The first four articles in this series focused on what might be the most important pair of fundamental factors - growth and value. Those factors have provided investors long-standing, dependable above-market returns. Now, we take the series in a different direction and focus on other factors that may also give us a leg up on the market.

The term ?a leg up? is important to clarify. In general, factor-based investing is used to gain positive alpha or performance that is *relatively* better than the market. While ?better? than market returns are nice, investing based on factor analysis should not be the only protection you have when you fear that markets may decline sharply. The combination of factor investing and adjustments to your total equity exposure is a time-trusted recipe to avoid large drawdowns that impair your ability to compound wealth.

We continue this series with a discussion of market capitalization.

The four prior articles in the *Value Your Wealth* series are linked below:

Part One: Introduction

Part Two: Quantifying the Value Proposition

Part Three: Sector Analysis

Part Four: Mutual Fund and ETF Analysis

Market Cap

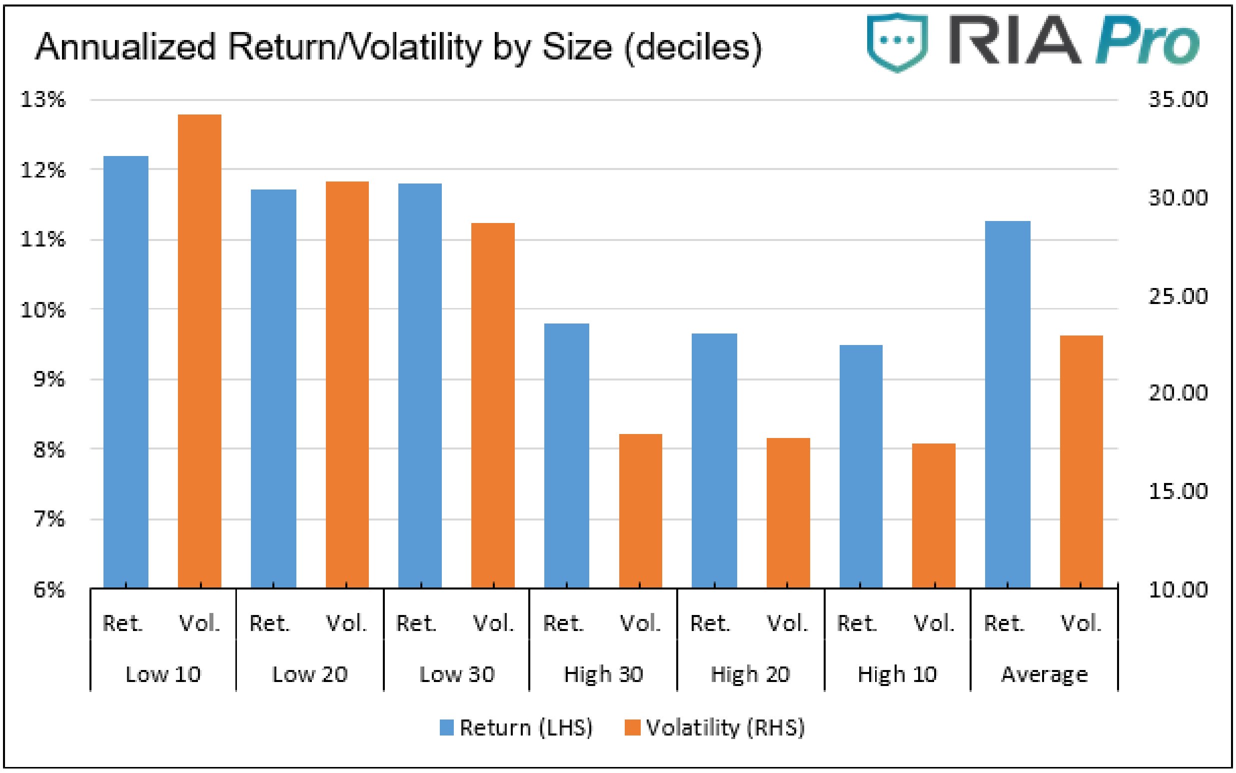
Market capitalization, commonly known as market cap, is a simple calculation that returns the current value or size of publicly traded companies. The formula is the number of shares outstanding times the price per share. For example as we wrote this article, Apple has 4.601 billion shares outstanding and Apple?s stock trades at roughly $210 per share. Apple?s market cap is $966.21 billion.

Most investors, along with those in the financial media, tend to distinguish companies market caps/size by grouping them into three broad tiers - small-cap, mid-cap, and large-cap. Over most periods, stocks in the three categories are well correlated. However, there are periods when they diverge, and we are currently amidst such a deviation. Since September 1, 2018, the price of the Large Cap S&P 500 Index has risen by 4.1%, while the price of the Small Cap S&P 600 Index is down 12.9%. Deviations in historical relationships, whether short or long-term in nature, can provide investors an opportunity to capitalize on the normalization of the relationship, but timing is everything.

