

# PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

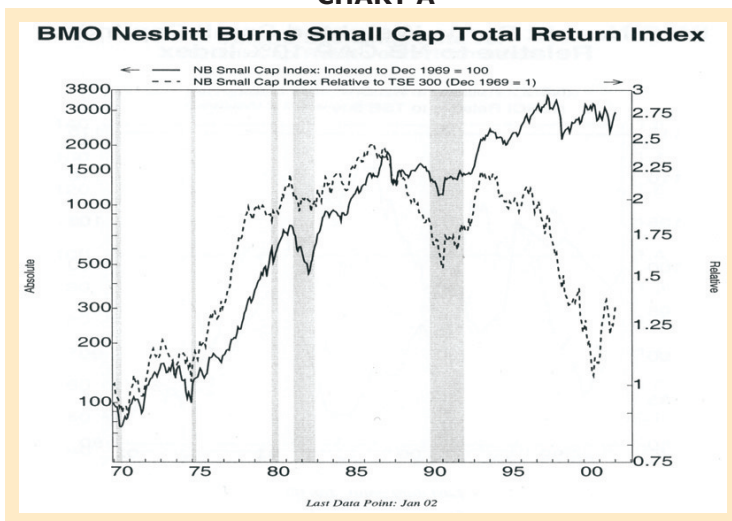
## Small Cap Investing A smart way to play an economic recovery

**W**hen building a well-diversified portfolio, a small-cap\* equity component generally makes a fitting addition, particularly for long-term investors. This is especially so in the current economic environment. History shows that small caps post their strongest performance as the economy recovers from recession. As recent data clearly indicate, both Canada and the U.S. have seen the bottom of their economic slowdown and are poised for a rebound.

### History tells the story

The performance of Canadian small-cap stocks over the past 30 years, as represented by the Nesbitt Burns Small Cap Index, is illustrated in Chart A. As you can see, there were five recessions during this period before last year's downturn. In each case, small caps fell to their lows for the cycle just as the recession was nearing an end. Before the recession was officially over, their stock prices turned around and began an uptrend that lasted several years. Moreover, they outperformed large caps, as represented by the TSE 300 Index.

**CHART A**



\* "Cap" is an investment industry abbreviation of the term "capitalization", which refers to the total market value of a company's shares. In Canada, small-cap stocks are generally defined as those with market capitalization under \$1 billion. In the U.S., they are under \$1.5 billion dollars.

It was a similar story in the U.S. between 1980 and 2000. In the final stages of three recorded recessions, the Russell 2000 Index bottomed and then set off on a steady climb, outperforming the Russell 1000 Index along the way. History appears to be repeating itself this time around, as well. After several years of weak performance, Canadian and U.S. small caps recharged in 2001, gaining on the year while large caps languished. In the early going of 2002, small caps continue to outshine their large-cap counterparts. And we have probably not seen the full move up yet, despite the surge in the past 12 months. The average bull-run for small caps is about three years, so the current upswing is likely just gathering momentum.

### Advantage small caps

There are two key reasons for small caps' current relative outperformance over large caps - earnings and valuations.

On the earnings front, there is a general misconception about which of the two asset classes produces the better profit growth over time. Some argue that large caps have an advantage. Bigger companies benefit from economies of scale to reduce costs and, because they are more established, they have a competitive edge in their respective industries.

Others make the case for small caps. Smaller companies have more flexibility, allowing them to be nimble in responding to market and economic forces that may influence the day-to-day operations of their business.

As it turns out, both schools of thought are right. Over time, large cap stocks and small cap equities grow earnings at about the same pace. During the past 20 years or so, that growth rate has been approximately 7.5% annually. Nevertheless, each group has its winning periods. We believe current conditions favour small caps.

*(Continued on page 2...)*

## Controlling the risk

It is important to remember that investing in small caps should not be a “roll the dice and see if you can come up big” gamble. Our investment philosophy is premised on a disciplined approach to managing money. We believe that a quality portfolio is built on a stock-by-stock basis.

We take a bottom-up approach, focusing on growing companies that consistently generate free cash flow and are leaders in their industry. We also look for companies that are run by entrepreneurial management teams who have a significant ownership in the firm.

