# The Financial Navigator – March Newsletter

In this issue we discuss the performance of small cap stocks relative to the more visible large company stocks. We also discuss the recent predictions of the more prominent financial publications as they relate to stock market performance; it is not a pretty picture if you use magazines such as *Money*, or *Fortune* for investment research or ideas. In addition, we touch on stock market returns of countries that have a high debt level; a timely topic based on the current news cycle with the focus on Uncle Sam's deficit.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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## ***Small Cap Stock Premium***

Small cap stocks outperformed large cap stocks by a significant margin in most global markets last year but capturing the size premium (the difference between large and small cap stock returns) required both patience and a willingness to ignore the advice from those claiming to identify the best-performing asset classes in advance. US small stocks got off to a strong start last year as the Russell 2000 Index jumped to a gain of 18.6% through April 23, more than double the return of the S&P 500®. But as stock prices wilted during the summer, small caps fell even faster and by August 24th both large cap and small cap indices were down roughly 5% for the year. A surprisingly strong rally during the remainder of the year drove the Russell 2000 up 31.5%, and for the year as a whole it was the best performance for US small stocks since 2003.

**Total Return for Twelve Months Ending December 31, 2010**

| Large Cap Indices | Small Cap Indices | Size Premium |
|---|---|---|
| Russell 1000: 16.10% | Russell 2000: 26.85% | 10.75% |
| S&P 500®: 15.06% | S& P Small Cap 600®: 26.31% | 11.25% |

The strength in small cap stocks caught a number of financial pundits flat-footed. An article appearing in the Wall Street Journal in mid-November 2009 claimed "small caps aren't looking that cheap anymore" and suggested that the stock market rally was in the midst of "an important change that has put the less-volatile large caps back in favor."[1]

In a similar vein, the 2010 Investor's Guide issue of *Money* argued that "smaller and junkier" stocks often did best in the early stage of a rally but since the bull market appeared to be maturing, now was the time to switch gears: "Speculative frenzy eventually gives way to the fundamentals," they said, "and that should bring your focus back to high quality blue-chip stocks this year." *Money* identified ten stocks to capitalize on this trend, including stalwarts such as ExxonMobil and Johnson & Johnson.[2] Investors following this advice not only missed out on the strong performance of small cap stocks, they failed to capture the market rate of return from large cap stocks as well: the ten stocks selected by *Money* had an average price-only return of 6.3% compared to 12.8% for the S&P 500® Index.

*SmartMoney* likewise emphasized large-cap stocks in their annual forecast issue, but for a different reason.[3] They foresaw a good chance the U.S. would remain mired in recession and favored large multinationals such as Procter & Gamble and Coca-Cola that "sell goods worldwide and don't need an economic rebound to make money." Their twelve stock picks produced an average price-only gain of 7.5% for the year.

*Fortune* made little distinction between large cap and small cap stocks in their 2010 Investor's Guide issue, and instead chose to repeat the familiar refrain that an uneven economic recovery would reward clever stock-picking: "Making judicious stock selections will be crucial in what is likely to be a topsy-turvy year."[4] It was indeed a topsy-turvy year for the markets, but even more so for *Fortune*'s ten stock selections. Among the combined 32 stocks selected by *Fortune*, *Money* and *SmartMoney* for 2010, *Fortune* had both the best performer for the year (Salesforce.com, up 78.9%) and the worst performer for the year (Amedisys, down 31.1%). *Fortune* finished last in this three-way magazine competition with an average price-only return for their picks of 1.75%.[5]

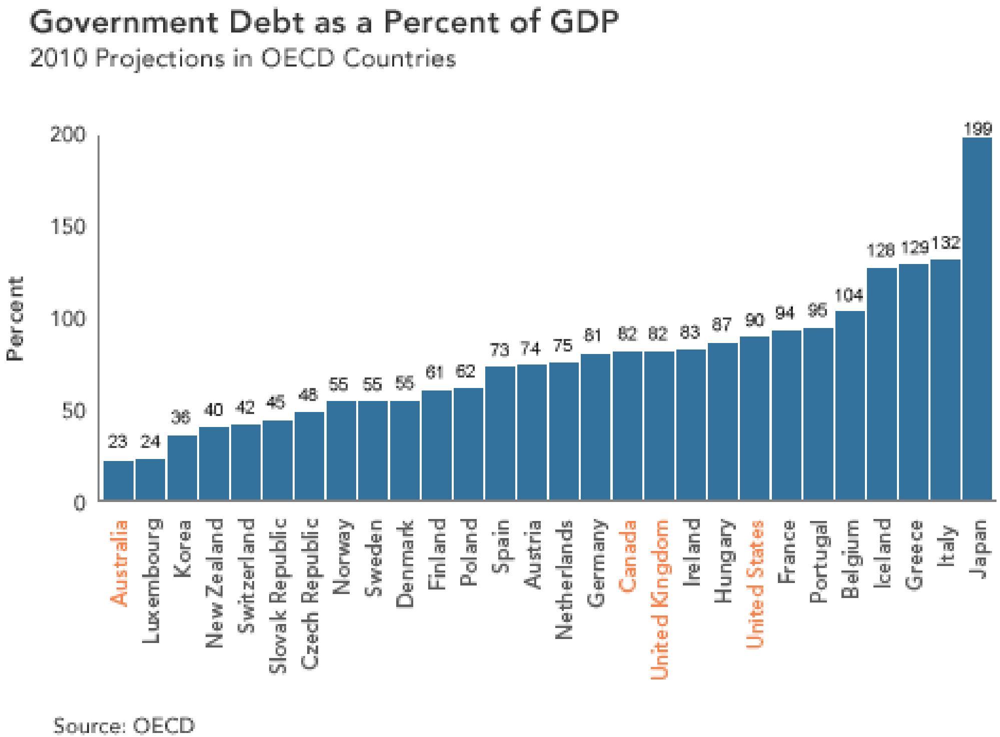
To its credit, the same issue of *Fortune* included a useful article on the appeal of a simple index fund approach: "Stock picking, whether you do it yourself or pay a pro to do it for you, is a mug's game", they wrote. " You're better off buying and holding a cheap, diversified, and consistent index fund, which passively invests in the stocks listed on a broad market benchmark."

