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What Will Lead Equities?

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Now that the economic recovery has gained some momentum, investors, quite naturally, have begun to ask whether recent leadership by small capitalization value stocks will persist. If history is any guide, the answer is yes, for a while longer at least (although there is no guarantee that they will perform in the same manner under similar conditions in the future). Small stocks tend to lead during these times, but the evidence is ambiguous enough to consider diversification.

Table 1 summarizes the relevant historical background. It ranks from best to worst the total return of large and small capitalization value and growth stocks during the first year of each of the last 10 major market recoveries. It shows as well how these categories did for the three years following the start of the recovery. Thus after the 1990 recession, for example, small capitalization growth stocks had the best performance for the first year of recovery, returning 69.04%. Larger capitalization value stocks showed the worst performance during that time, returning 32.78%. For the full three years after the recession, the performance leadership passed from small growth to small value stocks. For the most recent experience, the table ranks according to total returns for the period from the market lows last March to year-end 2009 (the latest period for which complete data are available).

The averages show clearly that small growth leads out of recessions, with a one-year average return of 48.2% for all 10 cycles, excluding the present, incomplete one. Small value comes in second, with an average one-year return of 43.3%. Large growth comes in third, with an average one-year return of 33.2%, and large value lags, with an average one-year return of 31.0%. But as should be apparent, the dispersions among returns vary greatly from one cycle to the next, making the averages a poor guide to the future. A better guide comes from the consistency with which each group leads and lags, which explains why the table is organized as it is.

From this vantage, the evidence looks clear for the small capitalization stocks in general. Either small growth or small value has shown the best one-year performance in all but one of these recoveries. Of the two small capitalization categories, small growth led in seven of these 10 recoveries and small value in two. Only once, during the 1953–54 recovery, did a large capitalization category lead. Of the larger-capitalization options, growth would seem to have an edge in times like these. It only came in last in three of these 10 instances, whereas large value came in last in half these instances. Consistent with this record, small value has led in the present recovery so far, and by a wide margin, too.

Looking out beyond this initial recovery phase, the evidence is admittedly more mixed. Still, it can tell something. In the two instances when small value led in the first year of recovery, it held its lead for the three-year average, though the wide margin of outperformance registered in this cycle is something of an unprecedented event. Perhaps even more compelling, small value or small growth have led in the three-year period in seven of the 10 previous recoveries and only once, after 1970, were the two small categories together in the lower half of these rankings.

Table 1. Returns on Equity Classes after Recessions
(ranked by one-year performance from the recession low)

	Subsequent Performance	
Recession Low	**One Year**	**Three Years**
June 1949		
Small Growth	45.61%	25.88%
Large Value	40.72	35.76
Small Value	33.71	31.67
Large Growth	33.13	24.56
September 1953		
Large Growth	44.48%	28.57%
Large Value	44.20	34.33
Small Value	37.19	27.59
Small Growth	29.14	20.55
October 1957		
Small Growth	57.03%	22.54%
Small Value	50.57	19.22
Large Value	48.99	17.53
Large Growth	29.38	12.33
October 1960		
Small Growth	32.47%	5.67%
Large Growth	32.09	13.83
Large Value	31.29	20.33
Small Value	31.25	17.12
May 1970		
Small Growth	52.78%	-0.80%
Small Value	49.25	6.90
Large Growth	39.64	16.80
Large Value	32.29	13.59
October 1974		
Small Growth	61.42%	35.92%
Small Value	41.22	39.04
Large Growth	40.51	17.36
Large Value	39.95	31.29
March 1980		
Small Growth	80.23%	29.61%
Small Value	58.88	40.13
Large Growth	47.47	21.68
Large Value	32.08	25.67
August 1982		
Small Value	79.12%	35.52%
Small Growth	72.33	18.63
Large Value	44.71	26.69
Large Growth	41.07	17.61
October 1990		
Small Growth	69.09%	28.70%
Small Value	49.47	37.64
Large Growth	43.07	19.86
Large Value	32.78	25.72
September 2001		

Small Value	3.51%	31.26%
Small Growth	-16.89	9.77
Large Growth	-18.11	2.77
Large Value	-34.79	1.46
March–December 2009		
Small Value	130.38%	
Large Value	96.90	
Small Growth	62.54	
Large Growth	47.74	

Source: National Bureau of Economic Research. **Past performance is no guarantee of future results.**

Note: Recession dates except the current cycle, on which the National Bureau has not yet commented. Stock indexes are based on Fama-French indexes for each class. The French-Fama indexes use all stocks traded on the New York Stock Exchange (NYSE) to set both growth/value breakpoints and small/large breakpoints. They then apply these breakpoints to all stocks traded on NYSE, AMEX, and NASDAQ to construct each index. Portfolios are formed at the end of June of each year, then held to the end of June of the next year, when they are rebalanced.

Note: This information is for illustrative purposes only. There is no assurance that individual investors will achieve returns on equities shown in this illustration. Indexes are unmanaged and cannot be invested in directly. Furthermore, indexes do not reflect gees and changes associated with mutual funds, which lower an investor’s return.

A Note about Risk

Investing involves risk, including the possible loss of principal. Growth company stocks tend to be more volatile than other types of stocks. Small cap stocks tend to be more volatile and less liquid than large cap stocks. Small cap companies typically experience higher risk of failure than large cap companies. These factors can affect performance.

Diversification cannot guarantee a profit or protect against loss in a declining market.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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