Small-caps value

JOHN CHISHOLM
Executive vice-president and co-chief investment officer of Acadian Asset Management.

The case for looking to small-cap equities for value and diversification.

Small-cap stocks are one of the more attractive asset classes in the world today. Not just any small-caps, but specifically non-North American small-cap stocks, which will be referred to as EAFE (Europe, Far East, Australia) small-caps. There are three reasons why this is the case:

1. Small-cap stocks are likely to show better returns than large-cap stocks in EAFE markets.
2. Small-cap stocks provide diversification benefits to Canadian investors relative to large-cap stocks.
3. Small-cap stocks offer prospects for stronger value-added from active management than large-cap stocks.

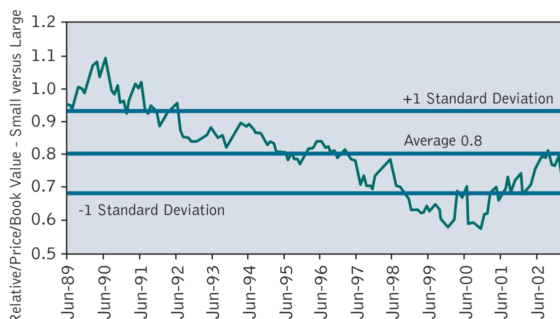
Let's look at the rationale for each of these assertions.

Better Returns

Currently, small-cap stocks (defined as stocks with a market capitalization below $5 billion) trade at 20% to 50% discounts to large-cap equities on most valuation measures, including price/book, price/forward earnings, and price/cash flow. Relative to history, small-caps outside North America are a little over 30% cheaper than large-cap stocks, as Exhibit 1 below shows. This level of undervaluation is significantly deeper than the average we have seen over time, supporting an expectation that small-caps will rise relative to large-cap stocks.

In addition, small-cap stocks show strong growth expectations relative to large-caps. A further reason to expect small-cap outperformance is that small-caps tend to outperform in environments where volatility is declining, and with volatility currently high but strongly mean-reverting, a decline in world equity volatility is likely over the next six months to a year.

RELATIVE VALUATION OF SMALL VERSUS LARGE STOCKS, BASED ON CITIGROUP EMI EURO-PACIFIC AND PMI EURO-PACIFIC 1990-2002



Diversification Benefit

Historically, adding small-cap equities to a large-cap portfolio has reduced total portfolio risk. Large-cap to small-cap correlations varying between 0.50 and 0.80, depending on time period and choice of index, provide the foundation for this diversification benefit. On a forward-looking basis, high levels of small-cap allocation could reduce total portfolio risk on the order of 20 to 40 basis points — modest but not insignificant in a total portfolio context.

The so-called "Law of Active Management" suggests that value-added potential is proportional to the number of independent investment decisions a manager can make, skill being constant. Since the investable small-cap universe is four times the size of the large-cap universe, value-added potential should be twice as high in this asset class. In addition, our theoretical measure of stock-picking skill, as well as availability of consultant data on manager performance in small-cap equities, suggest manager skill is greater in small-cap investing than in the more efficient large-cap universe. While these factors are partially offset by the higher transaction costs found in small-cap investing, overall it appears that active management can provide incremental value on the order of 100 to 200 basis points per year over large-caps.

Optimal Allocations

Utilizing careful projections of expected returns and risk in an optimization framework, it appears that using small-cap to replace 20% to 50% of EAFE large-cap exposure is desirable to achieve expected returns at least in the high single digits annually at the plan level over the next five years. The only way an allocation only to EAFE large-cap remains justified is if the investor believes that earnings growth for large-caps will significantly outpace that of small-cap EAFE equities over this period, an unlikely prospect. ▪