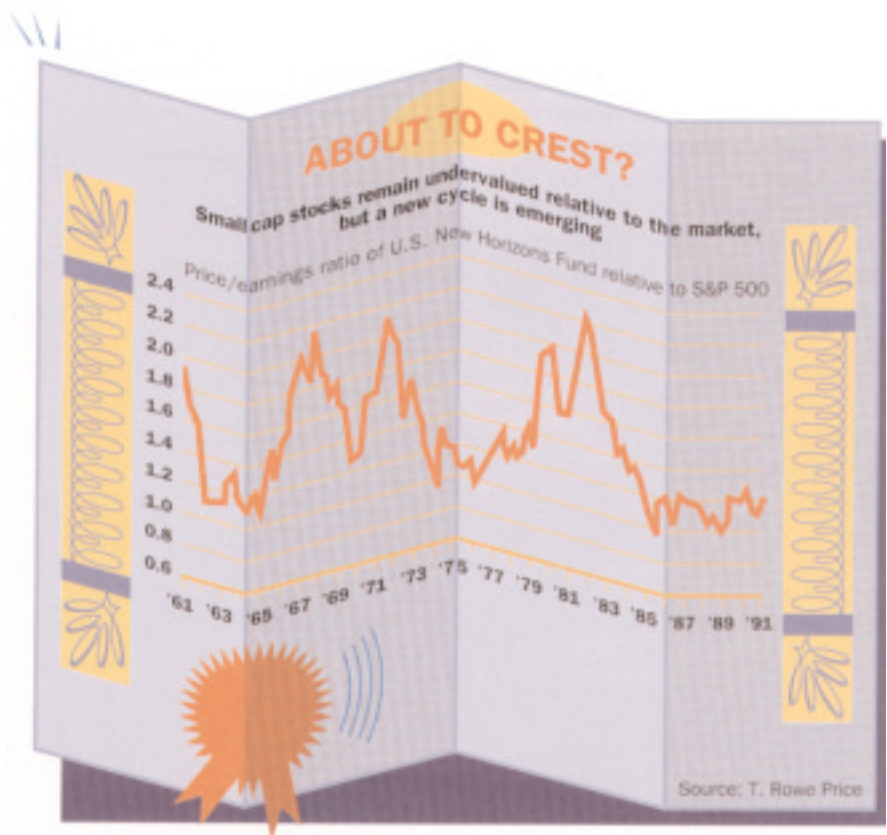


RIDING THE SMALL CAP WAVE



Undervalued in today's market, the performance of small cap stock portfolio may potentially offer an upward ride for investors well into the decade

Six out of every seven stocks on the Canadian market may be considered small fry on their own but, as a whole, the small capitalization market could be providing a reasonable feast for pension funds. Not only is Canada's small cap market big enough for pension funds to consider as a specialized asset class, but the additional returns and return contribution for the risk makes small cap stocks among the most dynamic asset classes around. And, since October 1990, a new cycle of value in this area has been underway which, if history is any guide, could last into the decade. Small cap is generally defined as those securities falling into the bottom fifth of a country's major stock markets. In Canada, where the total value of securities listed on the Toronto and Montreal

exchanges is about \$270 billion, this leaves about \$54 billion in the small cap arena. Another typical categorization is to use a minimum market capitalization of \$5 million as the low cutoff point and \$500 million as the high cutoff point for small cap. The Canadian market would then be sub-divided between 102 issues of large cap stocks, worth about \$218 billion and 644 small caps in a market of about \$51 billion – using figures as of Dec. 31, 1992.

Not such a tiny field after all. Given that trustee Canadian pension assets are in excess of \$200 billion, it would appear that pension funds could easily allocate up to about 5% of their

total assets (say, where from about \$10 billion, collectively) to a small cap stock market of at least \$50 billion in size.

Statistics on the returns of Canadian small cap stocks only go as far as 1950, in a study conducted by the University of Western Ontario (Canadian Stocks, Bonds, Bills and Inflation by James Hatch and Robert White, 1988). Compared with a longer US series by Ibbotson Associates, Chicago, since 1925, the Canadian stats have shown slightly higher returns and standard deviation than those in the United States. The lengthier Ibbotson Associates series is used in this article to demonstrate the performance

Small cap diversification

and diversification benefits of small cap stock investing.

