



Opportunities in Small Cap Equities

Introduction

Many investors—be they individuals building assets for retirement, company owners creating defined contribution/401(k) plans for their employees, or large institutions such as pension funds or foundations and endowments—allocate part of their portfolio or plan to large cap active or passively managed U.S. stocks.

Far fewer investors, however, have made small capitalization stocks a dedicated portion of their portfolio. Rather, these investors are often indirectly exposed to small cap stocks through their use of active equity funds and managers who “dip” in and out of small cap stocks.

We maintain that small cap stocks deserve a dedicated strategic allocation within the equity portion of many investors’ portfolios. **Small cap stocks offer greater opportunities for active managers to add value through stock selection and sector positioning;** in part because smaller stocks get less attention from the investing community and also because small cap managers have a greater variety of companies to choose from than their large cap peers.

We also discuss volatility within small cap stocks due to challenges such as trading liquidity and more vulnerable lines of business. We then conclude with a cautionary note on small cap funds and strategies.

Flying under the Radar

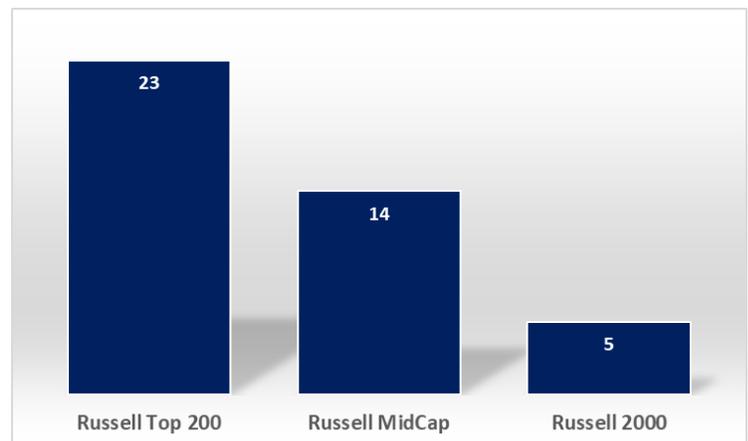
By their very nature, small cap stocks have less institutional research coverage. Since they constitute less than 10% of total U.S. equity market capitalization and a similar level of trading volume, small cap stocks represent smaller pools of investment capital and receive less attention from the investment community.

The research arms of many investment banks, also known as the ‘sell side,’ have less interest in covering small cap companies unless they are potential clients for financing advice. As a result, many stocks that could prove to be excellent investments go largely uncovered and potentially undervalued. Additionally, smaller companies rarely get attention from financial news channels or broader media outlets because they are not household names and typically do not distribute widely known products.

Less crowded research coverage can mean increased opportunities for managers to discover stocks that are generally overlooked by asset managers. In addition, most sell-side analysts who follow small cap stocks tend to work at smaller, regional brokerages located near where the company operates, as opposed to the national brokerage firms that gain extensive distribution and investor attention for their reports.

As illustrated below, Figure 1 shows the median number of sell-side analysts covering each stock in the respective large cap, mid cap, and small cap indices.

Figure 1. Analyst Coverage by Market Cap



Source: Factset as of July 2018

On average, a company in the Russell Top 200 (large cap) Index is covered by 23 analysts, while the average mid cap stock has 13 analysts following it. The average company in the Russell 2000 (small cap) Index is covered by only five analysts. For example, Apple—a member of the Russell Top 200—is covered by 44 sell-side analysts. Yet, one of their fabricators, a small cap company called TTMI Technologies, is covered by only six.

Analyst coverage serves as a proxy for overall investor attention. Intuitively, the fewer investors following a stock, the more competition there is to uncover information that can shed light on that stock’s proper valuation and the faster that information comes to light. With less coverage, less information is transmitted to the investing public and what information there is takes longer

to be disseminated. Less information often means greater inefficiency in a stock price, and thus an opportunity for active managers to seek to exploit their unique views on a company's outlook.¹

Depth plus Breadth Equals Opportunity

The second advantage that small cap managers have to add value is the size of their investment universe: the number of small cap stocks far exceeds the number of large and mid cap stocks. More stocks equal more opportunities for a manager to add value.

