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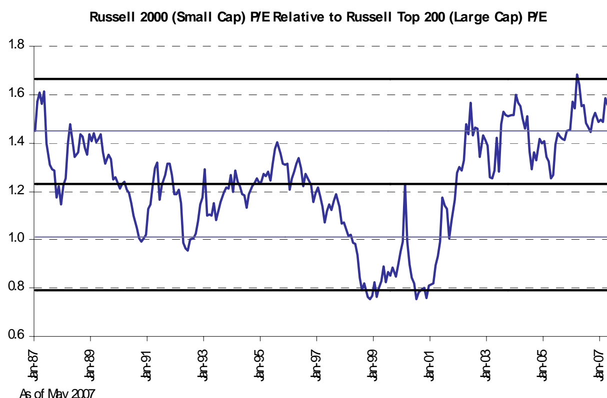
Bigger is Better…Are We There Yet?

Relative valuations of large capitalization companies have been improving over the last few years as small and midsize companies have led the equity market since 1999. Large cap companies now appear very inexpensive relative to small caps. As the chart below illustrates, on a relative P/E basis, the Russell 2000 (representing the smallest stocks in the Russell 3000) is now 1.6 times more expensive than the Russell 200 (the largest stocks in the Russell 3000).



Source: Russell and CIR – U.S. Equity Strategy

Over the last 10 years, this ratio has averaged just over 1.2. The odds of sustained outperformance by large caps are becoming much more favorable. In addition to valuation, we believe that better relative earnings delivery, the ability and willingness of large cap companies to return cash to shareholders, and favorable macro factors all support better performance by large caps going forward.

Better Earnings Delivery

Large caps have continued to improve relative to small caps on earnings delivery. In the most recent quarter, 70% of the Russell 200 surprised positively on earnings, while only 12% came in below analysts' forecasts. In contrast, only 55% of the Russell 2000 delivered positive surprises, with 29% failing to meet estimates. Moreover, the proportion of large caps meeting or exceeding expectations actually improved year over year, while the proportion of small caps actually deteriorated.

International exposure appears to be a key factor driving both revenues and profit margins. Morgan Stanley recently noted that companies that generate more than 25% of their revenues outside the U.S. significantly beat their domestically-focused peers in 1Q '07 both in terms of earnings surprises and absolute year-over-year growth. As might be expected, large companies generate a much greater percentage of their revenues outside the U.S. than their smaller counterparts.

On the revenue side, a number of earnings reports have noted surprisingly good growth in international markets despite weakness in the U.S. IBM and EMC Corp. each noted a slowdown in domestic corporate enterprise spending offset by strength in both Europe and Asia. In addition to experiencing faster current growth, emerging international economies are experiencing secular trends which large international companies are able to take advantage of, such as urbanization, infrastructure construction, and a rapidly growing middle class. As a case in point, United Technologies, with 50% of its revenues outside the U.S., is the number one manufacturer of elevators in the world. By 2010, about 26% of its revenues will come from developing markets.

Morgan Stanley's analysis of first quarter earnings surprises in large companies shows that while part of the upside came from better than expected revenues, the majority of positive surprises came from upside in gross margins, which they attribute to increased global sourcing of labor and materials. For example, 3M, which has underperformed the market substantially since 2003, surprised positively in its first quarter earnings. Not surprisingly, the revenue upside was driven by stronger international growth and margins were better than expected in 5 out of 6 segments. Going forward, the company believes that significant additional savings can be achieved by rationalizing supply chain inefficiencies. While two-thirds of the company's sales are international, only one-third of its manufacturing plants are outside the U.S. Ongoing restructuring and rationalization of manufacturing facilities and other supply chain initiatives should result in more margin improvement going forward.

Ability and Willingness to Return Cash to Shareholders

We see additional factors at work which currently favor large companies. A number of large companies, including 3M, IBM, and Wal-Mart to name a few, have started to return more cash to shareholders or better utilize their balance sheets to increase returns. And although large companies are less likely to be acquired in a merger or private equity deal, their size and strong financial positions enable them to make the strategic acquisitions necessary to improve their growth rates.

Favorable Macro Factors

Finally, on a macro level, there are a number of potential catalysts favoring large caps, such as slower economic growth, a weakening dollar, an increase in volatility, and a moderation in investor appetite for risk. These factors along with improving relative fundamentals and valuation make a strong case for large caps. However, the ability of these companies to continue to exceed expectations is key to sustained outperformance and we will continue to monitor this closely going forward.

The recent selloff we experienced in the market last week was the first real correction we have seen since February. As we pointed out in our last letter, market sentiment has been relatively bullish, suggesting some sort of pullback was in order, and our valuation work has shown stocks to be slightly above fair value. However, monetary factors are now relatively positive. Despite the recent back-up in interest rates, we expect the slower domestic economy, continued weakness in housing and improving inflation fundamentals to keep interest rates contained. In addition, we still anticipate the Fed to cut interest rates early next year which will lead to a significantly steeper yield curve.

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A copy of our Form ADV, Part II is available upon request.
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