BY KENNETH L. FISHER

Investing With Style

The stock market had a great 1998. Many investors didn't.

ON JANUARY 1, 1998, the S&P 500 made up 71.1 percent of the U.S. stock market's total dollar value and returned over 28.5 percent. Lagging it by 31 percent, the Russell 2000, representing small stocks, fell 2.55 percent. More than 61 percent of all U.S. equities experienced losses.

An investor's style selection was the principal factor determining terrific or terrifying results. Folks think stock-picking is the most important investment skill. Wrong! In most years, financial failure or success is simply a matter of style. The S&P 500 soared on the wings of huge growth stocks. Small-cap growth, small-value and so-called big-value stocks lagged the S&P and were in the aggregate largely down. Just 33 huge stocks provided more than 75 percent of the S&P 500's 1998 gain.

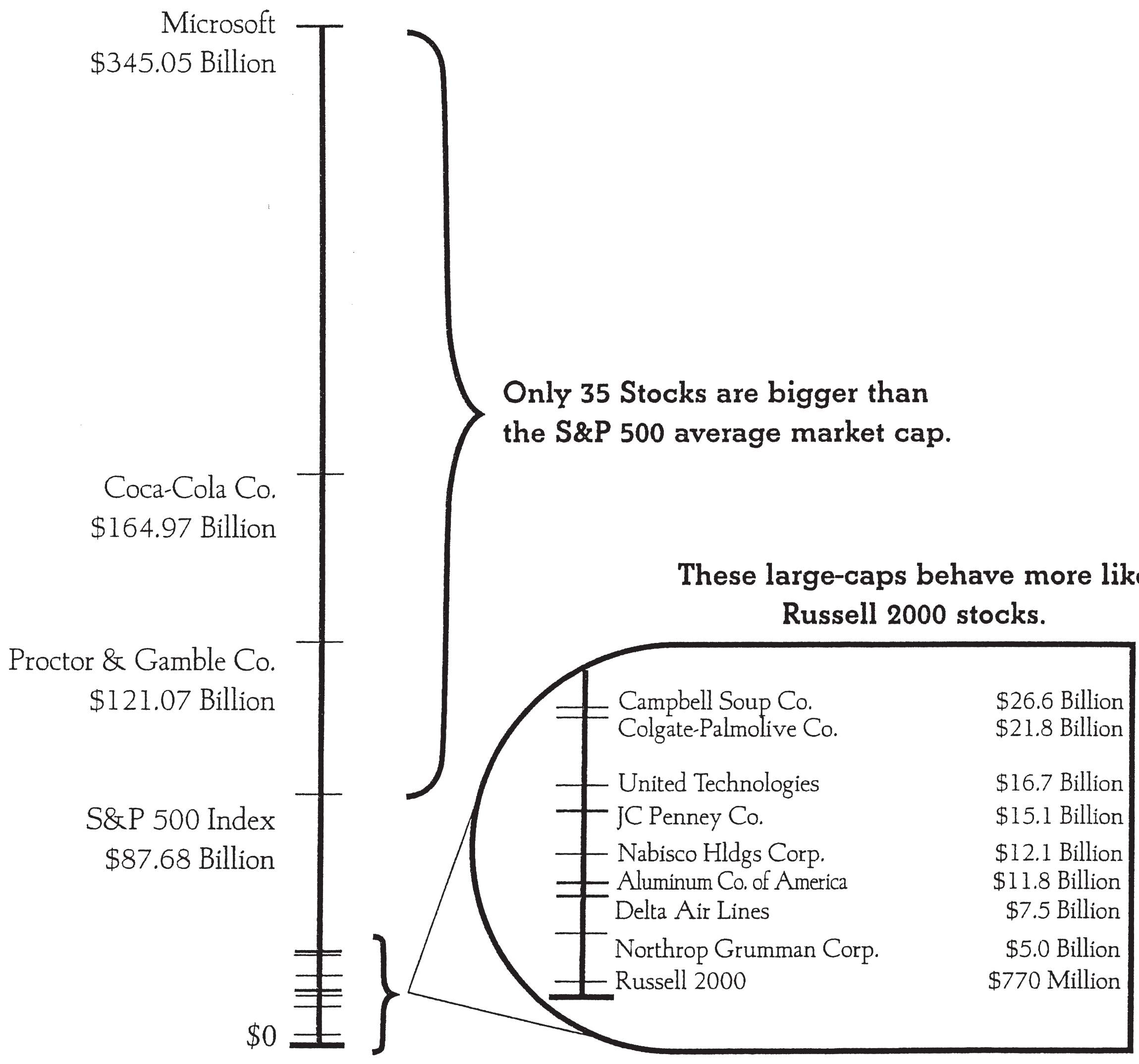
The seemingly simple tradeoff between big and small stocks is the most important style decision investors make. Yet regarding big versus small, the difference is less obvious than you may believe. Most folks think a $10 billion market cap is big. But as a group, stocks this size move closer to the Russell 2000 than to the S&P 500. People forget the S&P 500's average capitalization at year-end 1998 was over $87 billion. Because it's cap-weighted, a very few giants skew the S&P to act like its $87 billion size. A $10 billion-cap stock is only 12 percent that big — peanuts by comparison.

