

# Big Money Small Caps

Large cap bias  
contrarian play

BY MARK NOBLE

Right now is not the best time to be holding small cap stocks, but it is a great time to be investing in them – at least that's the impression given by three small cap pros, Jim O'Shaughnessy, Allan Jacobs and Scott Carscallen. Historically small cap discounts are at their best when money is moving to the perceived safety of large cap stocks.

Ever since global credit problems started to peak in August of 2007, small caps have been hammered. Generally perceived to be more illiquid, investors moved their money to blue chip large caps, which are generally thought to be better suited to weather a credit squeeze.

"Small caps have underperformed the broader market in the last year. In tough times, there is a flight to safety and the liquidity in the large caps," says Allan Jacobs, director of small cap investments at Spratt Asset Management. "Credit worries have raised the risk premium, which has affected small companies the worst."

Jacobs isn't deterred by tough times; he's seen them before. In the late 1990s, he says that small caps took a beating during the tech bubble. The aftermath cre-

ated some tremendous buying opportunities, and Jacobs posted tremendous performance numbers with his previous firm Sceptre Investment Counsel, which culminated in his being named Morningstar's Manager of the Year in 2006. Spratt launched its Small Cap Equity fund shortly after his arrival at that firm in the summer of 2007.

"Perhaps this downturn may have longer to go, given the higher Canadian dollar. It's a tough place to be but it might be a big place to be," Jacobs says. "Small caps always do better after they're not that popular. Valuations are certainly getting more interesting than a year ago, although not yet as cheap as 2000."

Carscallen, a portfolio manager with Saxon Mutual Funds who manages the company's Canadian small cap and micro-cap offerings, sees a similar silver lining.

Carscallen selects many of his stocks using an analysis that looks at balance sheet strength and internal cash flow, which usually highlights if there are liquidity problems. What he is finding is a lot of good companies with strong balance sheets are being dumped. He estimates the discounts of small cap stocks listed on the BMO Nesbitt Burns Canadian Small Cap Index are roughly 30% greater than large caps.

"In this environment right now I have no problems finding investment candidates. The market does not want to hold equities right now. You can go in there and find some great little companies – that's what we're doing – buying companies with good cash flow generation and clean balance sheets," says

Carscallen.

Jacobs also is big on companies that have a clean balance sheet and low levels of debt, which he says tend to mesh well with his growth at a reasonable price (GARP) approach.

"In the funds I'm involved in its relatively long investment horizon, about three to five years. Rather than buy a stock that's not really the style I'm comfortable with, I like to buy stocks that I think have good fundamentals that you wouldn't want to sell in the next few months even if it goes up 25%," he says. "I try to keep the quality bar high by keeping maybe 50 names broadly diversified."

Jim O'Shaughnessy, chairman and CEO of O'Shaughnessy Asset Management, has a very different approach on small caps, although he too is keen on the long-term prospects of the asset class. O'Shaughnessy and his U.S.-based shop run the hugely popular line of funds for RBC Asset Management.

In January, RBC launched the RBC O'Shaughnessy US Growth Fund II, which is the mirror mandate of a fund he has run in the U.S. for the last 11 years. The fund is not specifically a small cap fund, but small and mid-cap names best fit the statistical investment formula he applies to all his funds.

"It's the same methodology, it's the same rigour, the same set of models to select securities. The difference is in this strategy we actually use seven separate models that each select 10 stocks as opposed to 50. We eliminate duplications, so the portfolio will generally have between 45 and 60 names in the portfolio," he says. "The strategy

allows us to buy any size cap."

O'Shaughnessy uses price to sales as the primary metric for evaluating small cap stocks.

"If you've got bad margins, bad sales, bad six months – you are eliminated. After that we employ a low price to sales technique where we go down each of the 10 economic sectors and we buy the 10 names with the lowest price to sales ratio," he says.

The firm's predominantly small

caps were significantly ahead of that long-term average.

During the S&P 500's hot streak in the late 1990s until March 2000, it drastically outpaced this rate of growth, leading O'Shaughnessy to conclude that it was due for a long-term slowdown.

"Leading us to March of 2000, where the S&P 500 enjoyed its best [20 year] yearly rate of return ever, 13.8%, that

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to mid-cap weighting also fits with O'Shaughnessy's long-term view that small caps will outperform.

"I think last year wasn't a great year for small caps or for us, for that matter. You are going to have those types of years," he says. "Our thesis has remained since the year 2000 that we are in a 20-year cycle that supports small and mid-cap names. Eight years in that thesis has proven fairly accurate. If you had invested in the S&P 500 in 2000 and taken inflation into account, that dollar is actually worth 92 cents today. If you had invested the same dollar in small cap stocks, the same dollar is worth \$2."

O'Shaughnessy says he developed this thesis after conducting historical research on the U.S. stock market for the U.S.'s largest pension fund. O'Shaughnessy and his team found that by studying the S&P 500 for the rolling 20-year periods between 1927 and 2005, randomly selected, that the S&P grew approximately 7% [a year] over any 20 year period. Large

led us to conclude that between 2000 and 2020, our expectations for the S&P 500 would, at best, compound at 3% to 5% a year," he says. "Small-cap stocks were decidedly below their long-term average as late as 2003. That led us to conclude that should we see reversion to the mean – as we have seen in all of the data we have access to – small caps will be the buy of the century."

There are few Canadian names in O'Shaughnessy's portfolio because resource stocks represent such a heavy weighting of the Canadian small cap indices. Carscallen believes the balance sheet approach does reign in the Canadian small cap universe because it eliminates a lot of its heavy weighting in resource and energy stocks, who have their values tied to commodity prices rather than fundamentally strong business practices. "[In resources] our bias is more towards having companies that have already proven they can make a lot of money," says Jacobs. **AER**