

# THE CASE FOR Large Caps



Is a new day dawning for large caps? For seven years, small caps have enjoyed a run of outperformance, while large caps have languished to the point that they are now a bargain. In purely cyclical terms, large caps appear poised for a rebound. Although history can support this argument, examining relative valuations, fundamentals, and shifting demographics makes it all the more compelling.

## A Lesson in Recent History

In an attempt to deflate the market’s “irrational exuberance” during the mid-to-late 1990s, the U.S. Federal Reserve aggressively raised interest rates. Alan Greenspan’s famous comment, in a December 1996 speech, had little impact at the time, but in hindsight, it was a clue to what lay ahead. Yet, investors believed that the diversification benefits of owning large global companies (i.e., ability to leverage globalization, easy access to capital, and the scale and resources to exploit the Internet) were all that really mattered. Valuations soared as investors continued to pile onto the large-cap technology bandwagon. At the same time, small-cap underperformance was so significant that many questioned the survival of small caps as an asset class.

Not long after the turn of the new century, the market cycle turned as well. Global investors were left with an aversion to large-cap stocks, while almost unnoticed, smaller stocks were poised for a rebound, as cyclical underperformance drove their valuations to extremely low levels. Seven years later, in a market with parallels to the late 1990s, small caps are expensive by most measures, and large-cap stocks are cheap, no matter how you slice it: relative, absolute, or historical.

So, what should investors do? Is it better to concentrate solely on what has worked in the recent past, or look to history for intimations about the future? To provide some answers, let us address the current situation, focusing on the United States.

## Why Have Small Caps Outperformed?

During the late 1990s and early 2000s, the relative P/E multiple of the small-cap Russell 2000 Index was at a 20 percent discount to the Russell Top 200 Index of very large-cap companies. This was an extreme discount, since over longer periods of time, small-cap stocks tend to trade at a 20 percent premium to large caps.

Driving small caps’ extended period of outperformance was a very accommodative Fed, which lowered interest rates and made money free in real terms. The massive growth of hedge funds was also a factor. Small-cap allocations in hedge funds have been outsized, compared to the market-cap breakdown of the Russell 3000.<sup>1</sup> The economic recovery that followed the bursting of the high-tech bubble triggered a change in investors’ risk tolerance. This allowed smaller companies and more leveraged stocks to lead the market, due to their greater sensitivity to economic growth.

In a case of history repeating itself, as small caps soared, investors began to question the prospects for large- and mega-cap stocks. The chart to the left details this history, while illustrating how relative valuation continues to favor large caps.

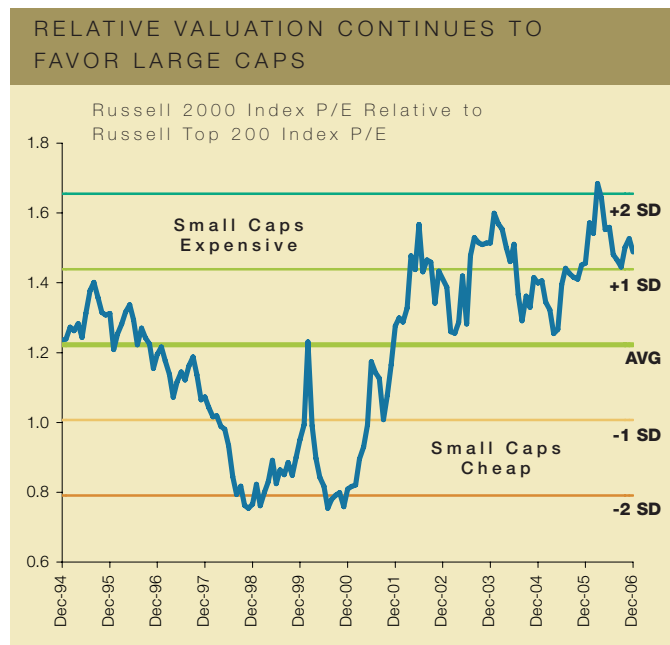
## What Are the Odds of a Reversal?

