Overview of Equity Asset Classes

Understanding of the main types of stocks

By: Troy Sapp, CFP®
Commencement Financial Planning LLC

Equity assets, also known as "stocks", represent ownership in a company. In this paper I will describe the main types of publicly traded stocks.

Growth versus Value

Whatever their size or home country, stocks can be divided into two main categories: Growth or Value.

- **Growth stock** - A company that is expensive when compared to its earnings and book value. Growth stock investors believe that a company will eventually grow into its current valuation. Growth stocks tend to be exciting and perhaps "cutting edge".

- **Value stock** - A company that is inexpensive when compared to its earnings and book value. Value stock investors believe they are buying a company at a discount which will eventually evaporate once the market has discovered it is mispriced. Value stocks tend to be older established companies that aren't very exciting and are out-of-favor.

Large versus Small Capitalization ("Cap")

Companies are also sorted by the size of their market capitalization. Market capitalization is simply the outstanding shares of a company multiplied by the market value per share. Though there is some disagreement as to the exact dividing line between large and small caps, the following is basically agreed upon:

- **Large Cap** – A company whose value exceeds $2 billion.

- **Small Cap** – A company whose value is less than $2 billion.

Foreign versus Domestic

Companies are also separated between foreign and domestic. The major categories are United States (U.S.), Foreign Developed, and Foreign Emerging.

- **U.S.** – A company that is based in the United States

- **Foreign Developed** – A non-U.S. company that is based in a country having an efficient market on which to properly evaluate and trade stocks. Additionally, the country's currency must be widely accepted around the globe.

- **Foreign Emerging** – A non-U.S. company not currently having an efficient marketplace or widely accepted currency, but that is successfully working toward those ends.

Real Estate Investment Trusts (REITs)
REITs are a special type of stocks that own commercial and residential real estate such as apartments, malls, hotels, and hospitals. REITs tend not to move in step with other stocks and tend to hold up well during inflationary times. These attributes make REITs an attractive asset class to help diversify an investment portfolio.

Targeted Asset Classes

Using the information provided above, we can then develop diversified stock portfolio targets utilizing the various asset classes. I will now discuss the stock asset classes that I currently utilize.

U.S. Large Cap Blend – These are all of the largest companies in the U.S. comprised of both growth and value stocks. For those seeking a Value bias in this asset class, a U.S. Large Cap Value vehicle can be utilized.

U.S. Small Cap Value – These are smaller than the largest 750 stocks in the U.S. and are comprised of only those trading at inexpensive valuations. Since these companies are small, thus more susceptible to competitors, I only recommend value stocks in this category. Small Cap Value stocks have also outperformed large cap stocks over long periods of time.

Foreign Developed Large Cap Blend - These are the largest companies based in developed countries outside of the U.S. and are comprised of both growth and value stocks. For those seeking a Value bias in this asset class, a Foreign Developed Large Cap Value vehicle can be utilized. These companies sell products and services in the global marketplace, therefore are highly correlated with the largest U.S. companies. Therefore, the true diversifying value of these stocks tends to be the currency hedge they bring.

Foreign Developed Small Cap Blend - These are the smaller companies based in developed countries outside of the U.S. and are comprised of both growth and value stocks. For those seeking a Value bias in this asset class, a Foreign Developed Small Cap Value vehicle can be utilized. These companies sell products and services in local foreign economies, thus tend not to move with the global marketplace. This fact, in addition to the currency hedge they provide, tends to make this class good investment portfolio diversifier.

Foreign Emerging Large Cap Blend – These are the largest companies in emerging markets. Emerging markets tend to be highly volatile with promising long term returns. Given the volatility of these markets as well as susceptibility to political type risks, I currently only recommend large cap companies and a well diversified position across many of these countries with the lion’s share to the most developed. Investors should tread lightly in emerging markets, but the diversification and possible long term returns they provide can make them a worthwhile addition.

Real Estate Investment Trusts (REITs)
Since REITs tend not to move in step with other stocks and tend to hold up well during inflationary times, they are an attractive asset class to help diversify investment portfolios. REITs are often represented in Small Cap vehicles, however, thus this should be considered when constructing asset allocation targets. International REIT vehicles are also coming to market, but at this point I do not recommend International REIT exposure until we obtain more data.

A Note on Commodities
Commodities are tangible goods such as metals, gas/oil, produce, etc. Though commodities have historically been very good diversifiers, these markets have changed dramatically over time. Historically, the commodity market has been driven by investors wishing to lock in future prices and avoid *deflation* (think farmers locking in the future grain price they will *receive*), but the tables have now turned. Now commodity markets are driven by users who wish to lock in current prices to avoid *inflation* (think airlines locking in future gas prices they will *pay*). This fundamental change in the commodity market causes me to not recommend this asset class until we have more data. That said, emerging markets do tend to provide a bit of exposure to commodity prices since it is in these countries where many commodities are produced.

Putting it all Together

Once an investor has identified the equity asset classes he wants to target, the task is then to properly allocate among them utilizing appropriate investment vehicles. The vehicles should also be placed in appropriate accounts, and then monitored for rebalancing opportunities. This can be a daunting and emotionally draining exercise for most investors, however. If you find yourself in this position, I strongly advise you find a fee-only Certified Financial Planner™ to assist you in developing a well-thought out investment program that you fully understand and agree with. Your future depends on it.