# Investment Watch

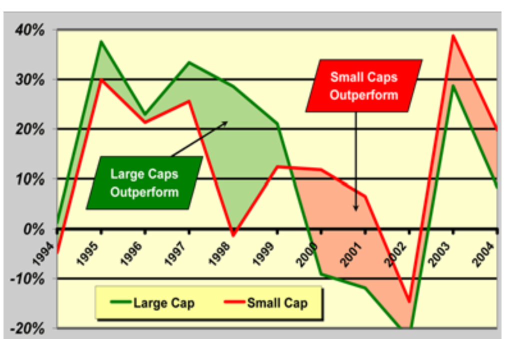



Every quarter this past year, I've stubbornly exalted the virtues of stocks and eulogized the death of bonds. As year end drew closer, I worried that the Grinch would steal my Christmas. I laid awake all Christmas Eve night by the fireplace. I didn't hear him. I didn't see him. But, the next morning, much to my delight there were many large and small packages under the tree. *This year Santa came through the back door*.

I like to open the larger gifts first. My wife says I'm *greedy*! She likes the smaller packages, hoping for jewelry. You'd think she'd know me better by now. Bigger is better. Right? *Sometimes*, but for the last few years our stock investments have proven that ***good things come in small packages.***

By small packages, I mean small companies. "Capitalization" is a measure of a company's size. It's easy to figure - just take number of shares and multiply by the current market price. Often called Market Cap, this is how much the whole company is worth. Stocks are sorted into **small**, **mid** and **large** sizes. **Large** Capitalization stocks (Caps) are above $10 billion, **Small Caps** less than $2 billion and **Mid Caps**, of course, are in between.

As shown below, there are times like the end of the 90's when the Large Cap stocks do better than the Small stocks. And then, periods like the last five years when smaller stocks outperform. Although everyone has a guess, some educated and some not, no one knows whether the large or small caps will outperform in the future.

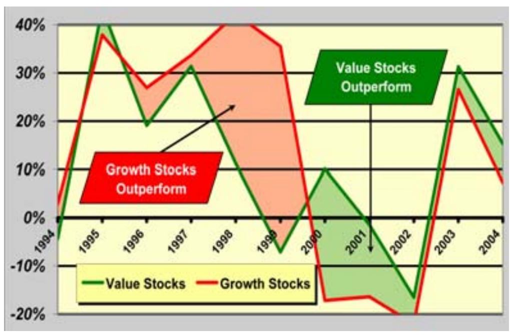



Larger stocks are considered to be *less risky*. Therefore, because smaller stocks are *more risky*, they generally cost a little less and return a little more than larger stocks. However today the smaller stocks cost more than their larger siblings. You might say there's a mini-bubble in small caps.

Size is not the only thing that matters, style also counts. ***"Growth"*** stocks are the high style, glamour companies which are expected to grow faster than the overall stock market. These "new economy" stocks, wrapped in shiny foil paper, cover the technology, telecommunications and healthcare sectors. Whereas, the ***"Value"*** stocks are dull, out-of-favor companies. These "old economy" stalwarts, wrapped in old newspaper, cover the boring fields of financial services, manufacturing and energy.

***Growth and Value*** styles tend to be at the opposite ends of the spectrum. ***Growth*** stocks generally don't pay high dividends and cost more for each dollar of earnings. This is called the Price/Earnings (P/E) ratio. If a stock costs $100 and it's trailing 12 months earnings are $4, it has a P/E ratio of 25 ($100/$4=25). ***Value*** stocks generally pay higher dividends and have lower P/Es. ***Blend*** stocks are merely a blend between Value and Growth.

As shown below, the ***Growth*** and ***Value*** styles come in and out of vogue just like the kids' toys under the tree. ***Growth*** was dominant in the late 90's but since then **Value** has been leading the way. Both styles have their proponents, but neither consistently provides higher returns. In fact over the history of the markets, they are in very close proximity.




Combining these Size and Style charts it's easy to see Large Cap and Growth were hot in the late 90's and it's been Small Cap and Value that have been the winners since Y2K.

These market capitalizations (Large, Mid and Small) and management styles (Growth, Blend and Value) are organized by using a matrix. Morningstar first named it a **Style Box**™. Other companies use the terms **style/size grid** or management style **matrix**. These grids assist us in comparing these different asset classes.

The matrix of the average **P/E ratios** illustrates the cost difference between Growth and Value. Growth stocks have a price tag <u>almost double</u> that of Value stocks for each dollar of earnings. Growth stocks usually cost more per dollar of earnings because their earnings are anticipated to grow faster than the Market. This is normal.

### Price/Earnings Ratios

| | VALUE | BLEND | GROWTH |
|---|---|---|---|
| LARGE | 12 | 18 | 23 |
| MID | 13 | 19 | 24 |
| SMALL | 14 | 20 | 26 |

The **P/E grid** also reveals that today smaller stocks cost more than larger stocks. This is not the norm. Smaller stocks usually cost less because of the added risk. Many pundits think that Large Caps will outperform smaller companies until this comes back into balance again. Also because Value has been dominant for five years, some people think the tide will turn and Growth will be the superior style for the next few years.

Okay let's get back to this year's stealth Christmas that snuck up on all of us. The style grid lends insight into the relative performance of each US equity asset class for 2004. Surprising isn't it! This lackluster year came in about average for the Large Caps but significantly above average for the smaller stocks. Also, Value dominated Growth by a wide margin.

### US EQUITY 2004 RETURNS

| | VALUE | BLEND | GROWTH |
|---|---|---|---|
| LARGE | 13% | 11% | 8% |
| MID | 14% | 13% | 11% |
| SMALL | 20% | 15% | 10% |

**Foreign** stocks had a great year averaging 19% due to the decline in the dollar. Finally the **bonds** weren't buried. Even though inflation edged up, the dollar declined, the budget and trade deficits swelled and the Greenspan Fed increased interest rates five times, bonds held their own with short-term returns averaging 2%, mid-term 4% and longer-term 6%.

Another small package will arrive tonight, the Baby New Year. Most experts don't expect the dominance of small cap stocks to extend into 2005. They sense that all of the P/E ratios are historically too high, especially Small Caps. The pundits warn that these high P/E's are a precursor of mediocre equity returns in the future.

My eulogy for bonds persists. The Fed will continue it's "measured pace" of interest rate hikes, albeit even at a slower pace. Which, along with the expected continued decline in value of the dollar, will put upward pressure on interest rates lowering bond values.

No one really knows if Santa's sleigh will be filled with big, small, dull or brightly colored packages next year. So let's make some sound New Year's resolutions! Don't gamble. Don't put all your eggs in one basket. Keep a long-term, diversified perspective. On the other hand, we could just ask the elves!

Keith Kowalczyk 12/31/04

The 401K store.com
4940 Washington Blvd.
St. Louis, MO 63108
(314) 367-6555
(866) 871-6356