AMG Market Commentary

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Size Matters, but Might Not Mean the Same Thing Anymore!

A large-cap stock isn't what it used to be. Neither is a growth stock or a value stock.

All but forgotten among the ramifications of this year's stock-market meltdown are changes in how stocks are categorized, which has an impact on the indexes that determine the composition of many mutual funds and on what investors decide to buy.

As stock prices have tumbled and market values have shrunk, many large-capitalization stocks are now midcaps or even small-caps. As sectors have rotated in and out of favor in recent months, many of yesterday's growth stocks have morphed into value plays -- shares that are cheap relative to current earnings or assets.

Meanwhile, the growth stocks of today -- companies whose earnings are expected to grow at a faster rate than the overall market -- are different than just a few months ago.

Standard & Poor's has deleted 30 companies from its S&P 500-stock index so far this year, based on their shrinking market values, including 16 just since Sept. 10. In September, S&P lowered the bar for inclusion in the index to $4 billion from $4.5 billion.

MSCI Barra recently reconstituted its indexes and found the cutoff for what it considers to be a large-cap stock has fallen since May, to $7.5 billion from $11 billion. Companies once needed nearly $300 million in market capitalization to make the small-cap index; that is now $200 million.

Most mutual-fund managers, even those who actively manage their stock selection, use an index to certain extent in deciding what to buy; their performance often is measured against that benchmark. Although active managers have some discretion in what they choose -- large-cap funds usually can include shares that have fallen into the midcap range, for example -- they often tweak their portfolios in response to index changes, which can affect returns.

Some managers may decide to stray from their benchmark index. The Russell 2000 index of small stocks now is more than 30% in financial services, said Preston Athey, portfolio manager for T. Rowe Price's Small-Cap Value fund, which is a bigger concentration than he feels comfortable holding.

It is hard to categorize even some well-known names.

General Motors, the once-mighty auto maker that is a component of the Dow Jones Industrial Average, is considered a midcap stock by some index arbiters.

Even after the gains from the last week of November, the Dow Jones Industrial Average is down more than 33% this year at 8829.04. The S&P 500, which many index mutual funds use as a benchmark, finished at 896.24, down 39% this year.

US and Europe: Neutral

The Dow Jones Industrial Average is down 33% this year, even after gaining 9.7% for the last week of November. But many benchmark indexes from Germany to China have fared worse. Germany's DAX index has slumped 42% in 2008, and China's Shanghai Composite is off 64%. For U.S. dollar based investors, a strengthening dollar has further magnified many overseas losses.

The Dow Jones World Index, excluding the U.S., was down 49% in dollar terms during 2008 as of Friday November 28th.

The breadth and depth of the declines across global stocks this year illustrate how in moments of extreme stress, markets tend to move in lock step.

In overseas markets, several factors have exacerbated the selloff. Non-U.S. shares had been beneficiaries of the benign economic environment in recent years, which saw investors roam far and wide in search of profits. From 2002 to 2007, they performed considerably better than the developed countries.

But as the financial crisis deepened, the capital that had flowed into these stocks went into reverse. Investors had to cover losses elsewhere or didn't see formerly highflying markets as a safe place to be in a storm.

According to the U.S. Department of the Treasury, investors sold $92 billion more of foreign stocks and bonds than they bought between July and September, the largest-ever flight from overseas investments.

Meanwhile, mutual funds that invest abroad had their worst drawdown in more than a decade in October, surpassing outflows in September and August, according to Lipper Inc., a mutual-fund research firm.

Japan: Neutral, Korea and India: Positive

It isn't just U.S. investors who have run from markets they used to favor. Other countries' investors of all stripes this year have withdrawn a net total of more than $100 billion from stocks in just three countries -- Japan, South Korea and India -- according to Standard Chartered Bank. The benchmark indexes in those countries are down 44%, 43% and 55%, respectively, this year. Mumbai's markets reopened Friday Nov 28th, following the terrorists attacks, with the Bombay Stock Exchange's 30-stock index posting a gain of 66 points, or 0.7%, to 9092.72.

Another factor compounding the woes for those stock markets: tumbling currencies. For much of the past six years, U.S. dollar based, investors got an additional bonus when putting money overseas to the European and Asian markets in the non U.S. currencies, courtesy of a weak U.S. dollar. As the dollar declined, gains in foreign currencies would convert into more dollars.

China: Positive

China's government announced a stimulus package of 4 trillion yuan in government and private-sector spending on public works and social programs after the first week of November. Economists expect the stimulus to diminish – but not prevent – the slump. The World Bank projected that China's economy, which grew a remarkable 11.9% in 2007, will expand by about 9% in 2008 before hitting an 18-year low of 7.5% in 2009.

While rapid by the standards of developed countries, growth at that level will pose a major headache for the Chinese government, which has said that the economy needs to expand about 8% annually to create enough jobs for the millions of people joining the urban work force every year. Widespread factory closures in the south of the country have already led to a series of protests, which leaders worry could ultimately threaten social stability.

It's unclear how much more the Chinese government could do to shore up its economy.

Hong Kong: Positive

Hong Kong's market has been highly correlated with the performance of the market in China. This will remain the way for the rest of the year.

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Latin America and Russia: Neutral
With oil prices dropping, these countries in the region are suffering the drop of foreign capital and can't enjoy the growth brought by strong trade surplus.

Commodities: Negative
The commodities continued the downward trend in November except gold had a rebound in the 3rd of the month while oil rebounded in the last week and closed at $52.

Hedge Funds: Positive
The best performing strategy for the month was convertible arbitrage. According to Eurekahedge, the strategy lost about 11% in the first 10 months of the year and had a recovery of over 2% in November.

Bonds: Negative
2008 was a very choppy year for sovereign bonds and that action set up the recent up-trend. Currently, prices are above the 125-day moving average and the close on November 28th was the highest in 20 years. An obvious sign of a bubble.

Things to look forward:
Now the opposite dynamic is unfolding. Since July, the dollar has surged against nearly all currencies, with the exception of the Japanese yen, as shares have tanked world-wide. Not only have foreign shares fallen, they also are worth less in dollar terms, amplifying the losses for U.S. dollar based investors.
By some measures used to value stocks, such as price-to-earnings ratios, international shares have been getting cheaper faster than U.S. companies have, because share prices abroad have fallen more, while earnings haven't fallen as fast and harsh.
With the uncertainties with the 3 auto makers, the U.S. government is now tied with the economic stimulation plan and also the burden to save the 3 car makers. This will start to put some pressure to the recently strengthen U.S. dollar.

* All figures and information are collected from the articles of Wall Street Journal and The Economist.

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