Good advice, but we suspect it won't be long before catchy cover stories such as "Top Ten Stocks for the Year Ahead" are crowding the magazine racks once again. And last year's results offer another example of how easy it can be to miss out on all the rewards the capital markets have to offer.

## ***Debts, Deficits, and Markets***

As government spending hits record levels around the globe, some politicians, economists, and pundits are warning that rising indebtedness may drag down economies and financial markets. This issue has raised concern among investors who assume that a government's fiscal policy is closely linked to the country's economic growth and market returns.

The graph below shows the projected state of indebtedness around the world.[6] Over half the Organization of Economic Co-operation and Development (OECD) member countries expect to have debt-to-Gross Domestic Product (GDP) levels above 70%—and the US, Canada, and the UK project debt levels exceeding 80% of their economic output.




Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions, and rising health care obligations are compounding the fiscal challenges of these countries.

Global investors may be particularly concerned about the economics of government spending in countries around the world. So how does public debt affect economic growth and market returns? The evidence might surprise you. Although rising levels of government debt create headwinds for economic growth, a country's deficit and debt levels do not seem to adversely impact stock market returns.

Let's explore these issues by addressing a few popular questions about government debt:

**Do rising deficits drive up interest rates?**

Yes. As borrowing increases, a government must offer higher interest rates on its debt to compete for capital. The public sector consumes savings and investment that may have otherwise fueled private sector growth—a displacement of resources known as the "crowding out effect" in economic theory. Additionally, as debt levels rise, market concerns about higher default and inflation risks put additional upward pressure on interest rates.

**Do higher deficits hamper economic growth?**

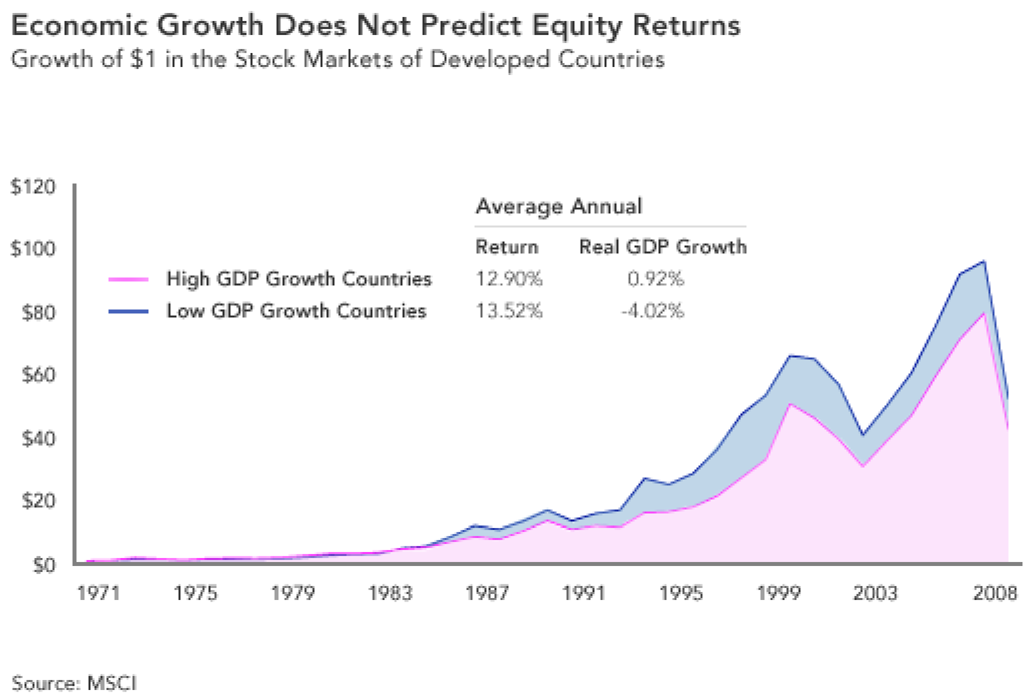
It depends on a country's debt level. Using World Bank data from 1991 to 2008, we compared current deficits to future GDP growth in sixty-seven countries and found an increasing interactive effect between deficits, debt, and economic growth. High-debt countries that run deficits are more likely to experience lower economic growth over the next three years. But numerous forces may affect a country's economic direction, and deficits explain only a small fraction of the variation in future GDP growth. The combination of high debt and deficits can create headwinds for economic expansion, but slower growth is not guaranteed.

