the 9:05 An excerpt from Bailard's Quarterly Review of Economic and Market Developments® Q4 2019

Expectation vs. Reality in Equity Styles

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Diversification is the only free lunch in finance. And it's no state secret that a diversified portfolio generally includes exposure across the domestic equity styles of large and small capitalization companies as well as those in growth and value lifecycle stages. In the context of diversification and long-term performance, let's take a moment to walk through one of the historically-unexpected outcomes of the 2010s.

For the first ten years of the 21st century, small cap value stocks trounced the other domestic equity styles, as shown in Exhibit 1. Now, here on the cusp of the 2020s, it has been a different story. Instead of winning, small cap value came near the bottom of the four style types for the decade ending in 2019.

Was this just a case of what goes around, comes around? Because small cap value had performed so much better for a decade perhaps it only made sense that the other equity styles did better more recently? A look at a longer performance history in Exhibit 2 suggests that the most recent decade was not typical. Over the past 90-plus years of available data, small cap value was the clear winner. Moreover, evaluating rolling 10-year periods for the same time frame, small cap value has outperformed the most recent decade's winner (large cap growth) 80% of the time.

Something happened over the past decade that at least temporarily flipped the historically-natural performance order of things, and most readers can guess what that something is. The past ten years could easily be called the "Tech Decade," as technology and its applications caused major disruption across the economic spectrum. E-commerce profoundly altered retail shopping behavior, streaming crushed broadcast and cable TV, ridesharing decimated the traditional taxicabs business, smartphones largely replaced both

Exhibit 1: A Difference in Two Decades
Annualized Market Total Returns

	Large Growth	Large Value	Small Growth	Small Value
2000-2009	-1.2%	2.2%	-1.4%	11.3%
2010-2019	15.7%	11.3%	13.1%	11.5%

Exhibit 2: A Long-term Look
Annualized Market Total Returns, 1928-2019

	VALUE	GROWTH
LARGE	11.7%	9.5%
SMALL	14.4%	8.7%

Exhibit 3: The "Tech Decade"
Market Total Returns, 2010-2019

	Cumulative	Annualized
S&P 500 NA Tech Index	403.8%	17.6%
S&P 500 Index	256.4%	13.6%
Small Cap Value	197.4%	11.5%

Exhibits 1, 2, and 3: "S&P 500 NA Tech Index" is the S&P North American Technology Sector Index. Sources: Bloomberg for S&P NA Tech and S&P 500 index statistics. Large Growth, Large Value, Small Growth, and Small Value statistics based on 1928-2018 data from Kenneth R. French - Data Library. Since 2019 calendar year data was not available at the time of publication, MSCI data was used instead. ***Past performance is no guarantee of future results. All investments have the risk of loss.***

landline calls and letters, and social media seriously wounded actual in-person socializing. Investors took notice and drove technology stocks ever higher, up over 400% for the decade as shown in Exhibit 3.

Lost in the shuffle were small cap value stocks. While unable to match the S&P tech sector's sales gains, small cap value still handily beat the overall S&P 500 Index's revenue growth for the period. Yet somehow, this superior revenue growth did not translate into better relative returns. Valuation discrepancies that were wide to begin the period got much wider as the decade unfolded, as evidenced by the price-to-sales ratio. Exhibit 4 shows that the S&P tech sector began the decade trading at a ratio just over 2x sales, and finished trading at well over 4x. The S&P 500 Index overall started the 2010s trading below 1.5x sales, and rose to almost 2.5x. In stark contrast, small cap value stocks (as measured by the MSCI US Small Cap Value Index) began the decade trading at below a 1x ratio and ended in almost an identical position ten years later.

The reason for this discrepancy is relative expectations. The S&P 500 exceeded expectations, with large technology companies leading the way. Yet, tech stocks are comparatively scarce in the world of small cap value and, by definition, large and mega cap tech stocks are missing entirely.

If the largest technology stocks can continue to produce relative revenue gains far into the future, their current substantial valuation premiums may be justified. Historically, investor expectations have tended to rise faster than underlying fundamentals often warrant. Whether that is the case now—or will be in the future—remains to be seen, but it is something for stock market participants to consider.

