PARAGON
CAPITAL MANAGEMENT

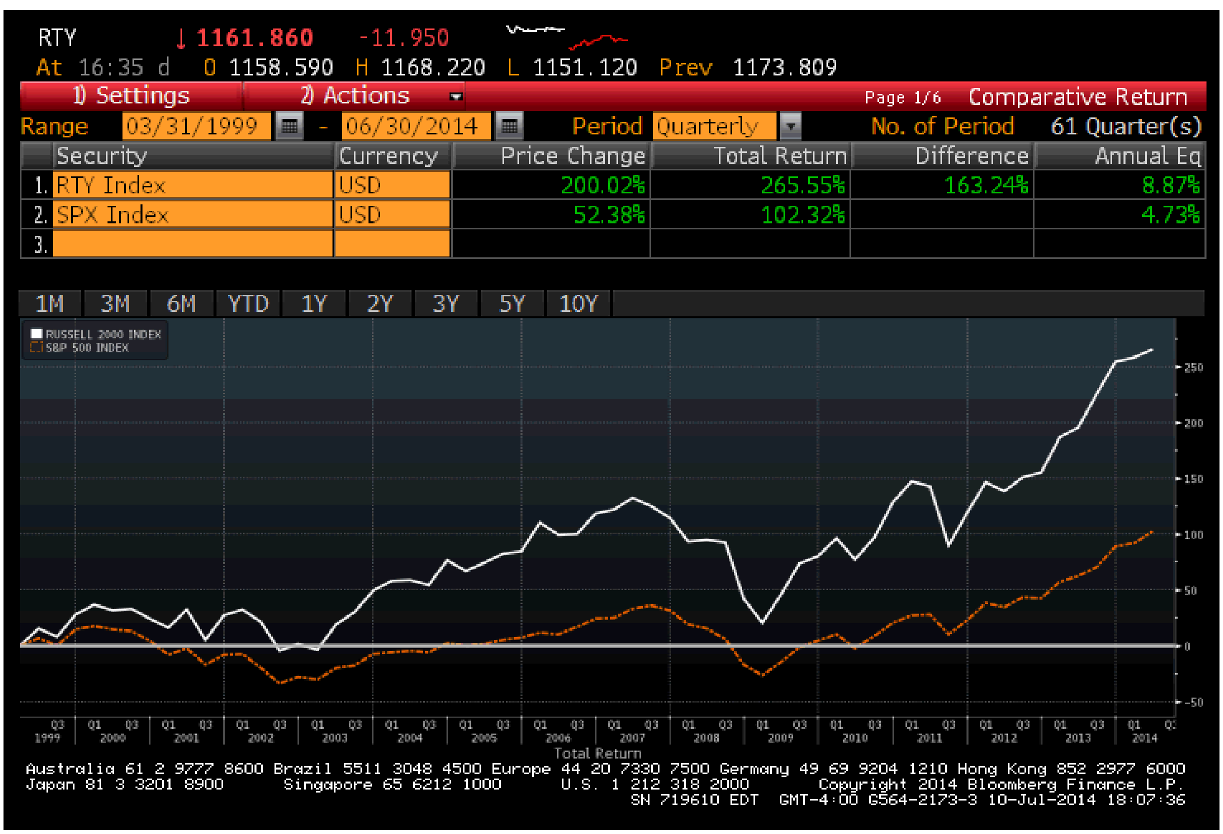
## SMALL COMPANY STOCK REVIEW

We recently reduced our allocation to small company stocks. We believe small company stocks will underperform larger company stocks prospectively, based on an over-extended small cap cycle and significant overvaluation.

### Small Cap Cycle

Small company stocks have significantly outperformed their larger counterparts during the current cycle. This makes sense, as these smaller stocks are considered more risky, and the market has been in a “risk on” mode for quite some time. Since the market bottom in 2009, small stocks have outperformed large stocks by nearly 50 percentage points.

Furthermore, over a fifteen year period since 1999, small stocks have risen 266% while large stocks have risen 102%. These are annual returns of 8.9% and 4.7%, respectively. Although these performance cycles tend to be long term cycles that last for years at a time, this spread in long term performance is more than two standard deviations from the norm, which is a fairly extreme event. Therefore, we believe we are nearing the latter part of this cycle, and we expect small stocks to underperform going forward. Small cap stocks’ relative performance peaked in March and has significantly lagged large cap stocks since then.



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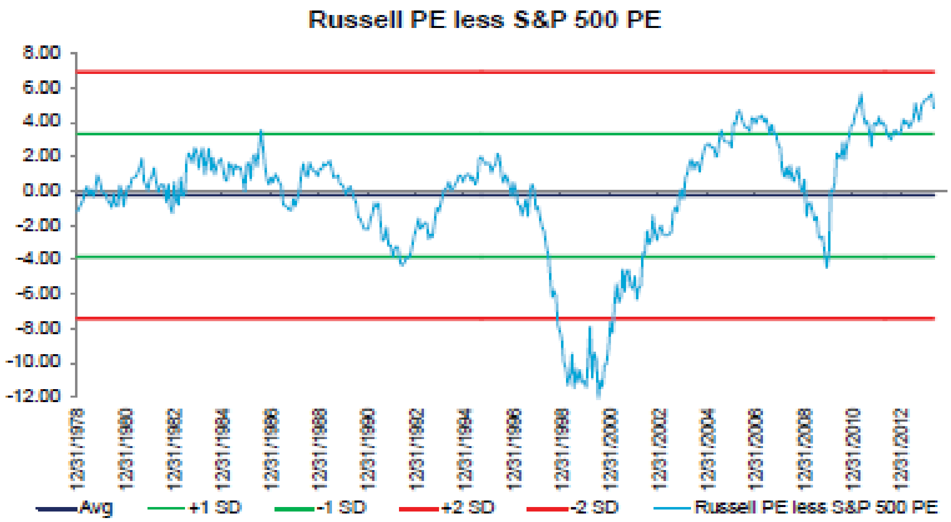
**Valuations**

While the price gains of small company stocks have been tremendous, their earnings growth has not kept up. The valuation discrepancy has also become very large. As shown below, the P/E ratio of small cap stocks has reached 27, compared to 18 for large cap stocks.

| | Large stocks (S&P 500) | Small stocks (S&P 600) |
|---|---|---|
| Price/Earnings Ratio | 18.3 | 27.0 |
| Price/Book Value | 2.6 | 3.9 |
| Dividend Yield | 2.0 | 1.5 |

By another measure, the P/E disparity between large and small stocks is at an all-time high, as seen in the chart below.




Source: Russell, Haver Analytics and Citi Research – U.S. Equity Strategy

**Tax Implications**

For clients with no capital gains tax implications (such as IRA accounts), we reduced the weighting of small cap stocks to zero. However, some taxable accounts have large capital gains, as the funds we own have doubled or tripled since purchasing. Therefore, for many of these accounts we could not justify paying such a large tax penalty.

While we report portfolio returns on a pretax basis, we manage client portfolios from an after tax perspective. Depending on the individual tax situation, we may not have sold any small cap stocks, or we may have only trimmed the allocation.