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U.S. small-caps can boost returns

Clients will still need patience to cope with the volatility of these stocks

By Michael Nairne

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With returns in the past decade so dismal, advisors need to examine options to enhance long-term portfolio performance. Based on an analysis of U.S. small-cap equities conducted by my firm, Toronto-based Tacita Capital Inc., this asset class deserves serious consideration, but only for very patient investors who can also weather volatility in this part of their portfolios.

U.S. small-cap stocks are almost 60% more volatile than large-cap stocks. From January 1926 through July 2009, the annualized standard deviation of the Ibbotson U.S. small-company stock index was 34.2% — the most volatility among all major asset classes, and significantly in excess of the 21.5% standard deviation of the Ibbotson U.S. large-company stock index.

Small-cap stocks suffered 44 drawdowns in excess of 5% during this period, averaging more than one every two years and six more in total than their large-cap brethren. The typical decline was 19%, one-quarter greater than large-cap stocks, and several declines were in excess of 50%.

Investors were well rewarded for this risk. The Ibbotson U.S. small-company stock index had an annualized compound rate of return over the entire period of 11.8%, outdistancing the 9.7% return of the Ibbotson large-company stock index. Over the 83-year period, the incremental wealth creation by the small-caps was staggering, almost five times more than large-cap stocks. On the important reward/variability metric measured by the Sharpe ratio, the small-cap index was virtually equivalent to the large-cap index, indicating that investors were being compensated for the risk taken.

Unfortunately, U.S. small-cap outperformance is tremendously streaky. Since the Second World War, the premium earned on small-cap stocks has been concentrated in four distinct periods: the late 1960s; the mid-1970s to the early 1980s; the early 1990s; and the early part of this decade. At other times, small-caps typically have lagged large-cap performance. Advisors need to explain to their clients that patience is the vital element in accessing the higher-return potential of U.S. small-cap stocks.

In an optimization analysis, both historical and forward-looking, U.S. small-cap equities consistently earn a role in a broadly diversified portfolio. In fact, an allocation that is as high as one-third of the U.S. equities component could be suitable for aggressive, growth-oriented investors. This should be tempered, however, by the fact that many investors will not be able to tolerate the episodic nature of the outperformance or will fail to evaluate performance in a total portfolio context.

Advisors can access U.S. small-cap stocks through a variety of vehicles. Although there is a range of mutual funds focused on this asset class, the growth has been in the exchange-traded fund arena. In the U.S. there are now more than 40 ETFs tracking a variety of U.S. small-cap stock indices such as the Russell 2000 or the S&P 600, offering a choice of styles, dividend yields, leverage, short positions and company sizes (including micro-caps). For advisors concerned about currency risk, in Canada, Barclays Global Investors NA offers the iShares CDN Russell 2000 index ETF, which is hedged into Canadian dollars.

Although the small-cap sector is often identified as an area in which active management adds value, in an analysis of 17 U.S. small-cap mutual funds and ETFs that have been in existence for a minimum of five years, the three ETFs were ranked second, fourth and seventh in return performance. Also, although higher MERs have traditionally been associated with small-cap funds, Vanguard Group Inc. offers three small-cap ETFs in the U.S. with an annual MER of 15 basis points. IE

Michael Nairne is president of Tacita Capital Inc. of Toronto, a private family office and investment-counselling firm.