Large Cap vs. Small Cap Stocks

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We believe small cap stocks are over-valued. As of December 20, 2006, the Russell 2000 (a proxy for small cap stocks) forward P/E of 18.3 was over one standard deviation above the Russell 1000 (a proxy for large cap stocks) forward P/E of 15.7. The equity risk premium (Baa corporate bond yield minus the 10-year U.S. Treasury bond yield) is very low, indicating little quality risk is being priced into the financial markets.

Over the last six months of 2006, some economic catalysts have shifted in favor of large cap stocks. Historically, small cap issues tend to do well early in the economic cycle and as the recovery gains momentum. In a typical cycle, they tend to become overpriced as improving economic conditions are discounted, only to underperform in the late stages of an expansion as growth decelerates. Today, we believe small caps have discounted a lot of good news. In addition, late cycle indicators such as interest rates, inflation, the yield curve, and the dollar are signalling that growth may slow. However, given our more optimistic view on the economy, these signals may be premature. In addition, small cap stocks tend to do well all the way through a bull market. If the bull market is still intact, then small cap stocks could outperform.

Small cap relative momentum is looking toppy but is still trending higher. With the bull market in small caps six years old, it would not be surprising to see a relative correction.

Bottom-line: Although relative valuations indicate small stocks are overvalued, as long as the economic recovery and bull market in stocks are intact, we believe they could move higher. With small caps over-extended on a long-term perspective, a slight underweight is warranted. The evidence is not compelling enough to make a big bet in one direction or another.

market indicators

Valuation	Current Bias	Tendencies
Relative Forward P/E	Large	
Relative Trailing P/E	Large	Watch for valuation extremes
Relative Dividend Yield	Large	
Equity Risk Proxy	Large	Baa/EP narrow / not paid for risk
Economic/Market Cycle	**Current Bias**	**Tendencies**
Economic Cycle	Neutral	Early cycle small; late cycle large
Market Cycle	Small	6-12 months after bull market peaks favor large
Consumer Confidence	Neutral	At negative/positive extremes favor small/large
Coincident Indicators	Large	High (>2% y-y) and rising favors large
Commodity Prices	Small	Rising commodity prices favor small
Inflation Pressure	Small	High and rising favors large
Interest Rates	Neutral	Rising and high interest rates favor large
Fed Policy	Large	After last Fed Rate hike favor large
Dollar and Bonds	Large	Both rising favor small
Yield Curve	Large	Narrow favors large
Price Action	**Current Bias**	**Tendencies**
Relative Momentum	Small	Relative strength regression model
Breadth	Small	More stocks outperforming favor small
Trend Indicators	Small	Trend reversal
Volatility	Large	Rising volatility favors large
Seasonality	Small	May-to-October favors large
Reversion to Mean	Neutral	Small-Large y-y rate of change deviation
Ned Davis Research Perspective	Large	Ned Davis LT, IT, ST Model Composite

Sources: Bailard Research, Bloomberg, Ned Davis Research

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