If small stocks are stocks smaller than the market, then shouldn't big stocks be stocks bigger than the market? There are only a few. Historically only about 35 are bigger than the S&P 500's correctly calculated average (the root mean square of the caps). It's these biggies that have driven the post-1994 market. The reason most fund managers can't beat the S&P 500 isn't poor stock-picking — it's poor style selection.

WHY VALUE HAS LAGGED

Managers must buy stocks smaller than the market unless they restrict themselves to those very few biggies. This is

Big and Really Big



Market cap data as of 12/31/98

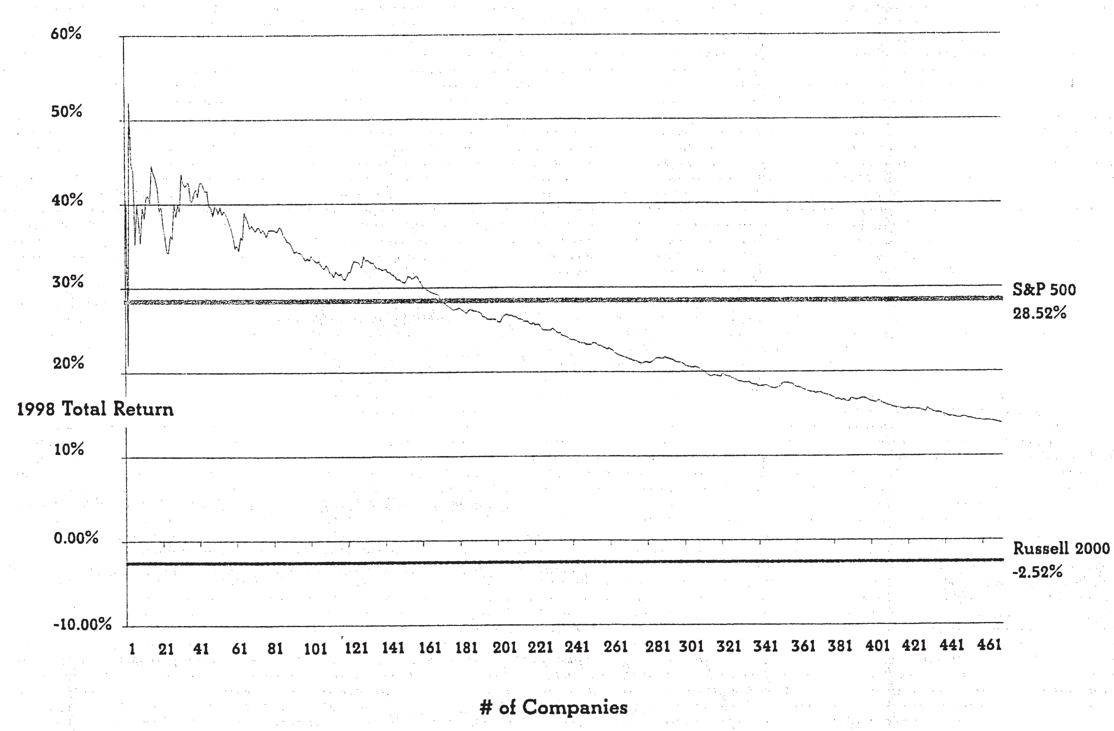
why value investors have lagged badly. The stocks bigger than the market are almost all growth stocks. The few value stocks therein are almost all energy dependent. That's why I argue that big-cap value doesn't even exist — you can't build a portfolio of value stocks bigger than the market that has industry and stock diversification. It is impossible.

