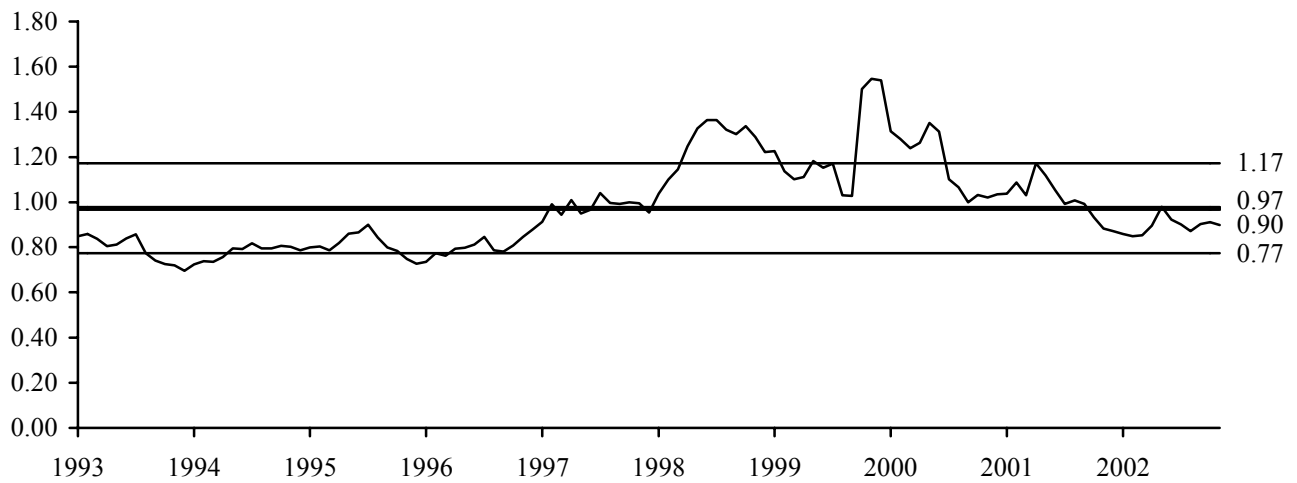
FTSE Small-Cap Relative to FTSE 100

1 June 1993 - 30 April 2003

Price-Earnings



Dividend Yield (%)



—	Mean
—	One Standard Deviation

Source: Thomson Datastream.

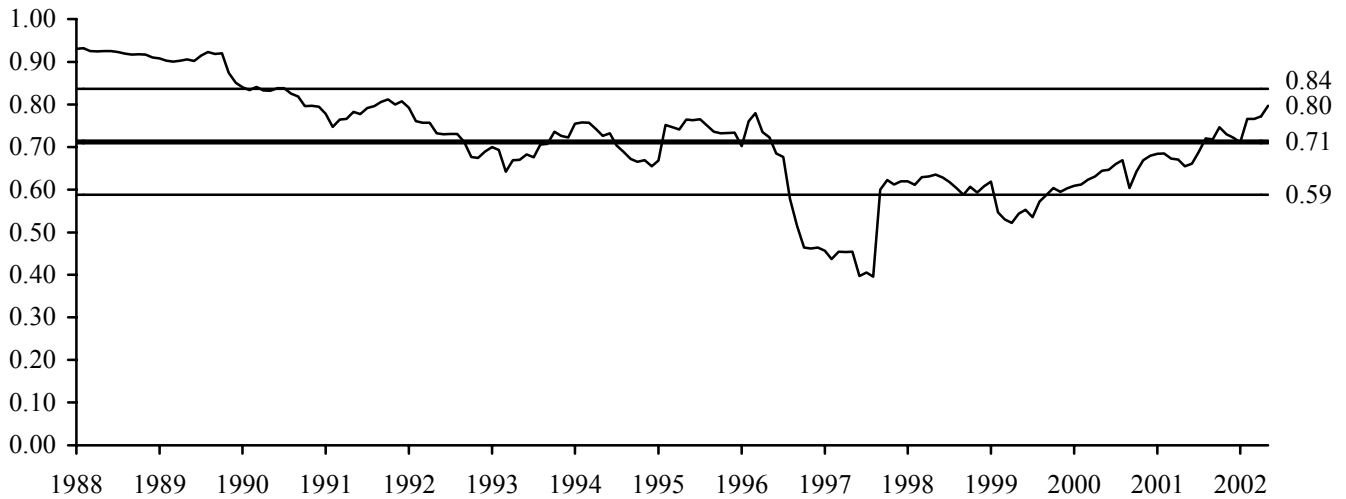
Table E

ROLLING 36-MONTH CORRELATIONS WITH THE FTSE SMALL-CAP INDEX

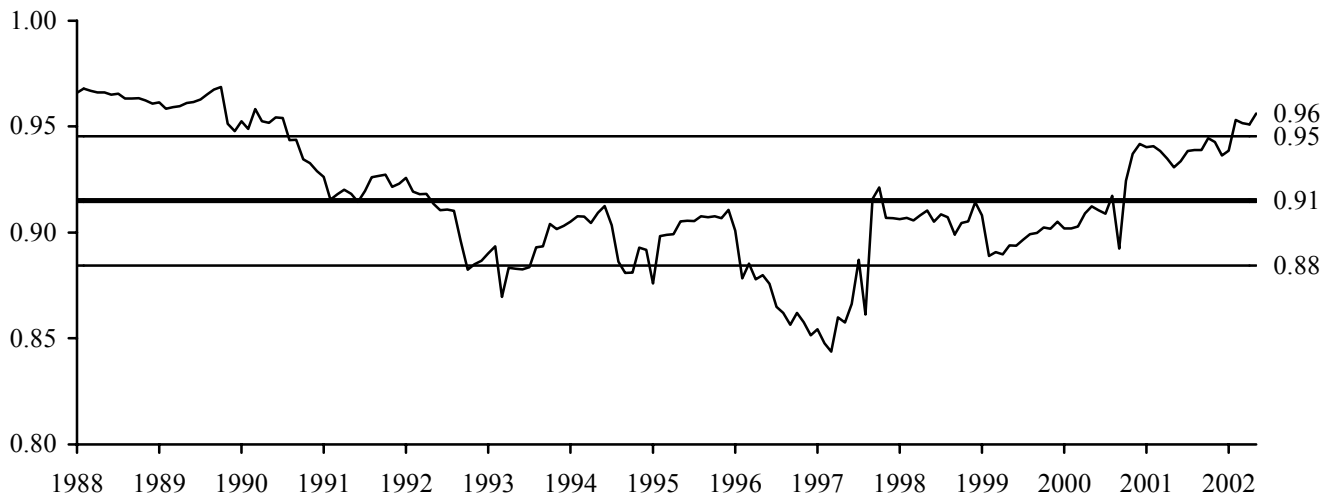
1 January 1986 - 30 April 2003

Sterling (£)

FTSE Small-Cap and FTSE 100



FTSE Small-Cap and FTSE 250



—	Mean
—	One Standard Deviation

Source: Thomson Datastream.