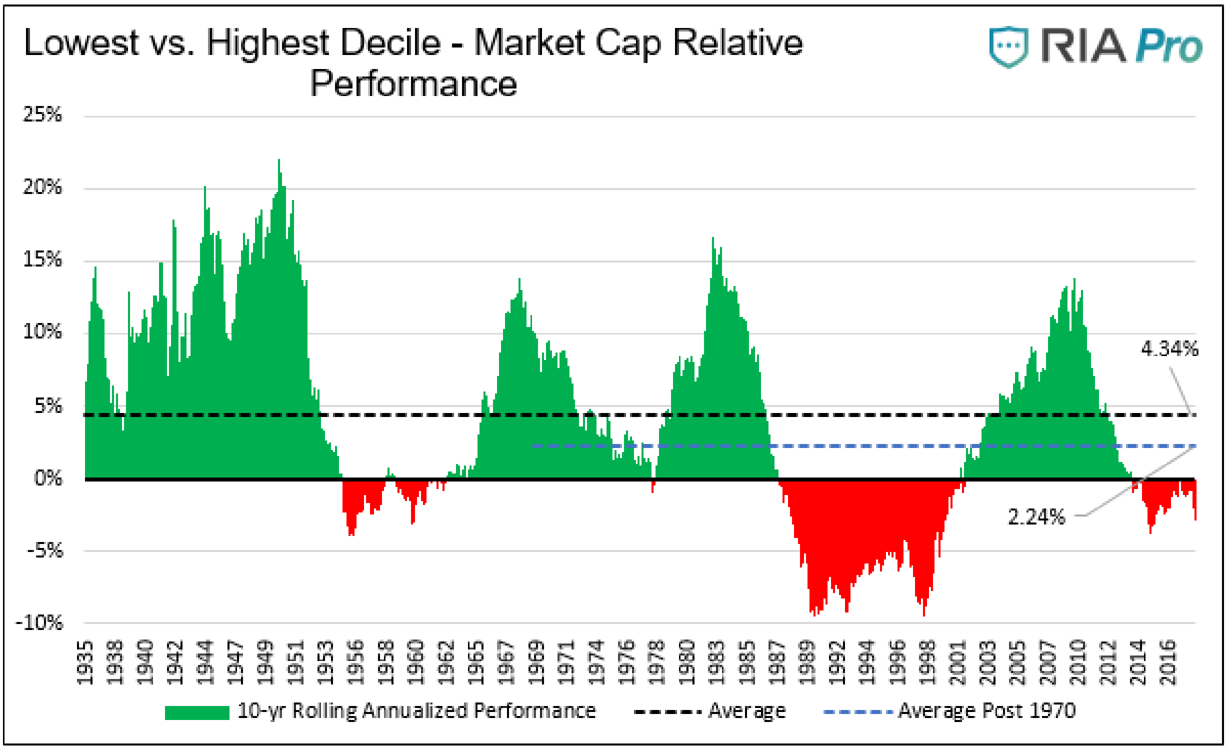
Historical Relative Performance

The following graphs are based on data from Kenneth French and can be found HERE. The data encompasses a wide universe of domestic stocks that trade on the NYSE, Amex, and NASDAQ exchanges.

The data set provides returns based on market cap groupings based on deciles. The first graph compares annualized total return and annualized volatility since 1926 of the top three (High) and bottom three (Low) market cap deciles as well as the average of those six deciles. To be clear, a decile is a discrete range of market caps reflecting the stocks in that group. For example, in a portfolio of 100 stocks, decile 1 is the bottom ten stocks, or the smallest ten market cap stocks, decile two is the *next* ten smallest cap stocks, etc.



The next graph below uses monthly ten year rolling returns to compare total returns of the highest and lowest deciles. This graph is a barometer of the premium that small-cap investing typically delivers to long term investors.



The takeaway from both graphs is that small-cap stocks tend to outperform large-cap stocks more often than not. However, the historical premium does not come without a price. As shown in the first graph, volatility for the lowest size stocks is almost twice that of the largest. If you have a long time horizon and are able and willing to stay invested through volatile periods, small caps should fare better than large caps.

Small-cap stocks, in general, have high expected growth rates because they are not limited by the constraints that hamper growth at larger companies. Unfortunately, small-cap earnings are more vulnerable to changes in industry trends, consumer preferences, economic conditions, market conditions, and other factors that larger companies are better equipped and diversified to manage.

