April 7, 2006

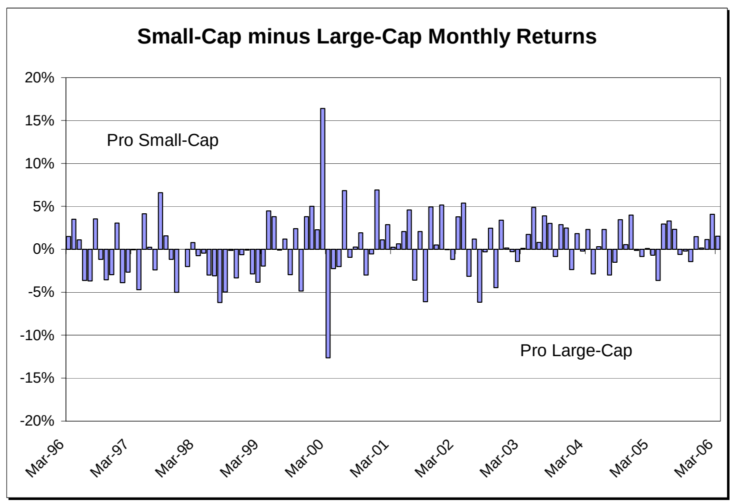
Note

RE: Mar06 Size Update

When we first started tracking the market's Size Cycle, LrgCap stocks were in the midst of a protracted run (Feb94 to Mar99). Our P/V data doesn't extend quite that far back, but at the beginning, SmlCap stocks were priced at a significant premium (well over 10%). By the end of that phase, LrgCap stocks enjoyed the market premium to the tune of 33%. At the time, we believed that to be an extreme stretching of the fundamental dynamic that underlies this cycle. As you'll recall, in 1998, LrgCap stocks enjoyed an unprecedented run at the expense of SmlCap stocks, finishing the year with a 30-percentage point return advantage. Clearly, this was not something we were likely to see again soon, right? Well, we couldn't have been more wrong.

Subsequent to this "aberrant" market episode, there was a Style-related bubble (dot-com) and then in time an awful bubble-burst. The stretching of the fundamental dynamic in this instance was far more extreme (over 100% at the pinnacle), but nevertheless, right on the heels of 1998 was yet another "aberrant" market event. After this second "excess", would the market now return to normal? Absolutely not!

Two years ago (Mar04), the premium accorded SmlCaps reached over 40%. Right on cue, three of the next four quarters favored LrgCaps, seeming to suggest a turn had occurred. Instead, since then there have been four more pro-SmlCap quarters, including a seven-percentage point SmlCap return advantage during the first quarter of this year. The SmlCap premium now stands at 50%, and with momentum reestablished, there's no telling how much longer this might continue.



As extreme as this evidence is, it actually significantly understates the market's present imbalance wrt Size, as thus far we've contrasted only SmlCap v. LrgCap relative fundamental valuations. Micro-Caps, which we define as any stock with a MktCap less than $750M, are even more extended, with about a 90% premium.

If there's any lesson an investor needs to learn, it's that in the end, a dollar's worth of earnings is just a dollar's worth of earnings. It might be fashionable for a time for investors to prize a big or a small or a value or a growth dollar more highly than another, hence the Size and Style Cycles we track, but these are fleeting advantages. So be careful, as we find ourselves once again in another "aberrant" market.

I'd label this present SmlCap fascination a bubble, but when *"irrational exuberance"* becomes the norm, seems like we need a new term. I'll consult my copy of *"Extraordinary Popular Delusions and the Madness of Crowds"* for an answer.

Lowell