The Russell 2000 Index has increased by 70 percent cumulatively (from December 1999 through the fourth quarter of 2006), while the Russell Top 200 has declined by 5 percent for the same period.<sup>2</sup> So the question for today’s investors to ask is: Are we at a turning point in the cycle, or have we reached a pause in an ongoing secular shift to smaller stocks? Does history provide a context for the future or, in other words: Will the massive amount of liquidity permeating the global economy continue to flow? Is volatility gone? Is economic growth likely to continue to be very strong, with no end in sight? Will the riskiest assets continue to deliver outsized gains? Will money continue to be cheap, and are the consequences of lending to troubled companies or overextended consumers irrelevant, as the financial markets have now taken risk out of the equation? Affirmative answers may not represent the common views held on Wall Street. But, after seven years dominated by riskier assets, the markets seem to be answering yes to each of these questions. So, while we think the current environment could continue for a bit longer, we also believe the odds of a reversal have increased dramatically over the last year.

## Additional Signs of a Large-Cap Rebound

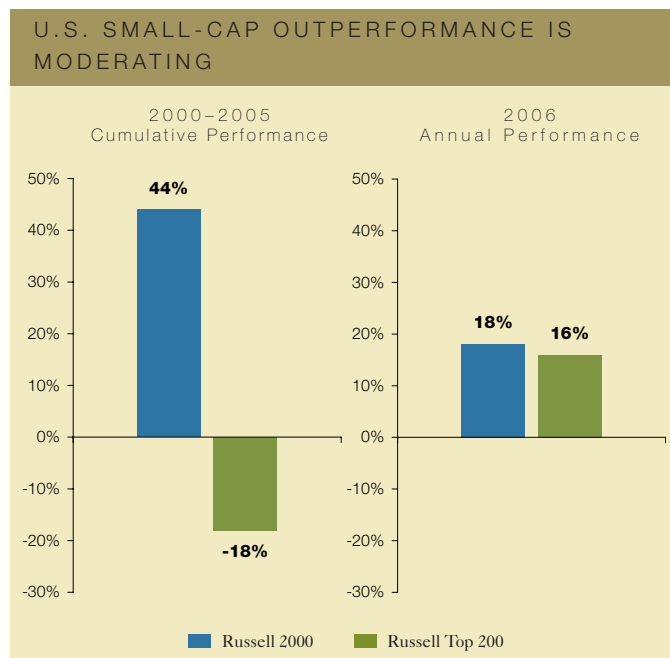
Today, there are a number of compelling arguments for a large-cap recovery on the horizon:

**Moderating Small-Cap Outperformance:** The magnitude of small-cap outperformance has moderated in the United States and in Japan, where small-cap stocks were down 16 percent in 2006. However, this trend has not yet affected European small caps, which have continued to outperform. As shown in the chart at left,



Source: Citigroup Investment Management, Frank Russell  
As of December 31, 2006

from its most attractive point in 2000, U.S. small-caps' relative valuation has become increasingly expensive, while U.S. large-caps' relative valuation is now looking more attractive. As history makes clear, trends rise to extreme levels only to revert back to long-term averages.



Source: FactSet, Frank Russell

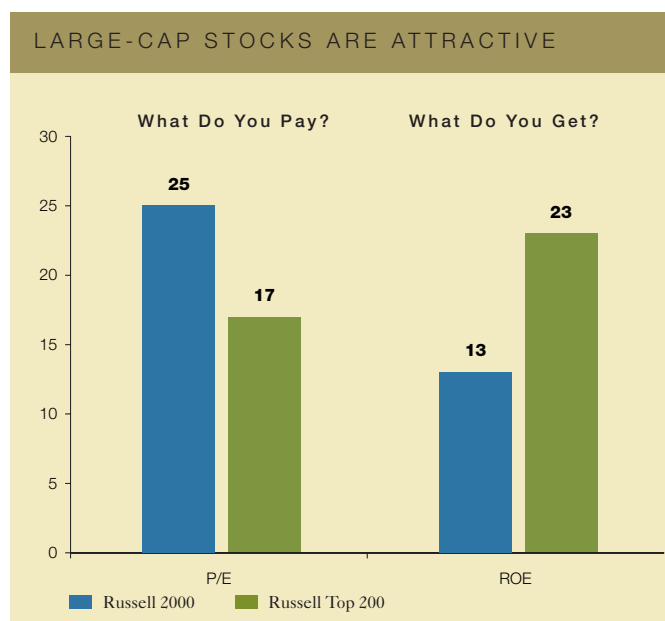
**Time and Magnitude:** The duration of the current cycle suggests that a change may be imminent. Since 1926, the average cap cycle has lasted approximately five years, while the current small-cap cycle has recently finished its seventh year. Is history giving us a hint? The magnitude of small-cap outperformance has also reached an extreme (i.e., note the cumulative 118 percent increase of the Russell 2000 Index since March 1999 versus 9 percent by the Russell Top 200).<sup>3</sup>

**Fundamentals:** Although the global economy continues to show healthy growth, current expectations point to a midcycle slowdown. As the economy slows and profit growth moderates from very high levels, investors are likely to search for companies with good fundamentals, as they have in the past. Such “quality” companies are larger, more consistently profitable, and tend to perform much better as earnings growth slows. In fact, during the last four times the profit cycle slowed,<sup>4</sup> higher quality stocks outperformed lower quality ones by a wide margin.

