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SMALL AND VALUE STOCKS

Various types of equities offer different risk and potential returns over the long term. A smartly constructed portfolio coupled with patience and discipline are key to capturing the rewards.

WHAT ARE LARGE- AND SMALL-CAP STOCKS?

The stock market universe can be divided into large and small company stocks on the basis of their market value or capitalization. Market capitalization is calculated by multiplying the number of shares a company has issued by the price of each share. For instance, if Apple Inc. has 900 million shares outstanding and its recent price is US$550 per share, then Apple's total market capitalization is US$495 billion. By calculating each company's market capitalization and ranking them by size, we can characterize them as relatively large- or small-cap (and sometimes mid-cap) stocks.

WHAT ARE VALUE AND GROWTH STOCKS?

Two other measures also help us distinguish between expensive and inexpensive stocks. By comparing a company's market capitalization to its so-called intrinsic value, such as "annual profits" or "net assets", we can determine how cheap or expensive a stock is relative to that intrinsic value. For instance, if we apply Apple's market capitalization of US$495 billion to its annual profits (earnings) of US$28 billion, we arrive at a price/earnings multiple of 17.7 times. Another important multiple is obtained by comparing market capitalization to net assets (book value), in this case US$102 billion, for a price/book value ratio of 4.85 times. Both these calculations are commonly used to give stocks the moniker "growth" or "value". Growth stocks or high-priced stocks are often considered "glamour" stocks. They carry high investor expectations for profit growth in future years for some specific reason. For example, a fancy product with a patent, strong management or even exceptional customer relationships may be reasons investors will bid up a growth company's stock price to lofty levels. Value stocks, on the other hand, are often characterized as boring, such as bank and pipeline stocks, or distressed companies suffering from weak products, poor management or sub-par customer relationships. Since the company's prospects are out of favour with investors, their stock price languishes and becomes "cheap".

WHAT ARE THE IMPLICATIONS FOR INVESTORS?

It is a commonly held belief that, as a group, small company stocks provide investors with higher returns than large ones do over the long term. The reasoning is that smaller companies have higher risk levels than their larger company counterparts, and investors demand compensation through higher returns for taking on this added risk. Small companies, for instance, have a greater probability of falling into bankruptcy. Of course, if these small companies thrive, their stocks then have a greater potential of doubling or tripling in a short period of time. Regardless of scenario, in the financial world of risk and reward, more volatility (up or down) must be compensated with higher returns.

Similarly, value stocks are also widely viewed to have greater return potential than growth stocks but the rationale is not as clear and sometimes debated. Some behaviourists will argue that investors have a tendency to extrapolate past financial results into the future, creating overly favourable sentiment for growth stocks and overly negative or disinterested sentiment for value stocks. They also point to the influences of "agency costs" - meaning the press and the brokerage industry pump up "exciting"