As part of our research, we scour numerous analysts' reports, but in the end we rely solely on our own work, which includes establishing close relationships with company management and making regular site visits to stay in touch with the latest developments.

In addition, we vary the size of our positions in a stock according to the risk profile of the investment. And, not least of all, we buy shares at a reasonable price.

(...continued from page 1)

That brings us to valuations. From a historical perspective, small caps are currently more attractively priced than large caps. As you can see on Chart B, Canadian small caps have a price-to-earnings ratio (p/e ratio) of 12X versus 16X for large caps. Thus, small caps are trading at a discount, whereas they often trade at a premium. This atypical situation offers a timely growth opportunity.

As a point of reference, the Nesbitt Burns p/e ratio includes only companies that have positive earnings. Companies that do not make a profit are excluded from the overall p/e calculation. This allows for a more constructive reading.

## South of the border

As you can see in Chart C, in the U.S. the valuation of small-cap stocks relative to their large-cap brethren is more in the middle of the historical range. While this makes the case for U.S. small caps somewhat less compelling than that for Canadian small caps, there is still a sizable discount to exploit overall. When you look at specific stocks, the discount is even greater in certain sectors. That is why we are overweight in consumer-related shares, not because we have made a call on the group as a whole. Stock selection is the key.

So, after lagging large caps for some time, small caps, we believe, are in the early stages of a potentially lengthy period of outperformance. At least that is what history is telling us.

**Bruce Cooper, Colum McKinley, Small-Cap Investment Team, TD Asset Management**

CHART B

### Absolute Price/Earnings Index Levels \*

\* only includes companies with positive earnings

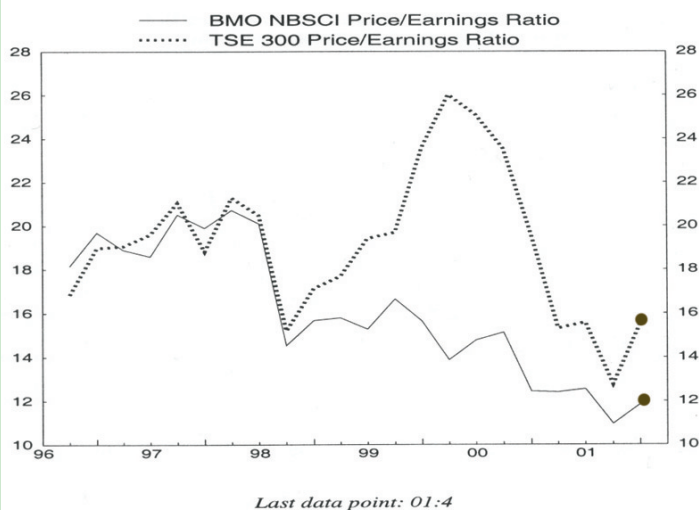
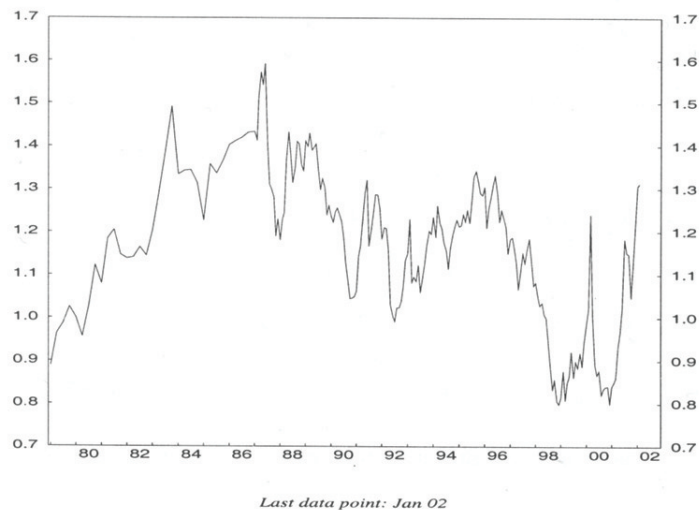


CHART C

### Russell 2000 Price/Earnings Ratio Relative to Russell 1000 Price/Earnings Ratio



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