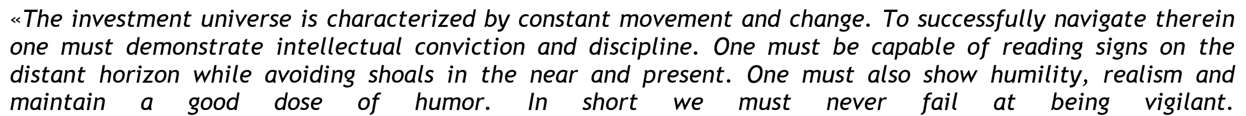
THE VIGIL

JANUARY 2010

Small Cap Equities

A Strategic Asset Class Whose Time To Shine May Be Upon Us

"VIGIL: from the latin 'Vigilare'. Keeping awake at a time when sleep is customary; an act of watching; surveillance"
– Merriam Webster


«The investment universe is characterized by constant movement and change. To successfully navigate therein one must demonstrate intellectual conviction and discipline. One must be capable of reading signs on the distant horizon while avoiding shoals in the near and present. One must also show humility, realism and maintain a good dose of humor. In short we must never fail at being vigilant.

Those qualities are brought forward daily by Natcan's team of professionals. The following commentary reflects the views and opinions of our team on issues impacting Canadian investors and their advisors. »

- Pascal Duquette, President and CEO

>>> NATCAN

Founded in 1990, Natcan Investment Management Inc. is a subsidiary of the National Bank of Canada with approximately 25 billion dollars under management. Natcan is one of the premier institutional money managers in Canada. Our investment leaders follow their convictions with discipline and rigour to serve the best interests of our clients and their financial advisors.

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Small Cap Equities: A Strategic Asset Class Whose Time To Shine May Be Upon Us

Canadian Small Cap equities experienced an impressive turnaround in performance from the March 2009 lows. The TSX/Small Cap Index ended the year up 62.38%. This came as a surprise to many and compares favorably to the return on High Yield Bonds (Merrill Lynch index return of 53.75% in 2009) and Emerging Market Equities (MSCI Emerging Markets Index: 52.03%), categories viewed favorably by investors for both fundamental and tactical reasons.

Will attractive returns prevail in 2010? Should the asset class be viewed as strategic, tactical or simply abandoned by investors? The current edition of the Natcan Vigil attempts to answer these questions. In order to do so we review academic research on the asset class before analyzing the various drivers of risk and return in this area. We also review arguments for investing in the asset class at a time of healthy skepticism geared towards overall equity investing.

A Distinctive Asset Class: Academic Research On Small Cap Stocks

Small Cap issues are clearly different in important ways from their larger cap brethren. Historical performance cycles show variant patterns not only from larger cap names but also from several other asset categories. One should never neglect to consider the key attributes of this asset class which are strong contributions to return and diversification.

It's interesting to note that Small Cap stocks occupy a special place in investing theory for they were the first and perhaps strongest argument *against* the theory of Efficient Markets. Indeed, as early as 1981 research indicated the return achieved in this space exceeded what one should expect under efficient markets. This evidence became to be known as the Size Anomaly. Early work by Banz et Reinganum in 1981 created a storm leading to testing and retesting of this effect which continued all the way to Hawawini and Keim in 2000. The summary evidence is as follows. From 1927 to 2007, US Small Caps generated an annual compound rate of return of 12% versus 10% for large cap stocks. The spread in returns is too large to be explained by the added volatility of this category. In other words, over very long periods of time, Small Cap investing may provide for the capture of a 'free lunch' in financial markets.

James P. O'Shaughnessy provides a key counterargument in his 2003 book: '*What Works on Wall Street*'. Without taking on the original (Banz and Reingaum) findings he suggests the asset class advantage could be derived from the outstanding returns achieved on so called micro-cap stocks. Those are companies with market capitalizations below $50 millions dollars who are often so illiquid that most investors cannot expect to capture their returns. Mr. O'Shaughnessy argues that once micro-cap stock returns have been removed, their historical risk-adjusted return becomes slightly inferior to large cap names.

The author suggests that individual investors capable of handling outsized volatility favor micro-cap equities as no other asset class has a better long term track record (average annual compound rate of 24.32% for the 1963 – 2003 period) while institutional investors should avoid or severely limit exposures for liquidity reasons. Interestingly, Carpentier and Suret (2009) published a recently completed study of micro-cap stocks and caution that professional portfolio management resources are required in order to tame the risks inherent to these issues.

Morningstar, a leading data provider, has developed a ranking system which is driven off a rather intuitive methodology. They essentially rank mutual funds by average market capitalization and deem those funds in the bottom 10% (decile) to be small cap funds. The key benefit of this approach is to avoid using an arbitrary cut-off level.

