

Managers Of U.S. Assets The Case For Small Cap

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In last year's federal budget, the Canadian government substantially increased the foreign content level for Canadian pension funds from 20 per cent of book value to 30 per cent in 2001. Most Canadian pension funds had been lobbying for such a change for many years, and many are now faced with implementing the more aggressive response by government to maximize their foreign content exposure to 30 per cent.

With sponsors looking for vehicles outside of Canada in which to invest, U.S. small cap enables Canadian pension funds

the Frank Russell Company. It breaks down the U.S. equity market into four key market capitalization groups. The Russell 3000 Index represents about 98 per cent of investable U.S. stocks and small capitalization stocks represent approximately eight per cent of the total capitalization of the Russell 3000.

The average market cap of the Russell 2000 was \$482.9 million and the median market cap of the index was \$361.6 million, as at June 30, 2000. Small cap stocks had a market-cap range from the smallest to the largest of \$17.6 million to \$3.3 billion.

stocks have outperformed the other asset classes and have provided significant total returns to large company stocks as represented by the S&P 500 Index.

Although the long-term rates of return of small cap stocks versus the S&P 500 Index did well, the relative rates of return, clearly demonstrate that there are significant periods of under and/or outperformance for small cap stocks versus the market.

While the long-term relative trend is positive, there are long cycles of under and outperformance that are summarized in Chart 2.

On average small cap stocks underperformed the S&P 500 Index for 5.7 years and outperformed the S&P 500 Index on average for 6.1 years. During the year 2000, small cap stocks significantly outperformed the market. In the following sections, we will explore whether the year 2000 may turn out to be the bottom for small cap stocks.

Valuation Of Small Cap Stocks

There are many ways to look at the valuation of U.S. small cap stocks versus the market. Over the years, many U.S. consultants and sponsors have adopted a real U.S. small cap growth fund as one of the many ways to look at the relative value of U.S. small cap stocks versus the market. Chart 3 shows the relative valuation of the New Horizons Fund managed by T. Rowe Price since 1961. The New Horizons Fund manages more than \$6 billion in 283 U.S. small cap growth stocks.

The graph in the chart shows the relative P/E ratio of the New Horizons Fund versus the S&P 500 Index. As you can see, the relative valuation of the New Horizons Fund is at the low end of the historical range of relative value. In fact, now is the fourth time in the last 40 years that the relative valuation is at the low end of the historical range.

Therefore, it would appear that after an underperformance period of 5.8 years, small cap stocks have not only matched the average duration of down cycles since 1925, but also now trade at the lower end of the range of relative valuation. The fall of 1999 may very well have signaled the bottom in the relative bear market of small cap stocks versus large cap stocks.

The five years of total returns from 1993 to 1998 inclusive show that the Russell 2000 Index has increasingly underperformed the S&P 500 Index. In fact, these five years are the worst underperformance

Chart 1
STOCKS, BONDS, T-BILLS AND INFLATION - UNITED STATES (1925-1999)

(As at December 31, 1999)



Source: Ibbotson Associates

to achieve two objectives – the maximization of their foreign content limit and, at the same time, a reduction of their risk in a highly-valued U.S. stock market as measured by the S&P 500 Total Return Index.

The most complete analysis of the U.S. stock market is undertaken every year by

Stocks, Bonds, T-Bills And Inflation – United States (1925-1999)

Chart 1 shows the long-term rates of return of the most commonly used asset classes in the United States from 1925 to 1999 inclusive. During that time, small cap

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period for the Russell 2000 Index since its inception of the index in 1978! Performance since the fall of 1999 indicates that the Russell 2000 Index has started to outperform the S&P 500 Index.