This past decade saw low and generally falling interest rates, easy monetary policy, low inflation, and historically-low stock market volatility. All of these conditions typically have tended to lengthen investor time horizons and therefore have favored growth stocks. Will most or even many of these favorable tailwinds for growth stocks prevail for another decade? Time will tell.

While smaller companies certainly come with their own risks, some of their historical performance benefits may come from advantages inherent in their size. Small cap companies usually exhibit higher insider ownership percentages that reduce principal/agent problems. Moreover, there tends to be a greater focus on doing fewer things well in addition to a nimbleness and flexibility driven by better communication and less hierarchy, bureaucracy, and red tape.

A company's return on equity (ROE, a measure of profitability) tends to revert toward average over time. Highly-profitable companies usually attract competition, which generally reduces profitability. Conversely, barely profitable and unprofitable companies tend to lose competition over time, and those that can stay afloat tend to become more profitable as a result.

Think about investors in either high profitability (growth) or low profitability (value) companies over time. Which group is more likely to have their expectations exceeded or is more likely to be disappointed?

No one knows what the future holds, or which asset class or equity style will perform the best over the next decade. There are too many unknowns, and too many possibilities. However, when facing an uncertain future and needing to invest, why not play the odds? According to the wisdom of Damon Runyon: "*The race is not always to the swift, nor the battle to the strong, but that's the way to bet*." Lost in the shuffle were small cap value stocks. While unable to match the S&P tech sector's sales gains, small cap value still handily beat the overall S&P 500 Index's revenue growth for the period. Yet somehow, this superior revenue growth did not translate into better relative returns. Valuation discrepancies that were wide to begin the period got much wider as the decade unfolded, as evidenced by the price-to-sales ratio. Exhibit 4 on the following page shows that the S&P tech sector began the decade trading at a ratio just over 2x sales, and finished trading at well over 4x. The S&P 500 Index overall started the 2010s trading below 1.5x sales, and rose to almost 2.5x. In stark contrast, small cap value stocks (as measured by the MSCI US Small Cap Value Index) began the decade trading at below a 1x ratio and ended in almost an identical position ten years later.

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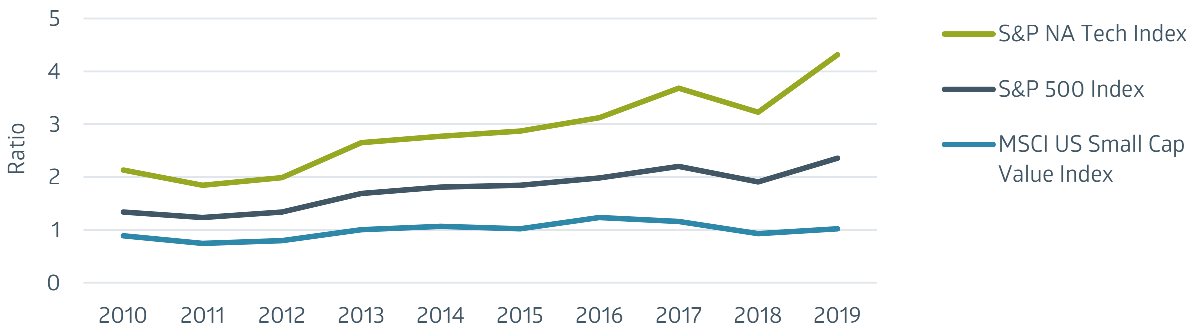
Exhibit 4: Price to Sales Ratio



Sources: Bloomberg, MSCI. "S&P 500 NA Tech Index" is the S&P North American Technology Sector Index. ***Past performance is no guarantee of future results. All investments have the risk of loss.***

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In addition to style risk and the normal risks of equity investments, small cap value stocks are usually more volatile, less liquid, and more vulnerable to adverse business and economic developments than those of larger companies. ***Past performance is no guarantee of future results. All investments have the risk of loss.***

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Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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