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2010 Revisited?

Frank Gannon, a portfolio manager at Legg Mason's US small cap affiliate Royce & Associates, assesses the outlook for US smaller companies over the remainder of this year.

Sentiment shifted dramatically for equity markets during the second quarter of 2011, as investors once again second guessed the economic recovery. Concerns over contagion from the sovereign debt crisis in Europe, coupled with the fear of a prolonged economic slowdown in China and anaemic economic data in the US put pressure on the markets. Even the Federal Open Market Committee added to the air of uncertainty at its most recent meeting, lowering their forecast for real US GDP growth for 2011 for the second time this year to 2.7% – 2.9% from 3.1% – 3.3% in April and 3.4% – 3.9% in January.

So how will US smaller companies fare against this backdrop?

After gaining more than 10% for the year, the US small-cap Russell 2000 index peaked on April 29th and subsequently corrected by10.2% by the middle of June. The CBOE Volatility Index (VIX), meanwhile, spiked and the yield on US Treasuries fell significantly. But is this the start of the next major market decline like the summer of 2010 or just another correction?

For some time now, we have maintained that we are in a more normalised market environment, where we should see positive longer-term returns for equities with normal corrections. True, this has not been a normal economic environment or recovery. Yet the recent 10% correction is in fact the fifth "speed bump" that the Russell 2000 has hit since the market bottomed in March 2009. Three of the four previous corrections declined on average 9.62%: July 2009 (-9.86%), October 2009 (-9.36%), and January 2010 (-9.65%). The only exception was the correction during last spring and summer, a 20.3% decline in the Russell 2000 from April 23rd until July 6th, 2010.

We have always believed that a 10% correction creates enormous opportunities, and this time is no different. In fact, when looking at the current correction up to June 13th's closing low, our research indicates that 50% of the Russell 2000 is down more than 10%; 18% of the Russell 2000 is down more than 20%; and 5% of the index constituents are down more than 30%. So while this economic recovery has been far from normal, it is our contention that this has been just another normal correction.

While there is no easy answer to the question of what happens next, we have always believed in the critical importance of focusing on what we know and not worrying about what we cannot control. We are ever-conscious of risk. So while many investors continue to focus on economic volatility, seizing on every piece of economic news to gain a sense of the overall shape of the economic future – and position their portfolio accordingly - we remain focused on individual companies and the opportunity that each presents.

A more normalised environment should usher in a period of positive long-term returns for equities with "normal corrections." This would be close to an ideal environment for active managers with an absolute return orientation like us.

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