

Small Cap Stock Investing for Pension Funds

by J. Sebastian van Berkom

Investing 5% of a pension fund's total assets in small cap stocks with an active investment manager can easily add more than 0.25% or better to total pension fund results longer term!

What are small cap stocks? How have they performed historically? How can they add value for pension funds? Are small cap stocks attractively priced today for long term investors? What are some examples of individual small cap stocks that could be considered for pension fund investing?

The Burns Fry Small Cap Index has generally been adopted as one of the most representative indices for small cap stocks by consultants, actuaries and sponsors. The other index was recently developed by Wood Gundy Limited. A small cap stock must meet the following criteria to be part of the Burns Fry Small Cap Index:

- a) the company must be domiciled in Canada.
- b) the company's shares must be listed on the Toronto and/or the Montreal stock exchanges.
- c) the company's total market capitalization must be less than 0.1% of the Toronto stock exchange's total market capitalization (i.e. as at December 31, 1991 it was \$260 billion, thus a small capitalization stock would be less than \$260 million).
- d) a company's minimum total market capitalization must be greater than \$15 million.
- e) all classes of a company's common stock are added together to calculate the above capitalizations.
- f) the Burns Fry Small Cap Index is rebalanced monthly.

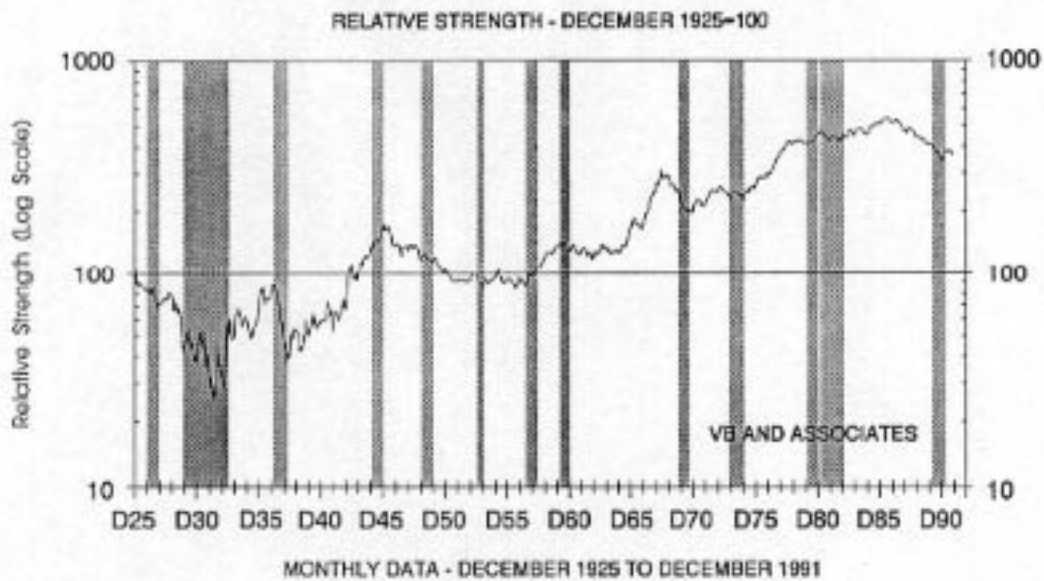
The table below summarizes the Burns Fry Small Cap Index as of December 31, 1991:

	Burns Fry Small Cap Index
Number of Issues	209
Average Market Cap (\$ Million)	91
Average Market Float (\$Million)	58

This index data is available from December 1969 to-date.

In an effort to demonstrate the very long term performance of small cap stocks, our firm has spliced the performance of the Burns Fry Small Cap Index with that of the Ibbotson Associates Inc.'s Small Company Index series to show the relative performance of small cap stocks versus the market from 1925 to 1991 as shown below:

BURNS FRY SMALL CAP VALUE INDEX VS TSE VALUE INDEX



NOTE:

Prior to 1970 Small Cap is Ibbotson Associates Series and prior to 1956 Large Cap is S&P 500 Series.

Some important conclusions that can be drawn from this graph are:

- a) that small cap stocks have outperformed the market significantly over the last 66 years (i.e. 11.9% annualized for the Burns Fry Small Cap Index versus 9.7% for the TSE 300 Composite Index).
- b) that small cap stocks have long waves of relative underperformance and outperformance as shown in the table below:

Relative Performance of Small Cap Stocks
Versus the TSE 300 Composite Index
(1925-1991)

Underperformance	N° of Years	Outperformance	N° of Years
1925-1931	6	1937-1945	8
1936-1938	2	1964-1967	3
1946-1957	11	1970-1973	3
1967-1970	3	1974-1978	4
1985-1990	5	1982-1985	3
		1991-	?
Averages	5.4		4.2

it seems that relative under and outperformance cycles last on average 4-5 years.

- c) that the relative performance of small cap stocks does not seem to have a consistent correlation with economic cycles.

What are the policy implications for considering small cap stocks as part of a pension fund portfolio? Actuaries, consultants and sponsors have generally agreed that an active Canadian equity manager should be able to outperform the TSE 300 Composite Index by 1% over a market cycle. Small cap investment managers usually should outperform the Burns Fry Small Cap Index by 4 % over a market cycle, since small cap stocks is a minor asset class within the Canadian equity portfolio, and since the Burns Fry Small Cap Index is a less seasoned index than the TSE 300 Composite Index. The following table summarizes the value-add implications for investing 5% in small cap stocks by a typical balanced Canadian pension fund.

