THE CASE FOR SMALL CAP INVESTING

And What to Look for In a Manager

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Investing in equities has historically been a proven method for long-term wealth creation - US stock market investments increased shareholder wealth by more than $47 trillion between 1926 and 2019. Within the universe of equities, a striking pattern has been documented by scholars and investors alike: the consistent outperformance of smaller cap stocks compared to their larger cap counterparts. This differential, which has been substantiated by rigorous academic studies spanning extended market cycles, presents compelling opportunities for experienced investors.

Research Shows Company Size Impacts Returns

Foundational studies have extensively examined the relationship between firm size (as measured by market capitalization) and returns.

1. Ibbotson Associates:

Ibbotson's research has noted the historical trend of smaller companies outperforming larger ones over the long term.

2. Fama-French and CRSP:

The seminal work by Eugene Fama and Kenneth French, which utilized data from the Center for Research in Security Prices (CRSP), introduced the 'three-factor model.' They demonstrated that, in addition to market risk, two other factors – size and value – played a significant role in stock returns. Empirical evidence suggests the following long-term trends:

- Micro caps outperform small caps.
- Small cap outperforms mid cap.
- Mid cap outperforms large cap.

> **"...In addition to market risk, two other factors – size and value – played a significant role in stock returns...."**

Not All Small Cap Managers Are Created Equal

It is important for investors to understand that behind the "small cap" label, not all funds or managers operate identically. Over the past several years, much of the performance differential has been due to the **Market Cap Footprint** rather than a manager's stock picking prowess or investment style. When managers or funds hold investments in companies too long that they can grow from small cap to SMID (Small to Mid capitalization) size, causing their portfolio's market cap footprint to 'grow out of' the small cap advantage.

The Misconception Of Small Cap Exposure

Many professional advisors and investors believe they already have adequate small cap equity exposure. However, detailed analysis often reveals an unintended over-representation of SMID cap stocks. These investor portfolios might be missing the full potential of pure small caps. Introducing a dedicated small cap strategy, like that of Essex, can capture the benefit of genuine diversification that holds the potential of significantly enhanced returns.

The Current Landscape: Opportunities Amidst Confusion

The recent divergence in performance, especially between large and mega caps and small and micro caps, has been a source of concern for many market participants. This current phase is disconcerting -- however, it is not unprecedented. Historically, extended small and microcap "mispricing anomalies" have eventually encountered catalysts that subsequently led to a cycle of significant outperformance. Given the nature of mean reversion in markets, this sector of the market, in our opinion, is primed to generate substantial excess returns.

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Key Performance Drivers For Essex

Essex's approach to small cap investing is guided by several principles:

1. **Size (Market Cap):** Staying true to the small cap mandate is a foundational criterion. If unintentionally underexposed, investors can potentially miss significant opportunities.
2. **Quality Matters:** Strong fundamentals and robust balance sheets identified in their extensive investment research often translate to sustainable performance. Small cap benchmarks are capitalization weighted and less concentrated, and therefore give managers a better opportunity to beat the index through active security selection.
3. **Risk Dynamics:** Swings in broad market sentiment, often termed as "risk-on" or "risk-off", can influence returns, but also create future opportunities. During bullish, momentum-driven markets, fundamentals might take a backseat. During downturns or bearish phases, however, quality and fundamentals regain their importance.

Conclusion

Within an equity allocation, small cap stocks offer compelling risk/return opportunities. While their short-term volatility can be higher than their larger counterparts, history and research support a convincing case for their inclusion in a diversified portfolio. It is not just about boarding the small cap train. Choosing the right carriage that aligns with an investor's goals and objectives is essential for achieving stock market success.

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