Goldman SMALL CAP RESEARCH

The Goldman Guide

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INSIDE THIS ISSUE:

Stock Resurgence?

KEY TAKEAWAYS

- ⇒ *Stocks suck. Either go to cash or stay invested and stay the course on the rough ride.*
- ⇒ *Best near term move is to S&P 500 Index ETFs, due to favorable valuations and money flows.*
- ⇒ *Big caps have tight window due to the strong dollar and unrelated secular trends.*
- ⇒ *Big cap and small cap multi year performance similar. Small caps to have their day beginning later this year.*
- ⇒ *Next year, small to outperform big.*

KEY STATISTICS

Index	Close	2014
DJIA	16875	1.8%
S&P 500	1965	6.3%
NASDAQ	4455	6.7%
Russell 2000	1095	-5.9%

(figures are rounded)

If You Can't Beat 'em...

We might as well face the music. October is going to be one ugly month for stocks, especially small stocks, now that we are officially in a corrective phase for the Russell 2000 Index. Frankly, I am relieved it finally happened. We had been waiting so long, we can now actually move forward. It's like a child with a high fever for a few days. Your fret and you fret and then it peaks right before it breaks, giving you relief that the worst is over.

This is not to say the worst is over for small caps. But, with the fence-sitting over, we can finally return to an era where stock-picking can be effective again. Although it will not likely occur for a few weeks, stocks pros will be able to better identify a stock that can be bought with conviction, not just for a half-hearted trade.

Still, with few exceptions, we recommend taking a Rip Van Winkle approach to small caps and snoozing until Halloween, at the earliest.

In the meantime, where do you put your money? In our view, you have two choices: sit on cash or buy S&P 500 Index ETFs, which have enjoyed tremendous money inflows. If you choose the latter, consider the following factors.

The S&P 500 has really not been hurt too terribly in the recent downturn and if you hold to the theory that you should remain fully invested, this is the place to be. Valuations are fair relative to historical ranges (16.4x multiple times forward 12-month estimated EPS versus 18x for small caps) and business seems to be turning. You many not get rich here, but you should not really get hurt either.

Big Cap Window to Close...

Still, there is some risk at these levels. Yes, the ever-increasing strength in the dollar versus other currencies is great for U.S. consumers and the U.S. companies who pay for goods and services abroad in foreign currencies.

However, this means that multinational companies save money at the risk of selling fewer goods abroad due to the higher cost of the product to Europe and other regions. This currency trading event, which has been trending for a couple of months, is typical in the early stages of an economic recovery in the U.S.

Interestingly, it can also be a signal that we are in the 7th or 8th inning of sizable moves in big caps, meaning there isn't a lot of room to move higher. Moreover, news of behemoths splitting businesses into smaller companies for better focus and valuation are also signals of a market top in the not too distant future. When big companies buy smaller ones, it is bullish. When the big companies get too big and try to eke out more value or become more nimble, it is a positive for shareholders but not necessarily so for the market in general.

(By the way, we think that the PayPal unit of eBay (NASDAQ—EBAY) and the services units of Hewlett-Packard (NYSE—HPQ) will be the better values in the long run.)

Think about it. Banks were too small, so they diversified and bought up a bunch of businesses only to divest them or shut them down because they were not core or were too unwieldy to manage. Mega-company mergers that seemed destined for greatness were only disasters at the end of the day (see AOL/Time Warner).

Against this backdrop, what do we see? Based on data compiled by the Russell Co., which manages all of the Russell indices, the poor year-to-date performance of the Russell 2000 Index has had an impact on the long term performance of small stocks. In fact, the performance of big caps and small caps are now pretty even on multi-year-bases. Looking ahead, while big caps are markedly better than small caps this year, it is not uncommon for the one-year outperformance of one category to lag behind the poorer one, the following year.

...Small Cap Window to Open

Big Cap Performance					
	TOTAL RETURNS AS OF OCTOBER 6, 2014				
NAME	YTD	1 YR	3 YR	5 YR	10 YR
Russell 1000	***7.56***	***25.36***	***20.8***	***17.24***	***8.78***
Russell 3000	6.52	24.74	20.65	17.22	8.83
Source: www. Russell.com					

Therefore, we proffer that while big caps will still have their day, following a steady but not terribly protracted decline, big cap money will migrate back to small caps. The valuations will be attractive, a higher dollar will help the smaller firms, and the risk/reward maybe more favorable as compared to their larger cap brethren. The first place money will leave will be the one that attracted the most money recently: S&P 500 Index ETFs. Think of it as LIFO (Last in, first out). Moreover, the funds will move toward the perceived better value, or equity category that is in vogue, which we believe will be small caps.

Small Cap Performance					
	TOTAL RETURNS AS OF AUGUST 31, 2014				
NAME	YTD*	1 YR	3 YR	5 YR	10 YR
Russell 2000	***-5.9***	***17.68***	***19***	***17.03***	***9.36***
Russell 3000	6.52	24.74	20.65	17.22	8.83
* denotes as of 10/6/14					
Source: www. Russell.com					

Have a great week!

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