How Staying Seated Pays Off

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In the middle of the biggest share market downturn in decades, investors were flocking to the tried, the true and the familiar. Small and risky was no longer beautiful. But 12 months is a long time in the financial markets.

The Australian Financial Review, in February 2009[1], caught the mood in a report headlined 'Faint Optimism amid Gloom'. The article noted that signs of a turnaround in the small cap sector were scarce. Risk appetites were "anaemic" and earnings downgrades were outstripping upgrades by 5 to 1.

And why wouldn't investors be frightened of small, unknown, unfamiliar companies? After all, small caps had been - after listed property - the second worst performing asset class for Australian investors the prior year.[2]

The index was near a six-year low, reflecting the view that this sector finds it harder to adjust to an economic downturn, is more cyclical in nature and lacks the market power and balance sheet strength of large companies.

This was all perfectly logical. Small cap stocks looked riskier and the larger fall in their share prices relative to the wider market reflected those risks. Put another way, the expected returns from the small cap sector were higher.

The knee-jerk response to the gloom in the media and markets a year ago about small cap prospects might understandably have been to decide "this is too risky for me; I'm selling out and going back to a large cap fund".

But bailing out of an asset class in the doldrums often means just realising what was, until then, a paper loss and missing the opportunity to ride the rebound when it comes.

And so it was that the extraordinary recovery in risk assets last year was led by the very sector that suffered most in the prior downturn: Small caps.

In fact, the Small Ordinaries Accumulation Index rose by nearly 77% over the 10 months to December, easily beating the wider market's 51.5% gain. A similar pattern emerges in the performance of low-priced "value" stocks relative to the market. Value, as measured by the S&P BMI Value Index, gained 60.5% in the 10 months to December, beating the market by nearly 10 percentage points.

Economists have shown that over the long-term value and small-cap stocks tend to outperform the broad market, but that these superior returns can be particularly evident around turning points in the economic cycle.

This makes sense intuitively as we tend to see investors swing from extreme risk aversion back toward a hunger for risk as they anticipate economies emerging from a recession or period of weak growth.

And we have seen that the sectors that lead these turnarounds are often those that were the most beaten down during the prior downward cycle.

The problem is there is very little evidence, if any, that investors can accurately time these changes in any consistent way. The premiums come and go and, often when they do kick in, they do so dramatically.

The consequence of that is that the only way of securing these long-term excess returns reliably is to maintain one's exposure to these riskier assets in good times and bad. Jumping in and out may help you avoid the worst of the downturn, but it also opens up the threat of missing the best of the rebound.

It's another vivid demonstration of why it pays to stay in your seat.

[1]'Faint Optimism Amid Gloom', The Australian Financial Review, Feb 10, 2009
[2]Source: Returns program

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