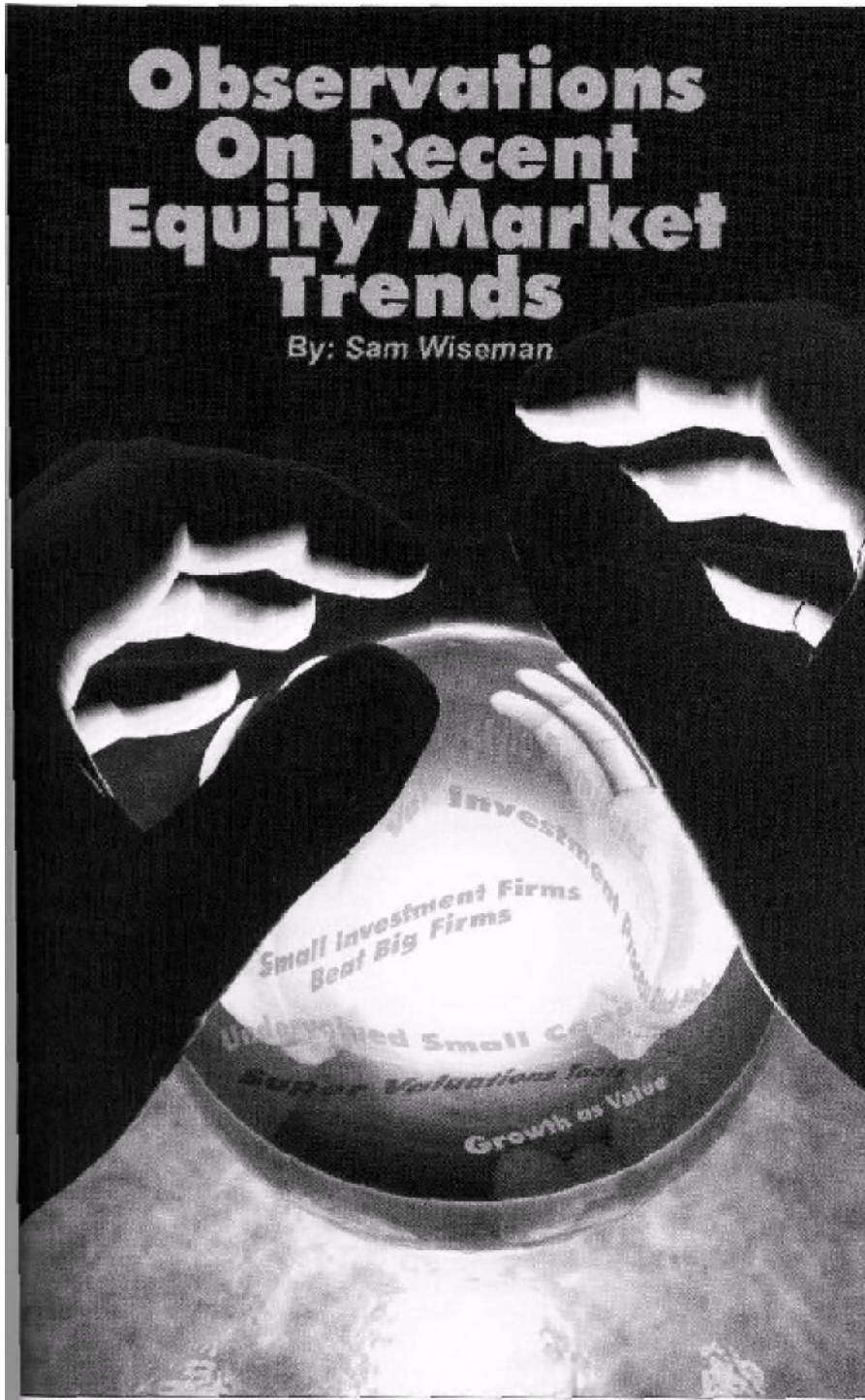


Investment



More than a generation ago, the academic world proved that it is better to hold at least several stocks across most major industries, rather than one or only a few stock picks. Since then, diversification has been accepted as a guiding concept for balance expected investment returns with risk management.

The original work in this subject, appropriate for its time, proposed that 20 names could constitute a

diversified portfolio. However, markets and businesses have not remained static and today this figure is much higher.

Over the past 30 years, price volatility has increased consistently while the correlation of price movement between individual stocks has decreased. Today, a portfolio manager needs 50 to 60 names across sectors to comprise a fully diversified portfolio. (See AIMR Conference Proceedings 2002 *How Much Diversification Is Enough* by Burton Malkiel. Other studies have confirmed these trends.)

One reason for the increased volatility is that markets have become more efficient. If there is news with respect to a certain stock, that information is more widely disseminated today and immediately traded upon. One reason for the lower correlation between stocks is the trend of businesses to focus on their own industries and not become conglomerates.

It would be a virtual impossibility for an individual investor to properly manage 50 to 60 stocks across all sectors. One method the investor may choose to get full diversification is to buy a market ETF (electronically traded index fund). This will give the individual diversification.

Alternatively, an individual can ignore diversification and identify with the experience of most retail investors over recent years of being concentrated in a couple of industries. This concentration leads to tremendous swings in performance, which is more volatility than individuals will normally tolerate.

The Real Beta

Net individual stock volatility (VIM) is becoming a widely followed indicator in our post-Enron world. VIM is the net volatility after accounting for other explainable influences. It signals extraordinary shorter-term swings in stock prices prior to widely disseminated news and way before the release of quarterly statements.