Two researchers from Montreal's Concordia University - Switzer and Huang (2007) – delved into the impact of human factors on small and mid cap equity portfolio returns. They arrived to several interesting findings. The first of their conclusions is well known by experienced practitioners: the size of assets under management is inversely related to performance. In other terms: as for stocks, small is better! They assessed the optimal size of assets under management for the category to be in the $1.43 billion to 3.89 billion range. One must keep in mind this specific study included 'mid' cap stocks. Our view is a true small cap manager in Canada best serve his clients by keeping total assets under management in this category below $1.5 - $1.8 billion. The other key conclusions are more revealing. Portfolios managed by *Chartered Financial Analysts* would outperform the peer

group on average while those managers holding 'only' an MBA degree would have had performance in line with their benchmark.

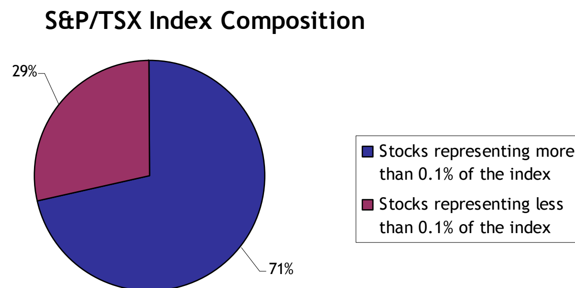
Beyond the issue of what constitutes a small cap fund is the more significant one of which school of investing (Value versus Growth) is likely to be most appropriate for this category. Analysts rely on two main approaches in this to determine a manager's style: holdings based and returned based style analyses. The first key message is that results appear to vary with the time period being considered. Keeping that in mind both O'Shaughnessy and Chan (2008) reached the conclusion that a Growth approach tends to outperform in the long run. In addition, Chan's work went so far as to identify a 3% average advantage to Growth over Value during the period under consideration.

Decades of research in academia and market evidence confirm small cap stocks compensate (or should we say overcompensate?) investors for the incremental risk involved. These findings are of great importance to the investor who's circumstances would justify investing in only one asset class. The vast majority of individual and institutional investors will however hold assets from a number of asset classes in order to achieve diversification benefits. Our next step is therefore to assess whether small caps are a good addition to a portfolio diversified across asset classes. Stated otherwise: will small cap stocks further diversify a portfolio?

The response from the world of academia is a unanimous yes. The diversification benefits of small cap stocks have been documented on numerous occasions. Two such studies - Huang (2007) and Eun, Huang and Lai (2008) – indicate that global small cap equity portfolios escape the global sector effect of their large cap counterparts. As such these portfolios will further diversify a global equity portfolio in a manner that will prove superior to that of large cap names.

Our review of academic research confirms the inclusion of small cap stocks will bring clear benefits to a portfolio. These will be higher returns which more than compensate for the higher volatility of the asset class. Additionally, given they react to different factors during a market cycle, chances are the overall portfolio's risk profile will be enhanced in the process. One factor of significance to the outcome will be the selection of a specific investment style and management team. In clear Small Cap investing requires dedicated and experienced resources, indexers beware!

There is another important argument in favor of small cap investing that needs to be made. It applies to Canadian investors specifically. It is the fact that – given the nature of Canada's equity markets – avoiding small caps will significantly restrict the overall opportunity set and thereby lead to less attractive outcomes. The following table, as at February 3, 2010, illustrates this:



Source: Groupe TMX and Natcan

Approximately 60 stocks (out of 210) have a market capitalization representing less than 0.1% of the S&P/TSX Index. By adding small cap names an investor will not only enhance the risk/reward profile of her exposure to Canadian equities but construct portfolio that will exhibit greater diversification and potentially stronger performance.

Small Caps – Big Performance?

A review of strategic arguments concerning small caps allows for a resounding body of evidence supporting their inclusion. What about the timing issue? After registering such strong returns in 2009 can small cap stocks 2010 deliver for investors going forward?

There are several cautionary flags at the outset of 2010. First off the fact we experienced a very strong bounce off the lows of 2009 and that new up cycles don't proceed in a linear fashion. Questions remain on the path of the economic recovery and we should all be concerned about the current, heightened, risk of policy error by regulators.

Yet an equivalent mass of evidence points to the sustainability of strong performance by small cap names. One must begin by recognizing that the magnitude of the stock market correction of 2008-2009 far exceeded that in our economy. Further, economic

prospects for Canada and small cap companies are better than those pertaining to most other regions in the developed world.

Additionally, small cap stocks have a tendency to outperform large cap names at the start of an economic recovery. From 1926 to 2009 large and small cap stocks both registered negative returns in only 13 instances including 2008. In 11 of the 13 years following these drops small caps outperformed significantly (by 21.2% on average). What we have described so far corresponds to the outcome experienced in 2009. It is interesting to note that small cap outperformance extended to a second year in 12 of the 13 series of events outlined above and persisted for a third year in a further six.

