

It's déjà vu all over again

Interestingly, as small-cap has become an established asset class, the companies trading closest to the periphery have become somewhat orphaned, and therein lies the opportunity. In fact, a spirited internal debate among our portfolio managers has always taken place about how best to treat the legacy of information and expertise developed for those businesses that have moved far out of our traditional capitalisation parameters, that is, above \$2.5 billion in market cap.

Frank Gannon, assistant portfolio manager at small-cap specialist Royce & Associates, wonders whether 2011 will look very like 2010.

We are struck by how eerily similar the first month of trading in 2011 was to the start of last year, especially from a headline standpoint. Consider the following: The strong 7.9% gain for the Russell 2000 Index in December 2010 was nearly mirrored by the small-cap index's 8.05% gain in December 2009. Its 26.9% return for 2010 was close to its 27.2% result in 2009.

And 2011 began with the market once again turning its focus to concerns about the pace of economic growth, stubbornly high unemployment, and the timing of further stimulus globally, especially from China. Sound familiar? It should, as these are the same headlines that kicked off 2010, when many thought the economy was speeding down the recovery runway, only to stall in the spring. Similarly, many strategists have once again predicted that large-capitalisation stocks will post a pronounced gain in performance at the expense of their smaller-cap siblings. Sound familiar? Maybe because it is the exact same prediction we heard at the outset of 2010. It is also one of the most commonly asked questions we hear from investors today.

Changes afoot

From our admittedly somewhat biased perspective as a small-cap specialist, we do not see it coming soon, though we do see what we regard as an important change in the market. We suspect that, as good as most of the last 22 months have been for stocks, the reign of high-beta, often low-quality companies is likely to end soon, replaced by companies with characteristics such as high returns on invested capital, free cash flow generation and dividends. These elements are more likely to determine leadership than market capitalisation. So while it would not be surprising to see large-cap enjoying periods of outperformance in the months to come, we do not expect the spread to be significant. We believe that the days of wide divergence between small-cap and large-cap, such as we saw in the '90s, are over, at least for the intermediate term.

We do not know how today's economic headlines will play out over the next year or what timely investment predictions will bear fruit. However, we remain convinced that shareholders of high-quality companies with solid balance sheets and high returns on invested capital should benefit, regardless of market cap, as the market becomes more discerning, and the economy continues to find a stronger footing.

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