There are approximately 2,000 small cap stocks as measured by the Russell 2000 Index compared to roughly 1,000 mid and large cap stocks combined. But beyond the difference in the number of small versus mid and large cap names, capitalization-weighted benchmarks such as the S&P 500 or Russell 1000 indices are heavily skewed towards the largest stocks. In the S&P 500, for example, the largest stocks in the index are 100 times bigger as measured by market capitalization as the smaller stocks and dominate overall index performance. In small cap indices, however, the dispersion between the largest and smallest stocks is much smaller, about 15 to 1.

Because the capitalization-based weight of large cap stocks in market benchmarks like the S&P 500 or the Russell 1000 is much more concentrated in fewer names, the range of opportunity for active managers seeking to outperform their benchmark can be significantly reduced—a hurdle much less onerous for small cap managers. Large cap managers, to reduce the risk of significantly underperforming their benchmark, often hold these “mega- cap” names—sometimes a bit reluctantly.

Active small cap managers may not be as constrained when building portfolios measured against a cap-weighted market benchmark, but the benefit of a wider universe and less concentration comes with an increased challenge of evaluating twice as many firms. This task is complicated by the fact that many of these candidate stocks may be beneath the radar of helpful analysts.

The job of a small cap manager is complicated further by the fact that small cap stock valuations and market prices are more often driven by company specific factors rather than by broad domestic and foreign macroeconomic trends. Small companies may be able to grow revenues and earnings in a slowing economic cycle and perform well, while larger companies may find it difficult to escape the headwind such cyclical forces create. But these types of challenges are exactly what create the

opportunities for active managers to outperform benchmarks.

In addition to the breadth of individual companies in the investable universe, small cap stocks can offer breadth at another level—industry depth. Among small cap stocks there are some industry categories with far more small company representation than large cap stocks, including companies in emerging growth industries as well as firms in downtrodden industries that offer potential rewards as turn-around stories. This characteristic is readily apparent in Figure 2, where we show selected industry groups drawn from the Russell 3000 Index.

Figure 2. More Room for Hidden Gems

Industry	Large Cap	Small Cap Firms
Energy Equip & Services	11	51
Construction	5	21
Internet Software	19	61
Banks	45	225
Savings Banks	2	60
Biotechnology	23	188

Source: Axioma as of 6/30/2018

For some of these industries, the nature of the companies changes as they get larger. For example, large cap biotech firms, such as the 17 shown in Figure 2, include Amgen and Genentech, which are large pharmaceutical companies competing against the likes of Pfizer and Merck. By contrast, small cap biotech companies—note that there are 144 in the table above—are typically one- or two-product firms with few revenues or any earnings but massive growth potential. Often their eventual exit strategy is acquisition by one of the large pharmaceutical or biotech companies. This difference poses a completely different challenge for the small cap investor. While large cap biotech analysts have to understand a whole pipeline of products and management capability across a broad organization, analysis of small biotech firms is more akin to venture capital. The firms have only one or two products and research is focused primarily on the development of those products and the potential acquisition value they might deliver.

In addition, while analysts covering larger firms and the portfolio managers who invest in them need to maintain a detailed understanding of the multiple layers of bureaucracy, committees, and management that are involved in new product launches and corporate governance, smaller firms are generally less complex, have fewer product lines to get to know, and can be nimbler in their operations. While small cap managers have a wider universe of stocks to research and have to consider market vulnerability and other factors that can be more pertinent for small cap companies, the task is

made somewhat easier as a result of the lower level of complexity of small cap companies.

The opportunities presented by small cap stocks are borne out by benchmark relative performance data for active managers as shown in Figure 3. This analysis of the relative performance of active managers broken out by capitalization focus over the last three, five, seven, and 10 year periods shows that small cap managers have added value versus the benchmark in all periods.

