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Investment Commentary

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The Start of Something Small

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In this article, Mr. Bernstein argues that the ongoing change in stock market leadership, from emerging markets and China to US small cap stocks, is well-grounded in historical precedent and may have broad implications for strategic investment allocations over the coming decade.

Fact: For more than two years, US small cap stocks have outperformed Chinese shares. This may sound heretical to investors who believe that US companies are worth considering only in terms of how they serve the emerging markets, but the performance of the global equity markets seems to increasingly suggest that equity market leadership is changing. A group of stocks that have little to do with the "global" economy, namely US small cap value, is perhaps the world's best-performing equity asset class.

This year (through April 28), the Russell 2000 Value Index is up about 18%, which compares extremely favorably to the MSCI Emerging Market Index's +2%, the MSCI BRIC Index's -1%, and the CSI 300 Index's -13%. Over the past two years, the Russell 2000 Value Index was down about 1% versus the CSI 300's -17%.

Some investors might chalk up the recent performance of US small cap value stocks as a temporary phenomenon, but long-standing economic and financial theories suggest that the past two years' performance might be only the beginning of a secular period of outperformance.

A basic investment axiom holds that returns on capital are highest where capital is scarcest. Investors' best returns come when borrowers badly need capital, but hurdle rates are prohibitively high. Simple laws of supply and demand suggest that if 20 borrowers confront one lender, the lender will set the terms of the loan. The lender's return on capital will be higher than if the opposite occurred and 20 lenders confronted one borrower. History has clearly demonstrated that investing under such capital-flooded conditions is generally unwise.

Investors often forget this simple rule, chase "hot" investments, and are subsequently disappointed when their return on capital is lower than expected. The technology bubble, the enthusiastic rush into private equity and hedge funds, and the housing bubble are all recent examples of investing in markets with an overabundance of capital. Because emerging-market funds continue to receive record inflows and the number of such funds continues to grow, investors need to consider whether emerging-market hurdle rates may be too low, and whether the prevailing investment environment in those markets is just the latest instantiation of the capital-flooded scenario (20 lenders confronting one borrower) that has disappointed investors so often in the past.

In March 2000, colleagues at my previous firm and I wrote a report titled, "Attention Venture Capitalists: Leave Silicon Valley for West Texas". The technology bubble was causing a gross misallocation of assets within the American economy. The markets were over-capitalizing the technology sector while sucking capital away from more productive uses in other parts of the economy. Our research concluded that energy and materials were the sectors being most detrimentally affected by the technology bubble, and those two sectors became our prime secular investment themes.

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Smaller US companies today face a similar extreme scarcity. These firms generally raise capital by borrowing from banks, but most measures of bank lending continue to indicate that the traditional commercial and industrial (C&I) loan market, although improving, remains rather dysfunctional. Banks are willing to lend only on terms that small businesses can't afford. In other words, the bid/ask spread for small business lending remains remarkably wide.

The traditional capital formation process in the US has broken down, and the resulting ongoing misallocation of capital around the world is central to our emphasis of US small cap value stocks. Although difficult to quantify, it seems reasonable to assume that the growth over the past decade in lending among financial institutions far outpaced the growth in financial institutions' lending to non-housing small businesses in the US. Financial institutions lent vast amounts to housing, to hedge funds, to private equity funds, and to non-US industries. However, the transmission mechanism between the US financial sector and the US real economy has clearly failed.

Despite this backdrop, most investors seem totally uninterested in US small businesses. Based on interviews in a recent article by *Barron's*, only one of 51 top financial advisors even mentioned small cap stocks as a potential investment, much less highlighted those stocks as a primary investment theme. Private equity firms, which in the past might have gravitated toward such small-company opportunities, are more interested in Asia and in structuring higher-profit-margin "mega-deals". Still reflecting views formed during the technology bubble, venture capitalists still consider traditional small companies too mundane relative to those in alternative energy, "clean tech" and "green tech", because the valuations of technology IPOs have typically been much higher than those of industrial IPOs.

Our work does not imply that the Chinese economy's growth rate won't significantly outpace that of the US economy, nor does it mean that the US economy will suddenly grow faster than trend. As investors, we worry less about economies and more about potential return on investment.

Claims made during the technology bubble regarding technological innovation have largely come true. However, despite those technological advances, the NASDAQ Composite today stands at roughly half its value in March 2000. Likewise, many of today's forecasts for the Chinese economy might indeed prove true, but that shouldn't imply that investments made in China and Asia today will necessarily generate superior returns over the next decade.

Periods of extreme equity market volatility have historically signaled a change in stock market leadership. Volatility occurs because of significant changes in the macroeconomy. Old investment themes that were geared to the previous economic climate are replaced by newer themes that are better suited to the new climate. This cycle's switch in leadership from emerging markets and China to US small cap stocks seems to fit that historical pattern.

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