Periods of Divergence

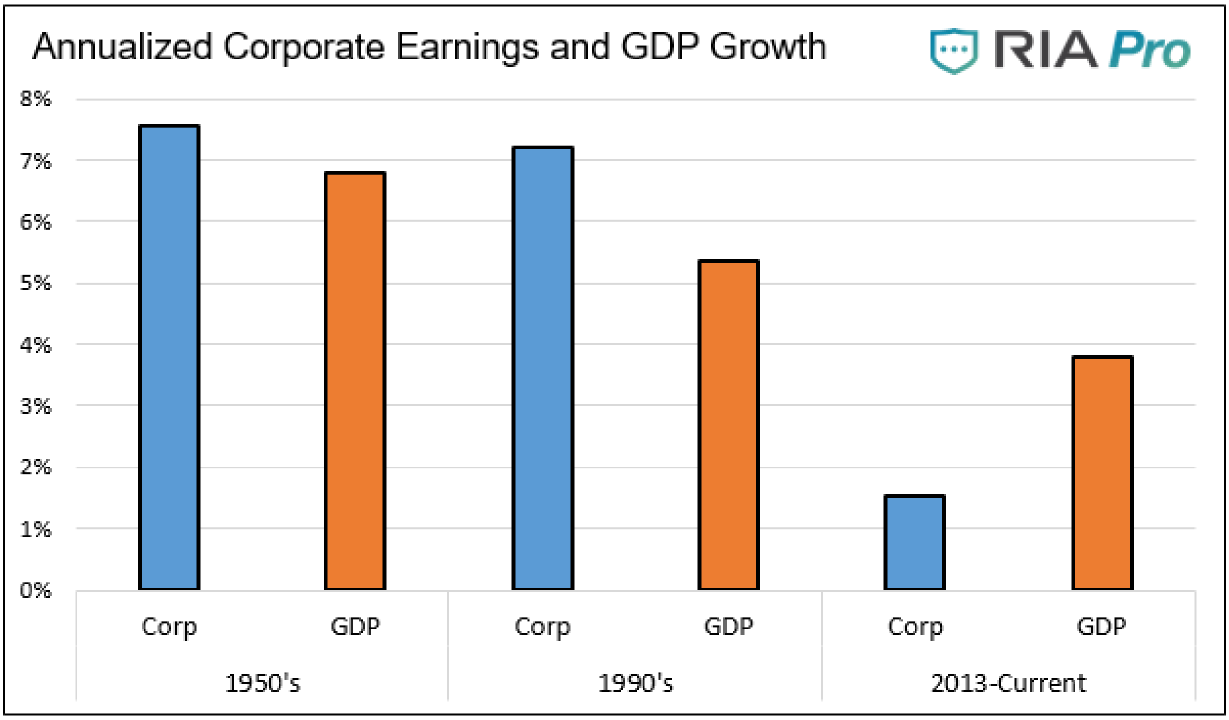
The second graph above shows there are only three periods where large caps outperformed small caps stocks since 1926. Those three exceptions, the 1950?s, 1990?s and, the post-financial crisis-era are worth considering in depth.

The 1950s The Nifty Fifty- The end of World War II coupled with a decade of historically low interest rates disproportionately helped larger companies. These firms, many global, benefited most from the efforts to rebuild Europe and partake in the mass suburbanization of America.

The 1990s Tech Boom- With double-digit inflation a distant memory and the swelling technology boom, larger companies that typically benefited most from lower rates, less inflation, and new technologies prospered. While this new technology benefited all companies in one form or another, larger ones had the investment budgets and borrowing capacity to leverage the movement and profit most.

The 2010?s Post Financial Crisis Era ?The current period of large-cap outperformance is unique as economic growth has been prolonged but below average and productivity growth has been negligible. Despite relatively weak economic factors, massive amounts of monetary stimulus has fueled record low corporate borrowing rates, which in turn have fueled stock buybacks. Further, the mass adaptation of passive cap-weighted investment strategies naturally favors companies with large market caps. Circularly, passive investing feeds on itself as indexed ETFs and mutual funds must increasingly allocate more to large caps which grow in size relative to the other holdings.

To reiterate an important point: the current period of outperformance is not based on solid economic fundamentals and resulting corporate earnings growth as in the two prior periods described. This episode is a byproduct of monetary actions.



The graph below highlights the distinction between the current period and the two prior periods where large caps outperformed.

Summary

Historically, small-cap stocks tend to provide a return premium over large-cap stocks. However, as we pointed out, there are periods where that is not the case. Currently, large-cap stocks are the beneficiaries of overly generous monetary and fiscal policy. We do believe the relationship will return to normal, but that will likely not occur until a bear market begins.

As we wait for a normalization of valuations and traditional relationships that have become so disfigured in this cycle, we consider the current relative valuations on small-cap stocks similar to those we described in value stocks earlier in this series. The time to weight your stock portfolio allocation more heavily toward small-cap opportunities is coming, but every investor must decide on their own or with good counsel from an advisor when to make that adjustment. When appropriate, a gradual shift to small-cap stocks from large caps depends on an investor?s risk appetite and defensive preference.

More importantly, have a plan in place because when the market does meaningfully correct, the premium small-cap stocks provide will likely help cushion against a stock market correction.