



August 22, 2012

**Dear clients and colleagues,**

One of the most persistent fears about investing in small caps is that they are more risky. Is it so?

If we take global markets, the definition of small is a market capitalization of less than US\$5 billion. That comprises around 85% of all companies. As a comparison, the median market cap of the TSX's 246 companies is C\$2.3 billion. We believe risk is more related to the industry rather than the size of a company. Why would companies such as Hugo Boss in the Global Index be more risky than Reitman's because it is considered a large cap in Canada? Or Navistar be more risky than Westport Innovation, again for the same reason?

The median small cap company in the Global Index has a market cap of around US\$1.6 billion and has approximately US\$800 million in sales. One big difference, small cap company managers tend to own a significantly larger share of the company than managers in larger companies, aligning their interests with those of all shareholders.

But we decided to look at some numbers to determine if small caps are more risky. In the last 12 years from 2000 to 2011, global small cap companies outperformed global large caps in 8 of the 12 years. The outperformance was over 6% annualized. That means that an investor who chose global small caps in 2000 ended 2011 with twice the amount of money than the investor who chose the large cap index.

But did he take on more risk? In those 12 years, large cap stocks had 6 years of negative returns. In those negative return years, small caps did better by an average of 3.4%.

How could this be?

One is told that diversification reduces risk. The most diversified index that one can find is the Global Small Cap. All 68 industries are well represented. No industry is more than 7% of the index. No stock in the index is more than 0.15%. So, with lower stock-specific risk, lower industry risk and with country diversification, we argue that small cap stocks are less risky, and the numbers seem to show it.

We recently read an article by Innosight that was quite interesting. It talked about how difficult it is for large companies to grow at or above the pace of their industry. Very few companies achieve it. Over the past decade, about half the S&P500 companies have been replaced.

Have a good week.

**The Global Alpha team**

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