Performance Of Various U.S. Equity Indices

A much broader comparison of how the Russell 2000 Price Index performed relative to various U.S. equity indices shows all of the small cap and mid cap indices in the U.S. outperformed all of the various large cap indices in the year 2000. For example, for U.S. small cap indices as of December 31, 2000, the rate of return for the Russell 2000 was -4.3 per cent; the S&P Small-Cap 600 was 11 per cent; and the S&P Mid-Cap returned 16.2 per cent. For large cap indices, the S&P 500 Composite returned -10.1 per cent; Dow Jones 30 Industrials were at -6.2 per cent; and the Nasdaq Composite return was -39.3 per cent. It would appear that either investors' liquidity preference is now towards undervalued mid and small cap stocks, or that the very large, cap stocks are experiencing a major downward valuation that is causing this relative outperformance.

We believe that small cap outperformance is a function of these two above-mentioned factors. The collapse in the high technology bubble has forced investors to look for value in stocks rather than just buying a narrow segment of the market that was seen as a new paradigm. Old-fashioned stock-picking techniques are now taking over from the mania of technology, and with an economic environment that appears to be slowing dramatically, investors now sense the need to look at fundamentals. Thus, we believe that liquidity will continue to be channelled into undervalued stocks, of which small cap is certainly one area where tremendous value can be found.

The Case For Diversifying

Canadian pension funds are increasing their foreign content to 30 per cent as a result of the limits being raised in last year's federal budget. Normally about one-half of the foreign content is allocated to the U.S. equity market and the other one-half is allocated to EAFE equity markets.

U.S. small cap stocks are an attractive long-term asset class that can add significant value relative to the market. The underperformance cycle for small cap stocks seems to have ended at the end of

Chart 2

CYCLES FOR SMALL-CAP STOCKS - UNITED STATES (1925-2000)

Relative Performance Versus the S&P 500 Index			
Underperforming Periods	No. of Years	Outperforming Periods	No. of Years
1925-1931	6.0	1932-1936	4.8
1945-1949	3.5	1937-1945	8.0
1951-1957	5.8	1963-1968	6.0
1959-1963	4.0	1975-1983	8.5
1968-1975	8.0	1990-1994	3.3
1983-1990	7.0	2000-	
1993-1999	5.8		
Average	5.7	Average	6.1

Source: Ibbotson Associates

1998, and the relative value of small cap stocks reached their lowest levels in 40 years in the fall of 1999! Recent performance of small cap stocks versus various indices indicates the continued strength in the performance of small cap stocks. This may be due to the fact that the market is finally broadening out and that the technology, telecommunications, and media bubble which burst in April 2000 is the principal driver in forcing investors to return to fundamental analysis and stock picking.

In conclusion, diversifying into U.S.

small cap stocks – using the Russell 2000 Index as the benchmark for this asset class – provides a low risk way of increasing foreign content into the U.S. market at this time. ■

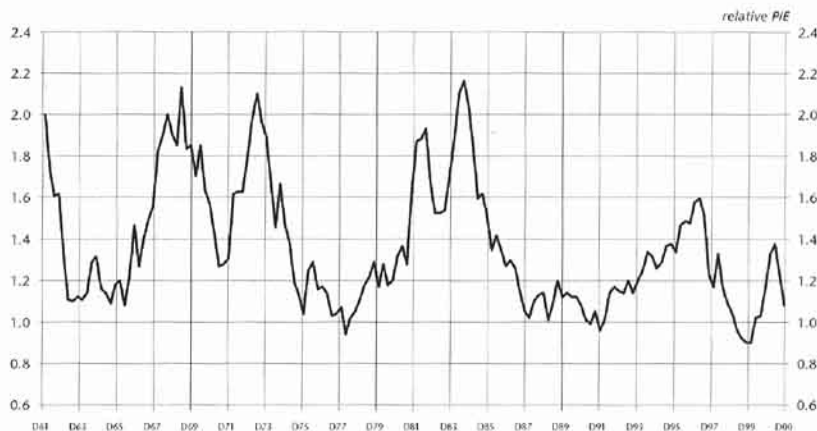
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Chart 3

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

Monthly Data - December 1961 to December 2000



Source: T. Rowe Price