Because big-value doesn't exist, being bigger than the market means owning growth. According to Morningstar, the typical big-value mutual fund in 1998 held stocks with an average cap-size of around $13 billion — less than one-fifth the S&P's average. It's not just value stocks that are small. Brand-name firms people think are big — such as Colgate-Palmolive, Alcoa, Delta Airlines or J.C. Penney — are much closer in size to the tiniest stock than to the market's average and, as a group, act like it (see illustration on previous page).

The 300 smallest S&P 500 stocks, which investors consider big stocks, perform closer to the Russell 2000, than their own large stock index (see illustration below). When small stocks lead, these smaller S&P stocks do well and beat the S&P. When big stocks lead, these smaller S&Pers lag. Since 1995, they've performed much closer to the Russell 2000's return than that of the S&P 500.

Conversely, any semi-diversified combination of the 35 largest stocks beat the S&P 500 over all annual

Size Pays



The graph above represents a rolling, equal-weighted average return of S&P 500 companies sorted from largest 12/31/97 market cap to smallest. The upward spike at the left of the graph represents the 1998 average return (52.15%) of the three largest S&P 500 stocks (General Electric, Coca Cola, and Microsoft). The farthest point to the right of the graph is the average 1998 return (13.82%) for all the S&P 500 stocks. Notice that as smaller stocks are added to the group, the line trends below the S&P 500 Index average of 28.52%. Remember, the S&P 500 is a cap-weighted average and is dominated by the largest stocks. The Russell 2000, a small-cap index, returned -2.52% in 1998.

The graph represents the near monotonic relationship between size and return in 1998. The bigger your cap was, the better you did.

Note: This graph includes only those S&P 500 stocks with data for all of 1998.

periods starting in 1995. When the S&P 500 beats the Russell 2000, the biggest stocks do best of all. Just having made a style decision to be in truly large stocks virtually guaranteed market-beating performance since the start of 1995.

No, super-caps aren't for all time. No investment style is. A rule of thumb is that big stocks lead in the last two-thirds of a bull market and throughout a bear. Small stocks beat big ones in about the first third of a bull market, and by a mile. So after a bear market, shift to small stocks, and not necessarily tiny ones; remember, $10 billion-sized stocks act very close to the Russell 2000, without the risks and illiquidity.

Numerous academic studies show that since 1926 small stocks beat big ones. Lots of folks lost money in recent years following that trend. Why? Because in most of those same years, big beat small. How so? Fact: If you exclude 1933 and 1943, the average since 1926 shows big stocks and small stocks doing exactly the same. Since 1926, if you exclude three homogenous early bull market runs, those of 1933-34, 1942-45 (the start of history's longest bull market) and 1975-76, big stocks beat small stocks by 2 percent per year (see illustration below).

If you take the first 12 months after every S&P 500

The Small-Cap "Premium"

	Cumulative		Annualized		Small-Cap Premium
	Ibbotson* Small-Cap	Big-Cap	Ibbotson* Small-Cap	Big-Cap	
1926-1998	529,011.8%	234,880.5%	12.46%	11.22%	1.24%
Less 1933 and 1943	115,560.4%	121,103.0%	10.44%	10.52%	-0.07%
Less 3 bear market bounces**	9,940.7%	36,710.4%	7.35%	9.52%	-2.17%

