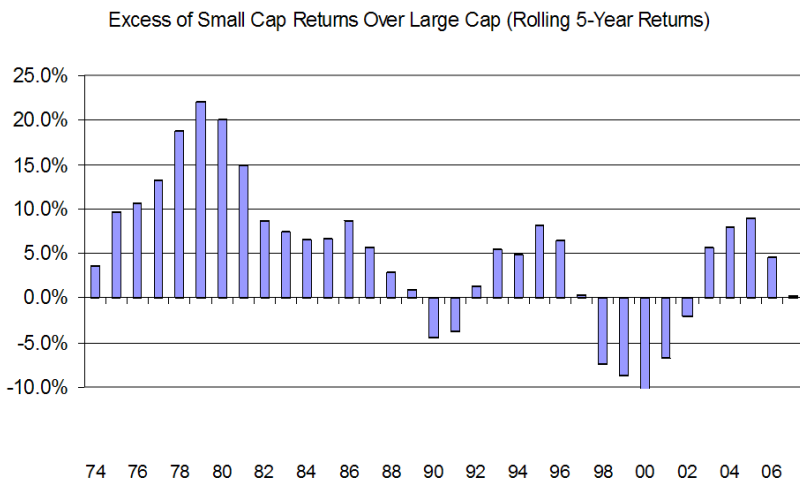


Sionna Insight

The Value in Small Caps

When equity investors are fearful, the markets often experience a “flight to safety”. In these circumstances, large capitalization stocks are often favoured over small capitalization stocks – the perception being that small cap stocks are less liquid, more economically sensitive, and thus less “safe”. Yet, history shows that over the long term, small cap stocks provide diversification benefits, as well as incremental returns over large cap stocks. Given the recent underperformance of small caps relative to large caps, Sionna believes that we are witnessing a flight from small caps that will eventually lead to significant outperformance in the longer term.

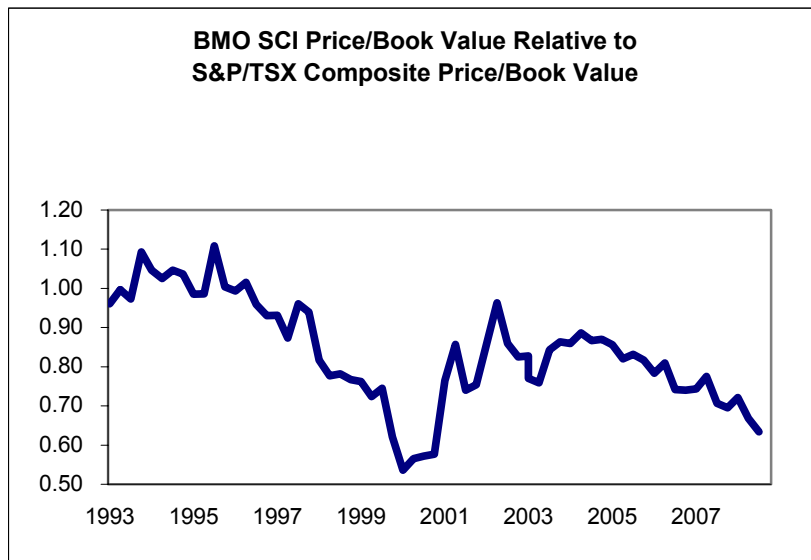
One reason why Sionna sees value in small caps is because small cap stocks tend to outperform large cap stocks over the long term. The chart below shows how small caps have performed relative to large caps on a rolling five year basis. All the shaded areas above zero illustrate the five year segments when small cap stocks outperform large cap stocks. As you can see, small caps tend to perform better than large caps over the long term. Other studies confirm these findings, including the famous Ibbotson study, which examined the U.S. markets over 70 years and found that small cap stocks outperformed large cap stocks 79% of the time over a 15 year period and 95% of the time over a 20 year period.



