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Stocks of large companies are poised to rise

Watchers think higher rates will turn tide

By KATHLEEN GALLAGHER, kgallagher@journalsentinel.com

Over the past five years, the small-company stock has been king.

The Standard & Poor's 500 Index dropped while its little brother, the S&P SmallCap 600 Index, gained almost 70%.

Yet there could be a swing toward bigger stocks, thanks to rising interest rates, says Milwaukee money manager Ignatius J. Smetek.

"When interest rates do start moving up at a more measured pace, we think that's the environment where large-company stocks will outperform small-company stocks," said Ignatius L. Smetek, president and chief investment officer at Arcataur Capital Management LLC in Milwaukee.

The Federal Reserve has increased short-term interest rates four times this year, doubling the benchmark to 2%. The rate is what banks charge one another for overnight loans and is used to set other rates.

Smetek says big companies will handle the rising rate environment much better, on average, than their smaller counterparts.

Interest rate increases tend to hurt small companies more because they typically don't have as many financial resources, Smetek said.

Before founding Arcataur, Smetek was a managing director at Northwestern Mutual Life Insurance Co., where he managed big-company stock portfolios and oversaw asset allocation for the company's foundation, pension and one of its Mason Street mutual funds.

Some big companies overspent their budgets on technology in the mid- and late 1990s but have retrenched and built up their cash stash over the last few years, Smetek said.

Debt levels and capital spending among blue-chip companies are near 40-year lows, according to Empirical Research Partners, a New York City firm that provides research to money managers. Meanwhile, the amount of cash on the balance sheets is near 40-year highs, Empirical's data shows.

"The average big company has unprecedented flexibility coming out of the recession, now the question is how do they use it," Smetek said.

Smetek is lightening up on interest rate-sensitive stocks such as utilities and banks.

He's adding to positions in market-sensitive financial companies, such as brokerage firms. Two examples are Morgan Stanley (MWD) and Goldman Sachs Group Inc. (GS). Smetek also favors energy stocks such as Schlumberger Ltd. (SLB).

In a rising interest rate environment, companies sitting on large amounts of cash that don't have a lot of debt will have the flexibility to buy back shares, increase dividends and make acquisitions.

Viacom Inc. (VIA/B) has "hugely underperformed" and intends to use the proceeds from its sale of Blockbuster Inc. to buy its own shares. Shareholders typically benefit when a company buys back its own stock because profit get spread over fewer shares outstanding, resulting in an increase in earnings per share.

PepsiCo Inc. (PEP) has been increasing its cash levels and paying down debt, yet its stock price has been flat, Smetek said.

"In a higher rate environment, they'll be good financial stewards of capital," Smetek said.

The biggest risk associated with Pepsi shares is the possibility that the economy could really take off, prompting rapid corporate earnings growth that would leave companies such as Pepsi trailing more aggressive companies. But if the economy grows more slowly, as Smetek is expecting, Pepsi should prove to be a good value, he said.

Smetek says that he would buy Pepsi under $50 a share and that he thinks it could go as high as $62 in the next 12 months.

This column examines one stock through the eyes of a professional investor to show how market pros make investment decisions. Neither Kathleen Gallagher nor the Journal Sentinel recommends specific investments or endorses the recommendations of those interviewed.

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