Small-Cap Premium Following Bear Market Bottoms

	12 Months After Bottom		
Bottom	Ibbotson* Small-Cap	Big-Cap	Small Cap Premium
3/31/33	296.49%	98.73%	
3/31/38	12.76%	17.26%	
6/30/40	15.07%	7.97%	
5/31/47	15.95%	12.39%	
1/31/58	64.88%	43.37%	
6/30/62	22.27%	22.94%	
7/31/70	52.43%	41.87%	
1/31/75	52.80%	37.21%	
8/31/82	96.20%	59.40%	
12/31/87	24.36%	23.20%	
11/30/90	49.47%	33.51%	
Cumulative	10,114.85%	2,444.01%	
Annualized	52.29%	34.21%	18.08%
All Other Periods			
Cumulative	12,373.23%	18,259.63%	
Annualized	7.71%	8.35%	0.64%

* *All figures based on Ibbotson Associates data except 1997-1998 small cap (Russell 2000).*
** *Excludes 1933-1934, 1942-1945, 1975-1976.*

bear market bottom, small stocks have beaten big stocks by 18 percent per year, with big stocks having never beaten small stocks. The time to shift into small is right after a bear market. Of course, you will know when we've had a bear market, just not when it's over.

SMALL-GROWTH VS. SMALL-VALUE

Among small-caps, sometimes growth stocks lead, sometimes value. Like cap-size, the factors determining whether growth or value will predominate are seldom appreciated. Value and growth investors, each believing their style is basically best, will talk ad nauseam about the differences between them. But few notice the main style driver. The difference is simple and tied to relative debt levels.

Value companies carry much more debt than growth firms and therefore depend on debt financing if they want expansion capital to fund growth. Higher debt dependence makes value firms more sensitive to the difference between short- and long-term rates. When bankers can borrow money at cheap short-term rates and lend at higher long-term rates, they make fat gross margins and are eager to lend. When that spread shrinks, the banking system's propensity to lend disappears. Thus, when the yield curve spread is fat and widening, small-value beats small-growth. When the spread shrinks and gets too thin (at about a 1 percent spread from short-end to long-end), growth stocks beat value stocks. The yield curve spread alone explains about 55 percent of the relative wiggles between growth and value stocks over history.

In 1981, for example, the curve began to widen after an unhealthy inversion caused by the Fed's full-scale war on inflation. Banks began lending again. Coming off the bear market bottom created by that yield curve's inversion, small-value stocks led all styles. The Wilshire small-value index posted an average annualized return of 41 percent from January 1982 through November 1983 versus 23.5 percent for small-growth. Other small-cap style indices showed similar results.

Then, big-caps, which had badly lagged, took over. Yet the performance of small stocks was so strong that missing it torpedoed performance for years. Just like 1998, when folks were hurt by not owning super-caps, most early '80s investors were hurt not owning small-value. In both instances, investors allowed prevailing sentiment to impair judgment.

FUNDAMENTALS AND FEAR

Style investing means selecting superior stocks in the market style that combines both powerful fundamentals and the sentiment of fear. In the early '80s, it was small-cap value. Today, it's super-caps that are supposedly too high-priced to keep rising. But the market is driven by surprising and humiliating the maximum number of investors.

Recently, investors have looked for the time when small-caps will take the lead from big stocks. It will come. But not until people stop looking for it. Based on history, it won't come until just after a real bear market in the S&P 500. Why? At the bottom of a bear market, as the U.S. is starting to have its strongest economic growth relative to global trading partners, shifting from strongly negative GDP growth to strongly positive growth, small stocks benefit from having the highest proportion of domestic revenue content. Later in the cycle, as our growth continues but looks more like Europe's, the largest global firms take over. Recently, this trend is exaggerated, on the margin, by Europeans and Japanese being able to borrow at their banks cheaply relative to our interest rates and then buy U.S. stocks. And the U.S. stocks they buy are the most global ones, the ones they know, the ones that are biggest.

It's among the great market myths that value is better than growth, or small stocks are intrinsically better than big. Perhaps the greatest fiction of all is that stock-picking is the main ingredient in investment success. Rather, style is what largely determines a portfolio's total performance. Most importantly, the ability to switch to superior stocks in the style that combines strong fundamentals with ripe contrarian sentiment ensures long-term success. Were you in super-cap stocks in 1998? If not, you were in the wrong style. You likely earned little in a year the S&P 500 returned over 28.5 percent. Perhaps it's time you invested with style.

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