Source: Bloomberg & Sionna Investment Managers

Another reason that Sionna sees value in small caps is related to valuation. The valuation of the small cap sector relative to large caps has widened dramatically after close to five years of relative underperformance. The chart below shows that historically, small caps have traded at a 15% to 20% discount to large caps on a price to book value basis. Currently, that discount has widened such that small cap stocks are

40% to 50% cheaper than their large cap counterparts. While this discount level is still marginally higher than the valuations experienced during the technology mania of 1999 and 2000, that time period was unique in that absolute small cap returns were strong – investors were just not compensated for the additional risk of investing in small caps so they fled to large cap information technology stocks irrespective of the strong returns of the small cap counterparts. In addition, small cap price to book value ratios have ranged from lows of 1.3X to highs of 2.2X. Small caps valuations are at their historical low price to book value ratios of 1.3X, implying low absolute valuation levels. Thus, the valuation of small cap stocks is inexpensive from both an absolute and relative perspective. In addition, many small caps stocks are showing large positive expected returns on Sionna’s intrinsic value model to a degree that Sionna’s team has not witnessed in many years.



Yet another reason why small cap stocks are compelling is related to their historical performance during periods of weak economic activity. The chart on the next page demonstrates how small caps have performed in recessions and slowdowns. On average, during recessions, small caps have essentially performed in line with large caps. The top left part of the chart shows that Canadian small cap stocks have essentially declined the same amount as their large cap peers during the past five recessions. What is more notable is that small caps outperformed large caps by a significant margin in the period following a recession. The top right part of the chart shows that Canadian small cap stocks have, on average, outperformed by 13% during the 12 month period following the past five recessions. In fact, small cap stocks provided outperformance in both the Canadian and the U.S. markets in the 12 month period following every economic recession since 1950. Thus, small cap stocks have historically had similar declines in weak economic environments but have bounced back much more afterwards.

BMO Small Cap Index Relative to S&P/TSX Composite						
	During Recession			12-mth following recession		
	BMO SCI	S&P/TSX	Relative	BMO SCI	S&P/TSX	Relative
Mar 70 - Jun 70	-20.7%	-18.6%	-2.1%	38.0%	27.5%	10.5%
Jan 75 - Mar 75	6.0%	1.8%	4.2%	27.5%	11.6%	15.9%
Feb 80 - Jun 80	-1.0%	-4.5%	3.5%	28.9%	19.0%	9.9%
Jul 81 - Oct 82	-18.3%	-16.3%	-2.0%	49.1%	38.4%	10.7%
Apr 90 - Apr 92	6.1%	8.3%	-2.2%	34.9%	16.5%	18.4%
Average	-5.6%	-5.9%	0.3%	35.7%	22.6%	13.1%
Russell 2000 Relative to S&P 500						
	During Recession			12-mth following recession		
	US SC	S&P 500	Relative	US SC	S&P 500	Relative
Jul 53 - May 54 *	10.1%	27.6%	-17.5%	51.1%	35.9%	15.2%
Aug 57 - Apr 58 *	-4.5%	-4.9%	0.4%	53.5%	37.4%	16.1%
Apr 60 - Feb 61 *	20.7%	20.1%	0.6%	18.0%	13.6%	4.4%
Dec 69 - Nov 70 *	-23.0%	-1.9%	-21.1%	12.1%	11.3%	0.8%
Nov 73 - Mar 75 *	11.5%	-7.8%	19.3%	58.1%	28.3%	29.8%
Jan 80 - Jul 80	7.5%	9.6%	-2.1%	30.3%	13.0%	17.3%
Jul 81 - Nov 82	14.8%	14.3%	0.5%	33.4%	25.6%	7.8%
Jul 90 - Mar 91	7.7%	8.0%	-0.3%	21.0%	11.0%	10.0%
Mar 01 - Nov 01	3.2%	-0.9%	4.1%	-10.6%	-16.5%	5.9%
Average	5.3%	7.1%	-1.8%	29.7%	17.7%	11.9%

* Ibbotson/DFA series used

Source: BMO Capital Markets, Russell Investments, Ibbotson/DFA, Global Insight

While the rest of the market may be fleeing from small caps, Sionna takes a different view. We believe that small caps have proven that they outperform large caps over the long term, that small cap valuations are currently attractive, and that small caps will rise significantly after a recessionary period. Sionna believes that the ongoing flight from small caps will eventually lead to significant outperformance in the long term for the patient investor.

Teresa Lee
Portfolio Manager
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