GLOBAL ALPHA

April 22,2011

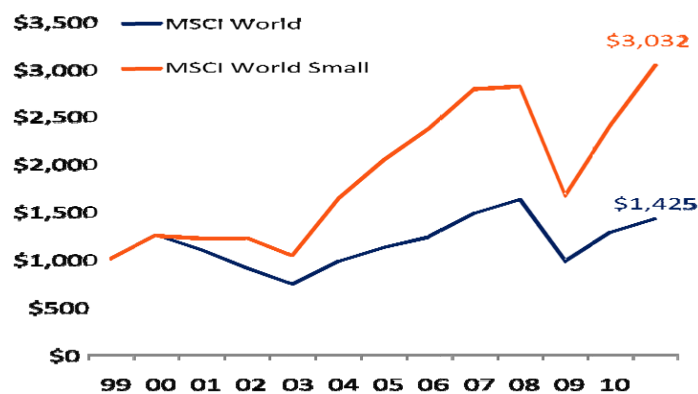
Dear clients and colleagues,

This weekend, we read two interesting articles in the Wall Street Journal. One was entitled "**Why so many blue-chip investors are still singing the blues"**

The article went on to describe how such blue chips as Cisco, Microsoft and Abbott Labs have all fallen in the last year when the market is up more than 10%.

In the last decade, the S&P100, an index of the largest companies, was up 2.1% annually whereas smaller companies were up around 9%.

A similar picture emerges when one looks at global markets:



source: MSCI

Many reasons are given to explain the outperformance of smaller (riskier?) companies: low interest rates, massive liquidity (QE2), hedge funds, etc.

In our opinion, the most important reason is growth. Revenue growth is what drives profit growth and profit growth per share is what drives stock price. It is very difficult for a large company to grow faster than its market due to its sheer size. Google was a good example when it reported results last week. Every next stage of growth requires higher investments with often declining returns.

When one looks at a list of Dow components from 1928, only one company remains; it is General Electric. Even looking at 1990, 13 out of the 30 companies are not there anymore. Actually, looking at the largest 100 companies of 1928, only half still exist today and only one third are bigger than they were then.

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The other article we read was titled "**Are small caps too pricey?"**

It is true that such outperformance of smaller companies has made investors cautious; more small cap investors (36%) now expect large caps to outperform in the next 6 to 12 months. In terms of relative valuation, small caps now sell at a 30% premium to large cap – 18 times earnings against 14 times – one of the largest premia ever.

However, smaller companies have been able to better grow revenues and cut costs in a tough economy and expectations for growth still remain higher now that the economy is recovering.

Mergers and acquisitions are also coming back strongly with both strategic and financial investors looking to deploy record cash balances and take advantage of attractive interest rates. 99% of M&A transactions involve smaller companies, providing support to valuations.

Smaller companies are a stock picker's universe. The index itself may be more pricey, but over 15% of small companies sell for less than 10 times earnings.

We also believe investors would now rather pay a premium for simpler business models. After all, the last financial crisis was about large banks taking on too much risk with too few controls and transparency. And some of the biggest frauds ever, WorldCom, Enron, Tyco, were all large companies.

We do not think an investment in smaller companies should be made with a short-term time horizon. We believe they should be an important part of every portfolio, as they represent over 85% of publicly traded companies.

And for some comfort for investors focused on the long term: If we take any 20-year period since 1926, small cap indices have ***never*** had a negative period of returns and have ***outperformed*** large cap indices 90% of the time.

Have a good weekend.

The Global Alpha Team

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