
INVESTMENT EXECUTIVE

CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Small-cap caution

Small-cap energy and resources are risky and volatile

April 2011 Print Edition

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Financial advisors who invested clients' funds in Canadian small-cap energy and resources stocks over the past decade have to be smiling. The BMO Nesbitt Burns small-cap energy and resources indices had annualized returns of 18.1% and 27.5%, respectively, from Jan. 1, 2001, through Feb. 28, 2011.

These returns were well in excess of Canadian small-cap returns in general, as well of those of the broader market. The MSCI Canada small-cap index had a 12.1% annualized return over the same time frame, while the S&P/TSX composite index was up by 7% a year.

The small-cap energy and resources sectors were not for the faint of heart. The Nesbitt indices had standard deviations of 34.1% and 44.1%, respectively — more than twice and almost three times, respectively, that of the composite index. Drawdowns in the recent market crash were massive. The Nesbitt small-cap energy index fell by 68.7% from peak to trough; the Nesbitt small-cap resources index plummeted by 70.1%.

Advisors who were able to persuade their clients to stay the course were on the money. The Nesbitt small-cap resources index came back with ferocity, recovering all of its losses by March 2010, while the Nesbitt small-cap energy index took until February 2011 to hit its prior peak.

Have investors been rewarded enough for these huge performance swings? On the important reward/variability metric measured by the Sharpe ratio, the Nesbitt small-cap indices were far ahead of any of the broad Canadian, U.S. or international small-cap or market indices. Similarly but notwithstanding the enormous downdrafts, small-cap energy's and resource's Sortino ratios, which measure reward vs downside risk, also led by a wide margin. Investors were winners on a risk-adjusted basis over the past decade.

A longer-term perspective, however, dramatically changes the picture. From Jan. 1, 1970, through Feb. 28, 2011, the Nesbitt small-cap energy index's annualized return of 12.8% led the S&P/TSX composite index's 10% return much more modestly, while the Nesbitt small-cap resources index's return of 9.6% was slightly less. Both small-cap indices were almost twice as volatile as the market overall and, hence, lagged miserably in risk-adjusted metrics.

Both indices suffered prolonged periods of extremely negative performance when commodities and energy were out of favour. For the decade ended Dec. 31, 1998, small-cap resources stocks endured an annualized loss of 8.4%; investors lost more than half their capital despite a 10-year investment period. Small-cap energy stocks suffered an annualized loss of 1.7% for the decade ended Dec. 31, 1990.

It is clear that the fortunes of the small-cap energy and resources sectors are inextricably linked to energy and commodities booms. Advisors need to warn their clients that the heady upside potential of these sectors will evaporate when these booms end, and that subsequent periods of prolonged negative performance are likely.

Also, even though these booms are intact, losses of more than 50% are to be expected during any major market setbacks. **IE**

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