Large and quality are not synonymous, but there is a tendency for larger companies to exhibit financial characteristics that are usually associated with quality, such as less leveraged balance sheets and steady records of earnings and dividends. Many large-cap compa-

nies consistently earn their cost of capital and, even during the worst economic times, are generally better than small-cap companies at making money. Quality companies tend to have more diversified business models and a broad geographic reach, with numerous end-markets to which they can sell goods and services.

Recently, the fundamentals for many large caps have improved dramatically, only to see their valuations compressed significantly. For example, Microsoft has grown revenues more than 200 percent since 1998. Yet its valuation has compressed by two-thirds over the same time period and is now similar to companies with much lower growth rates, weaker fundamentals, and less secure business models. One can certainly argue that Microsoft was overvalued in the past; however, today it is cheap. The following chart shows how attractive are both the valuation and financial productivity of large cap stocks, compared to small caps.



Source: Morgan Stanley  
As of December 31, 2006

**Weakening U.S. Dollar:** Another catalyst for a rebound in large caps is the weakening U.S. dollar. Many large-cap multinational companies based in the United States derive a significant portion of their sales and earnings from overseas markets. Therefore they benefit when the U.S. dollar weakens. Should the weakness of the U.S. dollar continue, it could benefit larger U.S. stocks and stoke investor interest going forward.

**Dividends and Baby Boomers:** The secular trend in demographics in the United States, particularly as it relates to ageing baby boomers, should also begin to have an impact on investor preference for larger stocks. The quest for returns, in a low-interest-rate

environment, has driven U.S. investors to pay up for yield. This trend is evidenced by the relative outperformance of utility and REIT investments, which we believe is unsustainable.

In the course of seeking yield, what would keep investors from shifting to higher yielding large-cap stocks? Today, many large caps pay respectable dividend yields, while still delivering strong earnings growth. Many of these stocks can be purchased at attractive valuations, especially when considering the fundamentals of their underlying businesses. We think this global phenomenon should lead investors to larger stocks that can provide a consistent payout. We also believe the substantial free-cash-flow yield of many large-cap stocks may lead to even higher dividend yields. In fact, many former growth stocks, which never paid dividends, are beginning to return cash to shareholders. We have also observed that many companies are increasing their dividends substantially. As baby boomer investors become increasingly averse to risk, large caps' historical stability should spark their interest.

## Large Caps on the Horizon

History is a good teacher of probability, indicating to us that at the height of any given trend, following the herd can be a dangerous course of action. As a firm with a substantial small-cap platform, Lazard encountered difficulties presenting small caps to potential investors back in 2000. During that cycle, the world was only focused on large-cap growth. Small-cap stocks, value styles, or even bond mandates were considered antiquated investment vehicles. But then, as always, the cycle turned. Why? One important reason is that markets are usually very efficient, migrating to where value can be found. This suggests to us that a large-cap cycle may be on the horizon. We believe that now is the time to focus on fundamentals and realize that many larger companies appear to be well positioned to outperform going forward.

### NOTES:

- 1 "Watch What You Wish For," U.S. Portfolio Strategy, Morgan Stanley Equity Research, North America, February 16, 2006.
- 2 Source: FactSet. Cumulative returns for the Russell 2000 Index and Russell Top 200 Index are from December 31, 1999 through December 31, 2006.
- 3 Source: FactSet. Cumulative returns for the Russell 2000 Index and Russell Top 200 Index are from March 1999 through December 31, 2006.
- 4 Source: Merrill Lynch. The last four periods of profit deceleration include: June '88–December '91, March '95–September '98, March '00–December '01, and December '03–June '05.

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The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell Top 200 Index offers access to the especially large-cap segment of the U.S. equity universe, representing the largest 200 securities by market cap. An investment cannot be made directly in an index. Indices are unmanaged and have no fees.

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