

## INVESTING

## STOCKS

# SMALL-CAP SPRINT

By Tara Kalwarski

Little guys do win, at least during a recovery. Small companies are often more nimble—with less burdensome balance sheets and lower fixed costs—than larger rivals, advantages that usually help them bounce back from slumps more quickly. Since the market bottom last March, the Russell 2000, a benchmark for small U.S. stocks,

returned 99%, topping the S&P 500's gain of 75%. Lord Abbett senior economist Milton Ezrati thinks the outperformance will persist: His research shows that in seven of the past 10 major recoveries, small caps have beaten large caps for at least three years.

#### DIGGING FOR DISCOUNTS

Small cap companies may not be the screaming deals they were a year ago. They're trading at about 25 times estimates for the current year's earnings, up from about 22 a year ago. At this level, they're fairly priced, according to T. Rowe Price Small-Cap Value manager Preston Athey: "All measures are right in line with long-term norms, or even slightly cheaper."

And despite the rally, plenty of small companies are undervalued. For instance, nine stocks in Athey's portfolio trade at less than one times book value, while boasting a yield of 3% or more. These include Kite Realty Group Trust, a real estate investment trust whose share price is 78% below its June 2007 high; Gladstone Capital, which invests in debt securities in small- and mid-sized companies and provides loans to private businesses; and transporter Overseas Shipholding Group, a 42 stock that sold above 90 in 2007. "That they pay a dividend tells you management has enough confidence in cash flow that they don't have to hoard every dollar that comes in," says Athey.

Such lesser known companies are not with-

out risk. "Any one of them could have a problem," says Athey. A sensible way to get in on the action is to buy a diversified fund (table).

The 1,700 companies in the Russell 2000 that Wall Street covers are about 10% undervalued, according to Bloomberg's consensus of analyst forecasts. Telecom and health-care companies could rise as much as 15% over the next 12 months, say the analysts, and shares of drug firm ARYx Therapeutics could climb from 1 to 6.50. Telecom General Communication could see its stock, which trades at 6, rise to 10, they say.

The resurgence in mergers and acquisitions could give small caps a boost, says Jane White, a founding principal at Granahan Investment Management, a subadviser to Vanguard's Explorer Fund. White says they've just "started to have buyouts from our portfolio." In the second half of 2009, 39 members of the Russell 2000 were scooped up in mergers or acquisitions. That's more than double the rate in the first half of 2009, according to a study by Ernst & Young.

Ultimately, a continued rally depends on investor enthusiasm. Ernst & Young reported that 32 initial public offerings joined the Russell 2000 in the last half of 2009, up from six a year earlier. That appetite for small companies could bode well. Only three stocks were delisted over the same period, compared with 11 a year earlier. Maria Pinelli, E&Y director of strategic growth markets for the Americas, said on Mar. 10: "The current numbers suggest that all boats are rising with the Russell tide." | BW |

## PINT-SIZE PICKS, OUTSIZE GAINS

Morningstar recommends these five small-cap stock funds, which for the most part have outperformed funds that invest in large companies

FUND	TICKER	EXPENSE RATIO	TOTAL RETURN*		
			1 YEAR	3 YEARS	5 YEARS
Royce Special Equity Investment	RYSEX	1.17%	54%	5%	6%
Vanguard Tax-Managed Small Cap	VTMSX	0.19	67	-2	3
Bogle Small Cap Growth	BOGLX	1.35	81	-9	1
Third Avenue Small-Cap Value	TASCX	1.13	57	-5	1
Bridgeway Small-Cap Value	BRSVX	0.92	66	-9	0

\*As of Mar. 19

Data: Morningstar, Bloomberg