Are all the above statistical arguments the simple result of data mining? Citi Investment Research & Analysis reached similar conclusions broadly. The reasons placed forth for out performance by small cap stocks include the following:

- Lower volatility on equity markets – a return of risk taking
- Attractive absolute and relative valuations
- Relatively low interest rates
- The reappearance of merger and acquisition activity in the small cap space

It's of interest to note that the above factors are in evidence since the spring of 2009. Policy moves to induce corporate lending by banks are important to small cap companies. Attractive valuations have led to timid return to merger and acquisition activity to date.

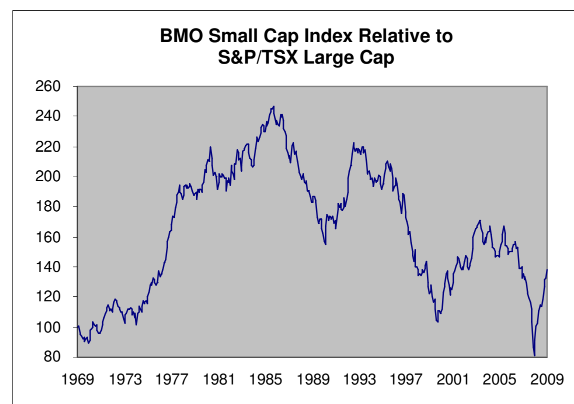
One can intuitively grasp the relationship between small and large cap stocks and the economy if one simply focuses on the fact the prior are most often suppliers to the latter. As large companies slammed the brakes once they became convinced a deep recession was gripping the world in 2008 the price of small cap names reacted quickly to reduced prospects for growth. Conversely, once the dark clouds surrounding the economy lifted, large companies resumed orders for goods and services to counter their severely depleted inventory levels driving sales levels higher for the small cap group.

We must also recognize that any market rebound is most noticeable for companies with the weakest fundamentals. Those are the very firms who came closest to disappearing and had their stock prices devastated in the downturn. The Materials sector is home to the largest cohort of this type in Canada. They typically make claim to owning rights to assets of dubious quality requiring massive capital investments before any production can take place. Yet these very stocks moved up strongly during the second half of 2009. In the end however companies with superior fundamentals will prevail over a full market cycle.

Various other factors also argue in favor of small cap stocks. When adjusting for the impact of Materials' sector effect small cap stocks compare favorably to their large cap counterparts on the basis of fundamentals. For example, few have to deal with the financial pressures related to legacy pension funds.

Having appreciated over 62 % in 2009 can one expect strong returns from the asset class? Few have noted that, in Canada, the relative performance of the BMO Small Cap index has been less strong than in previous cycles.

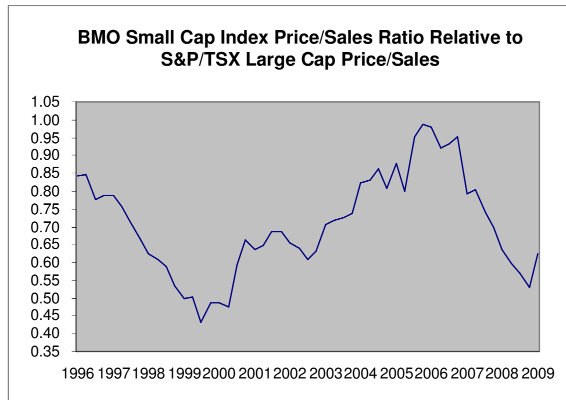
Relative valuation measures currently sit at levels last seen in 2000 which coincided with a key turning point and the start of a cycle of outperformance by small cap stocks.



Source: Natcan

The previous cycle of small cap outperformance began in the middle of 2000 and lasted four years. The cumulative small cap edge during that period was approximately 65% relative to the overall S&P/TSX index of large cap companies. As is the case today, low interest rates and valuations acted as motivational agents launching a merger and acquisition cycle in the small cap area.

On a relative valuation basis small caps are attractive at present. The chart below illustrates this situation on a price to sales basis. This metric is commonly used to compare small and large companies. One sees the current relative valuation levels compare to those at the start of the decade when small cap names were about to embark on a lengthy period of outperformance.



Source: Natcan

While the number of bargains may be smaller than a year ago there are many attractive situations that warrant our investment attention.

Conclusion

The weight of evidence argues in favor of considering small cap stocks as a strategic asset class. The category provides superior risk adjusted outcomes over the long term and a significant improvement to a Canadian investor in terms of optimizing her investment opportunity set.

In terms of timing, current valuations are attractive and several fundamental drivers of previous periods of out performance are in evidence.

Far from being over, recent outperformance on the part of small cap equities could be in evidence for several quarters.

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