Impact on Total Pension Fund
Returns of 5% Invested in Small Cap Stocks
(1925-1991)

	Annualized Rates of Return %
Active Management	
Burns Fry Index Plus 4% (5% x 15.9%)	0.79
TSE Index Plus 1% (5% x 10.7%)	0.53
Value Added Impact on Total Fund	0.26

Have investment managers in fact added value over the Burns Fry Small Cap Index over time? SEI Financial Services Ltd. has recently developed a small cap manager sample of 23 small cap managers in Canada for the four years ending December 31, 1991. The table below shows the value-added of the small cap manager sample versus that of the Burns Fry Small Cap Index.

Comparative Rates of Return of
Small Cap Canadian Equity Managers
Versus the Burns Fry Small Cap Index
(Rates of Return Annualized)

	Four Years to December 31, 1991 SEI Sample %
Maximum	17.5
First Quartile	12.8
Median	8.4
Third Quartile	2.9
Minimum	-7.2
 Burns Fry Small Cap Index	 0.1
VB and Associates #1	9.6

Source: SEI Financial Services Ltd.

As can be seen over the last four years for which small cap sample results are available, the median Canadian small cap equity manager has outperformed the Burns Fry Small Cap Index by 8.4 %. In the case of our company we have also outperformed this index by 9.5 % over the same period. Thus, it is reasonable to expect that an active investment manager will be able to add at least 4% in added value over the Burns Fry Small Cap Index.

Are small cap stocks attractively priced today for long term investors?
Since October 1990, small cap stocks seem to have commenced a new cycle of relative outperformance. During 1991, the total rate of return of small cap stocks significantly outperformed the broader market averages for the first time in five years as follows:

	Total Return 1991 Versus 1990
S&P 500 (\$ Cdn)	+29.9%
NASDAQ (\$ Cdn)	+57.1%
TSE 300 Index	+12.0%
Burns Fry Small Cap Index	+18.5%

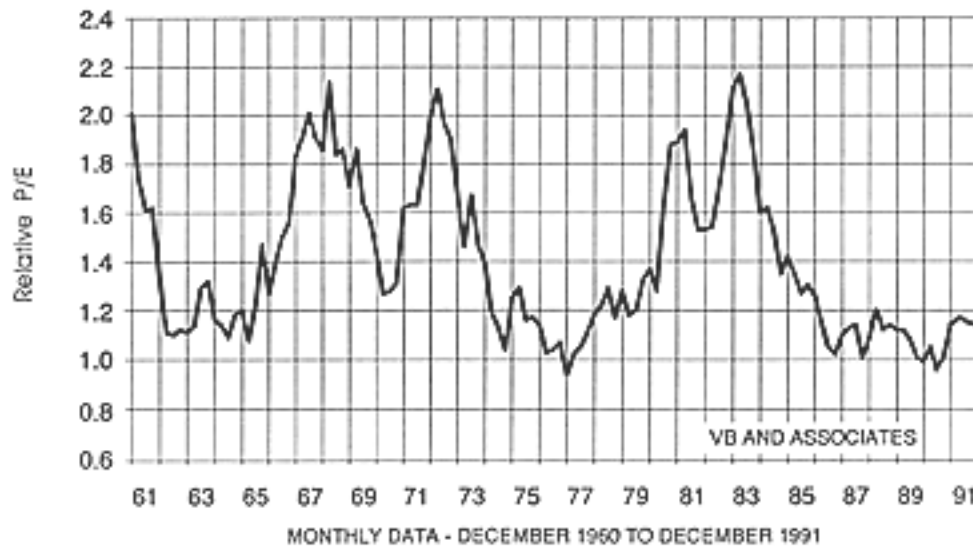
Although small cap stocks have shown a dramatic short term improvement in performance, what factors may cause small cap stocks to continue to outperform the market over the next several years? The following factors, we believe are the most likely to lead to outperformance:

- a) the valuation of small cap stocks remains historically low as illustrated below by a large U.S. based small cap fund. The T.Rowe Price New Horizons Fund has more

than \$1 billion invested in more than 200 individual small cap growth stocks, and has been engaged in such investing since the early 1960's.

NEW HORIZONS FUND P/E RELATIVE TO S&P 500

SOURCE: T. ROWE PRICE



The graph shows that the New Horizons Fund's relative P/E ratio has fluctuated between one and two times the market P/E ratio over the last 30 years. Currently, the ratio is at the low end of the historical range, for the third time during this period.

b) earnings growth for small cap stocks are expected to increase at a faster rate than that for large cap stocks as economic recovery continues into 1992 and expansion in the economy occurs in 1993 or 1994.

In summary, small cap stocks can provide well in excess of 0.25 % in additional value added performance to a pension fund by investing only 5% of its assets in such stocks. Such returns more than offset the risks, which have been calculated to be twice the standard deviation of that of the market. The evidence above suggest that these stocks are undervalued, which combined with much lower interest rates and an improving economy should translate into higher earnings growth. Thus, if liquidity towards small cap stocks continue, we should experience a classic double play over the next several years for these stocks (i.e. high earnings growth coupled with a P/E ratio expansion). What are ten seasoned small cap stocks that can be considered pension fund quality investments for the next several years? Examples of such stocks are: BCE Mobile Communications; Cambridge Shopping Centers; Cara Operations; Chauvco Resources; Dorel Industries; Gendis; GTC Group Transcontinental; Morrisson Petroleums; Sceptre Investment Counsel and Van Houtte (A.L.).

Mr. van Berkom has 20 years experience in small cap investment management, and is President of Van Berkom and Associates Inc., a firm specializing in small cap growth stock investing for pension funds.