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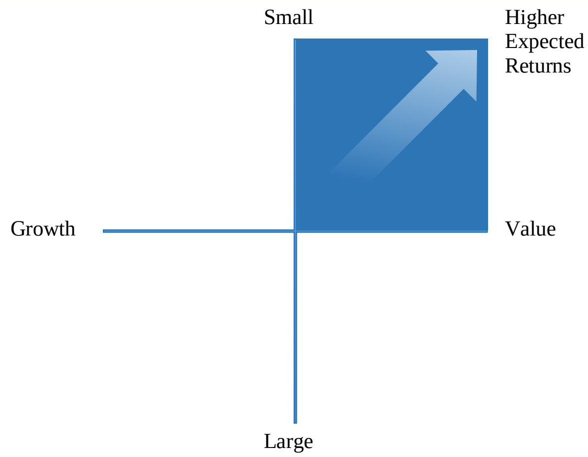
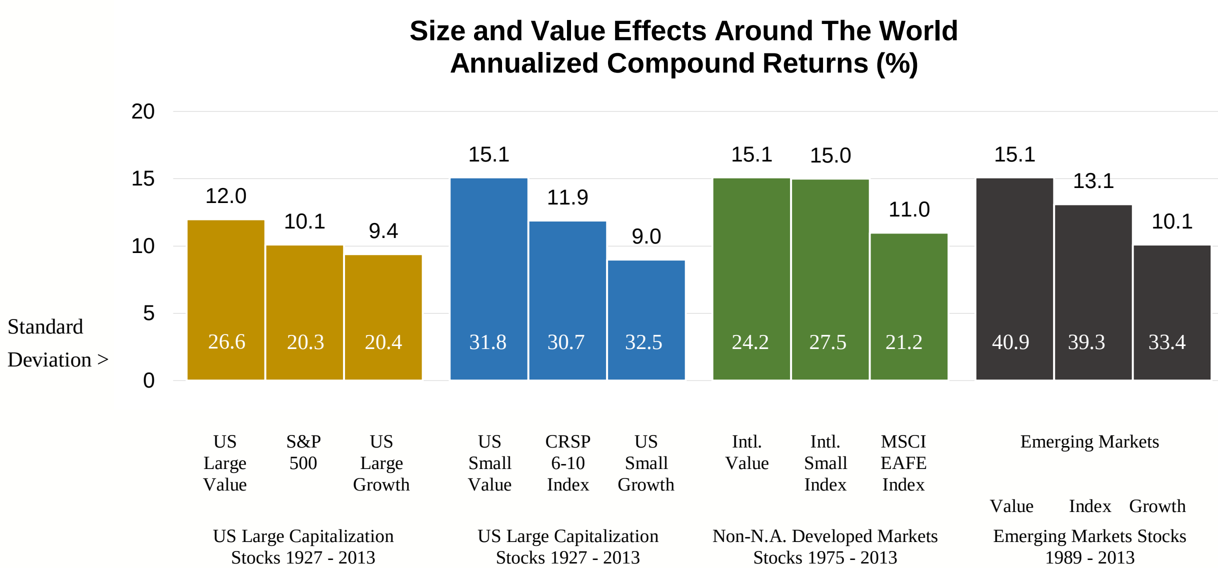


stories which they can easily sell, and downplay or ignore boring/negative ones, which present more challenges to create investor interest. An exciting new technology touted to change the world is much easier to talk about than a conservative company in need of a management shakeup. Even institutional managers of pension funds have an easier time maintaining positions in so-called success stories rather than negative ones. This can result in overly inflated prices for growth stocks and overly depressed prices for value stocks.

Another camp, led by Dimensional Fund Advisors (DFA), believes the “value effect”, just as with the "small-cap effect", is one of risk and reward. They theorize that value stocks (many of which are distressed companies) also carry higher levels of risk. Therefore, investors of value stocks must be offered higher returns to compensate. Both of these theories make some sense, but the real test is in the evidence, which we present in the illustration below.

Using the longest reliable data available, the bar charts show how strongly the "small company" effect and the "value company" effect hold true in stock markets around the world. In each region, groups of small and value stocks have offered superior returns according to available relevant data. It is also worth noting that the highest returns (the longest bars) generally have the greatest volatility (standard deviations) although not always (US Small Growth vs. the CRSP 6-10 Index or US Small Index).



Source: Dimensional Fund Advisors

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MILESTONE'S APPROACH

At Milestone, we are convinced that small cap and value effects are real. We think the keys to capturing the premium performance of these groups are diversification and patience. We hold small and value stocks as part of a broader portfolio of many stocks, recognizing that there may be periods of time where the small and value premiums do not materialize. Among total equity holdings of literally thousands of stocks, this effectively creates a "tilt" toward small cap and value which is expected to add value over broadly based indices like the TSX/S&P Composite, the S&P500 or the EAFE Index. The extent of the tilt is determined by the investment risk parameters of each client's situation and incorporates the likelihood that there may be extended periods (as long as 10 years) where value and small companies will underperform their growth and large company counterparts.