Rather than accepting one beta, or measure of price volatility, it has become apparent that there are many betas influencing the volatility of a stock, as many as a dozen. So, once we take out explainable factors, such as the effect of how much debt or profitability a company has, we come up with a 'net beta' on price volatility alone that tells us, for example, that Power and EnCana are long-term holds. It's a virtuous circle because the market actually gives these stocks a premium for not having stock volatility.

At the other extreme are Nortel and Air Canada, which the market is penalizing because of their volatility.

Value Style Dominates

Longer term, the dominant Canadian equity style is Value. Over a market cycle, Canadian investors will not pay more for a stock than they believe it is worth. An active manager who closely followed the Value discipline for 10 years would have been among the highest performing managers over this period.

While not apparent at first glance, the Value universe is still undervalued, albeit not as underpriced as it was at its historic peak in February 2000. The BARRA Canada Value index has underperformed the TSX from the third quarter of 2001 through the third quarter of 2002, before rebounding in the last quarter of 2002.

Undervalued Small Caps

Canadian small caps lagged behind the general market in recent months. At Wise Capital, our valuation model

tells us that our average incorporated small cap name is one-third undervalued. Over the long haul, in Canada, one of a handful of markets with a small cap effect, small cap performance should maintain pace with the general market, if not outperform it.

Super Valuation Tools

Many investors put emphasis on Price-Earnings as a valuation ratio. Others put their emphasis on Price-Book. From one period to another, one seems to work better than the other. When combined they become a 'Super-Valuation Tool.'

To illustrate what we mean, let's use a sports analogy. In the old days, people used to evaluate skill by batting average as the single most important indicator of the value of a player. However, batting average is only slightly related to the total value of a player as it doesn't reflect the value of a player who has a premium percentage of walks or home runs. In our generation, statisticians recognized the value of combining on-base average and slugging average. This number correlates very well with offensive output. Barry Bonds, with an offensive rating of 1.381, clearly stands out, more so than merely looking at his batting average. His number is twice the average. It's like every time you go through the batting lineup, even if you have three outs, you get an extra at-bat. Similarly, you get a remarkable indicator by a statistical combination of (low) Price-Earnings and Price-Book. These stocks will clearly jump out at you as being potentially undervalued.

Growth As Value

Few Value managers ignore the growth potential of a company. Few growth managers ignore valuation. Nevertheless, there exists a basic philosophical difference between these two main styles. When we talk about growth, we don't talk about future growth. Rather, we talk about the past track record of management being able to grow its revenues; grow its assets.

We find value where a company's success has not yet been fully valued by the market. We look at what the market will pay for proven growth and this is the best way to evaluate the probability of a stock's ability to outperform.

Investment Process Black Hole

One black hole in investment management is what percentage of the stock to put into a portfolio. Yet, that's the most important, albeit the most boring investment decision.

Let's compare Ms. Stock Picker to Ms. Quant Process.

Ms. Stock Picker relies on random idea inspiration. She receives abundant street research and is marketed to directly from the companies themselves and indirectly through the brokers. Her subjectivity counts for much of her decision. This subjectivity extends not only to picking the stocks, but also to assigning the weights of the stocks and even the industry weights in the portfolio. Subjectivity can lead to style drift and to other avoidable mistakes in portfolio construction.

Ms. Quant Process uses fundamental analysis and experience in designing her investment process and always employs a model or models. Her reliance on a quantitative procedure meets the objective of ensuring that the consistently important factors of the equity market are covered in portfolio research and construction, and in systematic magnitudes. This type of research will insure that changing correlations of these factors will be

incorporated into the investment process.

**Small Investment Firms
Beat Big Firms**

The increased concentration of the Canadian investment industry over the last 10 years has led to fewer boutiques and more one-stop-jack-of-all-trade shops. Active management opportunities have improved in recent years. Indexing – larger amounts under management and larger teams of managers as in other aspects of business – led to more niches for small players to exploit. A small firm can be nimbler in execution of portfolio strategy.

Do performance numbers support this contention? Indeed!

Chart 1

The Case for Smaller Firms				
Percentage Return				
	25 Years	10 Years	5 Years	3 Years
Median Large Manager	10.6	10.2	1.7	3.3
Median Small Manager	13	10.5	4.1	5.6
<i>Source: API. All periods ending September 30, 2002.</i>				
Annual Return 1999 to 2002				
	2002	2001	2000	1999
Median Large Firm	1.7	9.2	17.2	12.3
Median Small Firm	4.1	12.6	20.7	13
				<i>Source: API</i>

The case for smaller firms was stronger than we could have imagined. We employed the API database of all Canadian equity pooled funds over 25 years (*Chart 1*). Over the entire period, and in any portion of it, small firms outperformed large firms, in rising markets and falling markets. These numbers help support the thesis that smaller firms are driven by performance.

The smaller firms have demonstrated more investment skill, adjusted for risk, than the larger firms. The Sharpe ratio, a commonly used method of adjusting return for risks taken by the manager, shows that for the longest period we were able to calculate, smaller firms displayed twice as much skill in their performance than larger firms. In the last five years, with a marginal increase in the TSX, larger firms have displayed negative risk-adjusted returns.

First-quartile managers were also more likely to come from the smaller firm group. And, as we demonstrated, it was not because they could afford to take all-out risks. The first quartile small firm manager had knock-out performance in that period, even compared to the first quartile large firm manager. •

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