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The Best Stocks to Buy in This Market

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You're probably getting all sorts of conflicting messages these days.

On the one hand, just months ago you heard gloom-and-doom predictions from luminary economists such as Nouriel "Dr. Doom" Roubini, saying that "markets have gone up too much, too soon, too fast."

At the same time, you have the world's most respected investor, Warren Buffett, saying that now is a good time to buy. Buffett is also putting new money to work, buying even more shares of **Wells Fargo**.

What's a Fool to do?
With so much debate over what has been roundly dubbed "the worst financial crisis since the Great Depression," I wanted to actually look back at how various strategies fared during each of the *other* financial crises since the Great Depression.

To get started, I turned to trusty data from Ibbotson Associates, a leading authority on investment research. I calculated the historical returns for cash, bonds, and stocks for those who invested the year following the start of each recession, and measured the five-year annualized return for each period.

Here are the results:

Recession	T-Bills	Corporate Bonds	S&P 500	Inflation
March 2001-November 2001	2.3%	7.8%	6.2%	2.7%
July 1990-March 1991	4.3%	12.2%	16.6%	2.8%
July 1981-November 1982	8.6%	22.5%	19.9%	3.3%
January 1980-July 1980	10.3%	17.9%	14.7%	4.9%
November 1973-March 1975	6.2%	6%	4.3%	7.9%
December 1969-November 1970**	5.8%	6%	3.2%	6.9%
April 1960-February 1961	3.1%	3.8%	13.3%	1.3%
August 1957-April 1958	2.4%	3.6%	13.3%	1.3%
July 1953-May 1954	1.9%	1%	22.3%	1.5%
November 1948-October 1949	1.5%	1.9%	17.9%	2.2%
February 1945-October 1945	0.8%	1.8%	9.9%	6.6%
May 1937-June 1938	0.1%	3.8%	4.6%	3.2%

August 1929-March 1933	1%	8.1%	(9.9%)	(4.8%)
Average return	**3.7%**	**7.4%**	**10.5%**	**3.1%**
Frequency of outperformance	**8%**	**38%**	**54%**	**NA**

Data from Ibbotson Associates, Salomon Brothers Long-Term High-Grade Index, National Bureau of Economic Research, Consumer Price Index, and author's calculations.
**Returns calculated from 1971 to 1975.

Rule your recession
Three lessons stand out from this data:

1. Stocks outperform bonds and T-Bills most of the time, and by large amounts.
2. Unless you need money or plan on investing it, don't park your capital in cash or Treasury bills. If you're bearish enough on stocks to avoid the stock market, history shows that it's much better to invest in a diversified batch of long-term, high-grade corporate bonds.
3. The only period the S&P 500 lost money in was the 1930-1934 deflationary death spiral, when deflation ran a chilling 5% annually. Inflation is basically flat, and so long as it doesn't plunge well below zero for an extended time, investors who are looking to buy a diversified basket of stocks today are well-positioned.

But that's not the whole story
Various studies -- including one of my own -- show that small-cap stocks tend to outperform their larger counterparts by a significant margin, particularly in recessions. To confirm this, let's look at the table again, this time including small stocks -- defined by Ibbotson as the smallest quintile of stocks:

Recession	T-Bills	Corporate Bonds	S&P 500	Small Stocks
March 2001-November 2001	2.3%	7.8%	6.2%	15.2%
July 1990-March 1991	4.3%	12.2%	16.6%	24.5%
July 1981-November 1982	8.6%	22.5%	19.9%	17.3%
January 1980-July 1980	10.3%	17.9%	14.7%	18.8%
November 1973-March 1975	6.2%	6%	4.3%	24.4%
December 1969-November 1970**	5.8%	6%	3.2%	0.6%
April 1960-February 1961	3.1%	3.8%	13.3%	20.3%
August 1957-April 1958	2.4%	3.6%	13.3%	16.7%
July 1953-May 1954	1.9%	1%	22.3%	23.2%
November 1948-October 1949	1.5%	1.9%	17.9%	11.5%
February 1945-October 1945	0.8%	1.8%	9.9%	7.7%
May 1937-June 1938	0.1%	3.8%	4.6%	10.7%
August 1929-March 1933	1%	8.1%	(9.9%)	(2.4%)
Average return	**3.7%**	**7.4%**	**10.5%**	**14.5%**
Frequency of outperformance	**0%**	**23%**	**15%**	**62%**

Data from Ibbotson Associates, Salomon Brothers Long-Term High-Grade Index, National Bureau of Economic

Research, and author's calculations.
**Returns calculated from 1971 to 1975.

Small stocks outperformed T-Bills, bonds, and the S&P about two-thirds of the time -- and they did so by a ridiculous margin.

But how much dough are we talking about?
A few percentage points might not seem like much, but remember, these are *annualized figures*. Here's how much money $1,000 invested and held for each five-year period would be worth today, adjusted for inflation:

Asset	Under the Mattress	T-Bills	Corporate Bonds	S&P 500	Small Stocks
$1,000 Would Be Worth ...	$145	$1,505	$13,602	$77,367	$808,984

The data over 13 recessionary periods and various academic studies reveal a powerful lesson: Small stocks really are the best stocks to consider buying in this market.

Why are small stocks so great?
There are many reasons all of the market's best stocks have been small caps. Among the three most prominent are:

1. Small caps attract less coverage from major brokerage houses and are, consequently, more likely to be mispriced.
2. Smaller stocks have more opportunities for growth.
3. Smaller companies have the ability to be nimbler in tricky situations.

Here are four small companies that have grown their sales over the past difficult year. They trade at price-to-earnings-to-growth ratios below one, which indicates they are underpriced relative to their growth opportunities, and because of their minimal analyst coverage, it's more likely that the mispricing is genuine.

Company	Market Capitalization (in millions)	Revenue Growth	Analyst Coverage	PEG Ratio
Ebix (Nasdaq: EBIX)	$586	31%	1	0.77
Yongye (Nasdaq: YONG)	$348	104%	4	0.15
China Security and Surveillance (NYSE: CSR)	$425	36%	5	0.21
ClickSoftware (Nasdaq: CKSW)	$208	17%	3	0.85

Data from Capital IQ, a division of Standard & Poor's.

These may also explain why *all* of the top 30 performers that emerged from the 2001 recession were small or mid caps, including **Research In Motion** (Nasdaq: RIMM) and **Tata Motors** (NYSE: TTM), which each rose more than 800%. Both of these companies are continuing to grow rapidly and could make great investments going forward. Research In Motion appears somewhat undervalued should it continue to execute on its growth strategy. However, both companies increased sizes means their future growth potential is that much more limited.

Small is good
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Ilan Moscovitz owns shares of Ebix and Yongye. Ebix is a Rule Breakers *recommendation and Motley Fool holding.* Motley Fool Options *recommended a bull call spread on Ebix. The Fool's disclosure policy is the best disclosure policy to read before bedtime.*

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