Tables I and II show the rates of return, standard deviations, returns due to diversification and contributions of four main asset classes since 1925. The significant results of small cap stocks for the periods from 1926 to 1940 and from 1941 to 1990 indicate that this asset class could be extremely important in designing a pension fund's long-term asset mix policy.

When examining the relative performance of small cap stocks versus large cap stocks since 1925, cycles of between five and seven years on average emerge. Since October 1990, small cap stocks appear to have started a new cycle of outperformance, accentuated as a new influx of liquidity enters the equity markets looking for undervalued stocks. During the 1980s, high real rates of interest, indexation of pension funds, globalization of world financial markets, and leveraged buy-out mania were the principal reasons investors steered / *Continued on page 47*

TABLE I: Domestic Portfolio with Small Cap Stocks 1926-1940

The contribution of each asset to a portfolio's compound return is greater than the asset's compound return. In this example, small caps bring in the best gains due to diversification.

	S&P 500	US Small Cap	20-Year Treasury Bonds	1-Month Treasury Bills	Portfolio
Portfolio Weights (%)	50	10	20	20	100
Average Monthly Returns (%)	0.78	0.99	0.42	0.11	0.59
Standard Deviations (%)	9.56	13.62	1.45	0.14	6.09
Annualized Continuously Compounded Returns (%)					
Compound Return of Portfolio					4.94
Compound Return of Each Asset and the Average Asset Compound Returns	3.96	1.73	4.87	1.31	3.39
Return Due to Diversification	2.09	4.79	0.10	0.03	1.55
Return Contribution	6.05	6.53	4.98	1.34	4.94

Sources: "Diversification Returns and Asset Contribution," *Financial Analyst Journal*, May/June 1992.

TABLE II: Portfolio with Small Cap Stocks 1941-1990

	S&P 500	US Small Cap	20-Year Treasury Bonds	1-Month Treasury Bills	Portfolio
Portfolio Weights (%)	50	10	20	20	100
Average Monthly Returns (%)	1.03	1.24	0.39	0.36	0.79
Standard Deviations (%)	4.14	5.61	2.39	0.28	2.70
Annualized Continuously Compounded Returns (%)					
Compound Return of Portfolio					9.02
Compound Return of Each Asset and the Average Asset Compound Returns	11.31	12.96	4.36	4.30	8.68
Return Due to Diversification	0.41	0.99	0.16	-0.00	0.33
Return Contribution	11.72	13.96	4.52	4.29	9.02

Sources: "Diversification Returns and Asset Contribution," *Financial Analyst Journal*, May/June 1992.

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Small cap diversification

Continued from page 44 / clear of the more illiquid small cap investment. During the 1990s, lower interest rates, anemic economic growth, and continued restructuring of large companies will allow the overlooked small cap stocks of the 1980s to continue to outperform their large cap counterparts.

The opening chart illustrates the relative price/earnings ratio of the T. Rowe Price New Horizons Fund, a fund with more than \$1 billion invested in more than 200 U.S. small cap growth stocks, versus the S&P 500 index since 1960. As can be seen, the price/earnings ratio of

approach and trading orientation toward sector rotation.

Small cap investors are generally "stock-pickers." They try to find either undervalued stocks or junior growth stocks. This is a "bottom-up" approach to selecting individual companies that are undervalued and are expected to thrive in spite of the economic cycle. Small cap specialists also tend to have many more choices than the large cap investor. As mentioned earlier, the Canadian markets offer about 100 large cap stocks and more than 600 small cap

stocks. Thus, a good small cap stock-picker can add significant value, relative to the market operating in a relatively inefficient market, versus the large cap counterpart, who is competing in a much more efficient market arena.

And, since these stocks are less liquid and more volatile than large cap stocks, investment in this asset class requires significant discipline, expertise and patience. **BC**

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Small cap specialists tend to have many more choices than the large cap investor.

the New Horizons Fund has fluctuated between one and two times the market multiple over the last 30 years. Since the mid-1980s, the relative price/earnings ratio is again at the low end of the long-term valuation range, indicating that small cap stocks remain undervalued relative to the market.

NOT A QUICK PICK

Small cap investments may hold promise, but there's a proviso: the fundamentals to investing successfully are quite different between small and large cap investors.

Large cap investors believe in their ability to forecast the economic cycle and the sectors that are likely to respond next in the evolution of the economic cycle. Thus, the "top-down"




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