So investors are justified in having some economic concern about higher government spending and borrowing. But the impact on investment returns is less clear. Let's now consider the potential effect on equity markets.

**Does low economic growth result in diminished equity returns?**

No. This relationship can be tested by comparing a country's GDP growth to its equity market performance in subsequent years. We conducted this analysis using all the developed countries in the world stock market universe, divided each year into high-growth and low-growth "portfolios" based on growth in real GDP. There was no statistical difference between the annual returns of equity markets in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average returns than high-growth countries.

The graph below illustrates this relationship in terms of a dollar invested in high- versus low-GDP growth portfolios from 1971 to 2008. The low-GDP growth portfolio's higher annual return would have generated slightly more wealth for the period. The chart details the average annual return and real GDP growth for both groups.




Applying the same methodology to the emerging market countries shows an even greater return difference, although the data period is much shorter (2001 to 2008). The return of the high-growth country portfolio averaged 19.77% (with 2.5% GDP growth), versus 24.62% for the low-growth portfolio (-4.94% GDP growth).

Other research has confirmed a weak relationship between a country's economic growth and its stock market returns.[7] Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company's stock price in its home market may not reflect economic conditions in other countries. Also, the fruits of economic growth do not accrue exclusively to public companies, but also to income earners, non-public businesses, and private investments.

Finally, consider that risk, not economic growth, determines a stock's expected return. Research indicates that this principle also applies to a country's stock market.[8] Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns. Consequently, while holding a "growth market" may be a rational investment approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

## Do fiscal deficits lead to currency depreciation?

No. It is commonly believed that large fiscal deficits and high debt cause a currency to depreciate as the government borrows more from foreign sources, and investors who are concerned about inflation and default risk flee the currency. Although recent developments in the US would seem to support this relationship, there is less convincing long-term evidence that deficits affect currency rates. During the 1970s and 1980s, the dollar strengthened while the government increased deficit spending.[9] This observation is consistent with academic studies concluding that exchange rates appear to move randomly, and there are no models to date that can reliably forecast currency returns.[10]

## Conclusions

Some economists claim that developed market countries are moving into an era of high government deficits and lower market returns. While higher deficits and debt may impact a nation's interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country's financial markets, or anticipate short-term currency movements.

Investors should assume that stock and bond prices reflect all that is currently known and expected about government spending and debt, economic growth, risk, and other issues affecting performance.

Endnotes:

1. Donna Kardos Yesalavich. "Large-Cap Stocks Are Back in Favor" Wall Street Journal November 12, 2009.

2. Pat Dorsey. "What's Ahead for Stocks" Money January/February 2010

3. Reshma Kapadia and Russell Pearlman. "Where to Invest 2010" SmartMoney January 2010.

4. Katie Benner, Scott Cendrowski, and Mina Kimes. "The Best Stocks in 2010" Fortune December 21, 2009

5. New York Stock Exchange/NASADAQ Trading Summary. Year-End Review: Markets & Finance 2010 . Wall Street Journal January 3, 2011

6. The Organization of Economic Co-operation and Development (OECD) is an international economic organization of thirty-three countries founded in 1961 to stimulate economic progress and world trade. It defines itself as a forum of countries committed to democracy and the market economy.

7. MSCI Barra Research Bulletin, "Is There a Link Between GDP Growth and Equity Returns?" May 2010.

8. Clifford S. Assness, John M. Liew, and Ross L. Stevens, "Parallels between the Cross-Sectional Predictability of Stock and Country Returns," Journal of Business 79, no. 1 (March 1996): 429–451. Their research uncovered strong parallels between the explanatory power of aggregate book-to-market and aggregate earnings-to-price ratios for country stock markets.

9. Another common assumption is that current account deficits and currency appreciation are related. (The current account balance is the difference between a country's receipts and payments to the world. This account is composed mostly of the balance of trade, with net income and foreign aid playing a smaller role.) Academic research yields equivocal results on whether this relationship holds.

10. Richard A. Meese and Kenneth Rogoff, "Empirical exchange rate models of the seventies: Do they fit out of sample?" Journal of International Economics 14, no. 1 (February 1983): 3–24. Kenneth Rogoff and Vania Stavrakeva, "The Continuing Puzzle of Short Horizon Exchange Rate Forecasting" (National Bureau of Economic Research working paper No. 14071, June 2008).

***If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.***