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Strategies

Beyond the Bubble, With Small-Cap Stocks

By MARK HULBERT

SMALL-CAP stocks are significantly overvalued. In fact, they are even pricier, on average, than they were in March 2000, just before the Internet bubble burst. In contrast, the average large-cap stock is moderately undervalued.

This picture of a highly bifurcated stock market is painted by data from [Ford](#) Equity Research of San Diego, which tracks around 4,500 publicly traded companies in the United States. Among companies that have been publicly traded for at least seven years, the firm reports that 55 percent have higher price-to-earnings ratios today than they did in March 2000. The bulk of these pricier issues, however, are in the smaller-cap sectors. Among the very largest companies, the average P/E ratio is now just a third of what it was seven years ago.

If investors focused only on the broad stock market averages, however, they might conclude that the entire market is undervalued. According to Standard & Poor's, for example, the P/E ratio of the S.& P. 500 currently stands at 17, based on trailing 12-month operating earnings. The comparable ratio at the end of March 2000 was 31.1, almost double the current level.

Though the S.& P. 500 includes many large-cap stocks, it also contains smaller-cap issues. Why is the index's P/E ratio nevertheless so much lower than it was seven years ago?

The answer lies in how the index is put together. The S.& P. 500 is a capitalization-weighted index, meaning that each company's contribution to it is a function of the company's size. That would not necessarily skew the average P/E ratio for the index itself, if the average valuations of both larger and smaller stocks were similar. But that's not the situation today, according to Ford Equity Research: the 50 companies in the S.& P. 500 with the smallest market caps have an average P/E ratio that is much higher than it was seven years ago, while the ratio for the 50 largest-cap stocks in the index is significantly lower.

According to Ford Equity Research, the average P/E ratio among the 50 largest-cap companies is now

19, about a third of the average of 60.7 for the biggest 50 in March 2000. The average market cap for the 50 largest companies is now \$123 billion, versus \$153 billion in March 2000.

Contrast those numbers with those for the 50 smallest companies in the index: their average P/E ratio is now 30.7, versus 20.3 seven years ago. And their average market cap is now \$3 billion, versus \$1 billion.

In other words, the smallest-cap stocks in the S.& P. 500 are significantly more overvalued today than they were seven years ago. Yet their higher P/E ratios barely affect the ratio for the index as a whole. That's because the combined market capitalization of the 50 largest stocks account for nearly half the market cap of the entire S.& P. 500, while that of the 50 smallest stocks add up to just 1.2 percent of the total.

“Investors who pay attention to the P/E ratio of cap-weighted indexes such as the S.& P. 500 therefore need to exercise great care when drawing conclusions about stocks' relative valuations,” Richard Segarra, director of research at Ford Equity Research, said in an interview. “At best, the P/E ratios for such indexes shed light only on their largest-cap stocks; we should avoid drawing any inference from a cap-weighted index's P/E ratio about the valuations of its smallest-cap members.”

MR. SEGARRA found that the index's prevailing pattern also holds true across the universe of stocks that his firm tracks. As a result, an investor who emphasizes market sectors according to relative P/E ratios would have a very different portfolio today than in March 2000. Back then, he would have favored small caps over large caps — and been handsomely rewarded for this choice. The trend is seen in the annualized total returns since March 31, 2000, of three Dow Jones Wilshire indexes: 10.1 percent for the U.S. Microcap Index and 7.2 percent for the U.S. Small-Cap Index, but only 0.5 percent for the U.S. Large-Cap index.

Today, however, according to Mr. Segarra, that investor would favor large caps over small caps. Not only is the average P/E ratio of large-cap stocks only a third as high as it was in March 2000, it is nearly 10 percent below its average level of the last five years. There's no guarantee, of course, that large caps will outperform small caps over the next five years — but there's a good argument to be made that they will.

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