Figure 3. Opportunity for Excess Performance versus Benchmarks



Returns shown are the difference between the gross of fee median manager in eVestment separate account universes and the respective benchmarks. Benchmarks are Russell 2000 (Small Cap Equity), Russell Midcap, and Russell 1000 (Large Cap Equity). Returns are annualized periods ending December 31, 2014

Source: eVestment

Small Cap Fund Caveat Emptor

Investors who are considering including small cap equity funds as a strategic allocation within their portfolios are well served to shop wisely. As investors have surely learned by now, fees reduce long-term returns. Because active small cap fund fees are generally higher than those charged by mid cap or large cap actively-managed funds, investors need to know they are “getting what they paid for” when investing in an active small cap fund.

Unfortunately, this is not always the case. **According to the Reuters article, “Analysis: What’s in Your Small-Cap Fund? Try Boeing or Pfizer,”ⁱⁱⁱ nearly half of the 476 actively managed small cap funds tracked by Lipper own companies with market capitalizations of \$10 billion or more, including mega cap stocks like Boeing and Pfizer.**

There are many reasons why funds declaring a small cap mandate may own large and mid cap stocks. In some cases, a name initially purchased within the generally accepted small cap range will appreciate above the range before the manager is willing to sell. Portfolio managers, and the firms that employ them, try to walk a fine line between

maximizing revenue from increasing assets under management in a fund and avoiding the “style drift” that can occur when a strategy is asked to absorb more and more assets. A particular challenge for portfolio managers of small cap funds experiencing rapid asset growth is finding enough good stock ideas in which to invest, while avoiding owning so much of a name that trading becomes difficult should a decision be made to sell the holding. To the benefit of the investors who chose funds for pure asset class exposure, many small cap funds have closed to new investors before their asset base grew to levels that might impair the strategy’s ability to transact in the market efficiently. Unfortunately, maintaining a dedicated small cap focus is not a priority for all managers. While six small cap mutual funds with greater than \$5 billion in assets under management as of the end of 2014 are closed, eleven remain open.ⁱⁱⁱ

When small cap funds hold large and mid cap names, these funds might not produce the results investors are seeking. Investors building an equity portfolio with defined asset class targets will most likely have allocations to managers benchmarked to the S&P 500 or Russell 1000 or a mid cap strategy. When names from these indices wind up in small cap funds, the investor can essentially end up with unintended overlap exposure.

Overall portfolio risk can then increase because overlapping asset class exposure can diminish the diversification and potential return benefit the investor thought he or she was getting by investing in small cap stocks in the first place. Ironically, some of the largest small cap funds may seem attractive because of strong returns versus their peers and benchmarks recently, but investors might consider that these returns may be due in part to forced style drift rather than stock selection.

Large cap names in small cap funds also impair one of the key advantages of investing in active small cap funds—namely the ability to outperform passive benchmarks. It is no surprise that some of the larger-sized small cap mutual funds have failed to maintain the success they achieved with a smaller asset base.

Investors can avoid “large and mid cap in small cap clothing” funds by investing in index funds that are passively-managed versus the Russell 2000. However, as noted above, small caps are one of the few areas where managers on average have been able to outperform the index fairly consistently. Investors, or their advisers, who are looking for a true small cap fund with active management don’t need to look through every holding of a candidate fund’s annual report to make sure they are not buying Apple when they should be

buying TTM Technologies. Rather, they might look at the market cap of the fund's top 10 holdings or the weighted average market cap of the fund and compare it to that of the Russell 2000 benchmark. Both metrics will offer reliable indicators of whether or not a manager is drifting up in the market capitalization spectrum.

Conclusion

Small capitalization U.S. equities deserve consideration as a strategic allocation within diversified equity portfolios for the following reasons:

- In a total portfolio context, a market capitalization weight (roughly 10%) to small cap stocks would provide an investor with complete exposure to the entire U.S. equity market.
- Small cap companies are underfollowed by the analyst community and may offer a better opportunity for skillful active managers to add value versus benchmarks relative to large cap managers.
- Because there are significantly more small cap companies for active managers to choose from, those with the resources to analyze a broad investable universe have an advantage relative to their large cap peers.

As with any investment, it is important to exercise a high degree of diligence when choosing an active small cap fund. Small cap stocks, on average, are more volatile than large cap names, and therefore, investors or their advisors should carefully understand how potential managers handle risk management in their investment process.