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EVALUATING SMALL CAP GROWTH MANAGERS

Taking A Longer-Term View

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For financial advisors seeking to maximize investment returns, evaluating investment managers, especially small cap growth managers demand a longer-term perspective to be truly meaningful. Short-term (i.e. one-year numbers) may not reflect the manager's true potential and can misguide investment decisions.

The Problem with Short-Term Evaluation

When assessing the performance of small cap growth managers, focusing on short-term, specifically one-year numbers, is often misleading. Small cap stocks can be more volatile than large caps due to several factors, including market sentiment, economic conditions, and company-specific developments. Because of this, they may demonstrate substantial fluctuations within shorter periods, rendering a one-year assessment meaningless in deriving long-term value. Consequently, a snapshot of the short-term could inaccurately portray a manager's capabilities, potentially leading to erroneous investment allocations and advice.

Why Consider Long-Term Evaluation

Small cap stocks typically have a higher risk-return tradeoff, and their true value is often realized over longer time horizons. Evaluating managers over extended periods allows advisors to gain a more accurate understanding of their strategic approach, risk management, and decision-making processes.

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Ideal Time Horizon for Evaluation

Given the dynamic and risky nature of small cap stocks, a full market cycle of five to seven years is frequently considered ideal for evaluating the performance of small cap growth managers. This duration is ample to observe how a manager navigates through various market cycles, economic conditions, and unforeseen challenges, providing insights into their adaptability, resilience, and strategic acumen.

Long-term performance data offer a clearer depiction of a manager's skill in capital allocation, risk mitigation, and value creation, allowing advisors to make more informed and robust decisions. It allows for the analysis of cumulative returns, risk-adjusted returns, and the sustainability of the manager's strategy, which are pivotal in understanding the manager's effectiveness and reliability.

Opportunity in Underperformance

Interestingly, periods of relative underperformance by small cap managers can often represent opportune moments for allocations. When a manager underperforms, it may be attributed to a myriad of temporary factors, such as macroeconomic trends or short-term market reactions, which might not have lasting impacts on the intrinsic values of the underlying assets.

Investing during these periods can allow for purchasing assets at discounted prices, setting the stage for potential future gains when market conditions stabilize or improve. Advisors who can discern between temporary setbacks and fundamental issues can leverage such underperformance to optimize their investment portfolios.

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Conclusion

Looking beyond the short-term volatility, which will inevitably include some periods of underperformance, small cap growth stocks provide an opportunity for diversification in companies that have high growth potential and over the long term have been shown to often outperform their large cap counterparts. It is important to review a manager's performance over a full market cycle to evaluate their skill in navigating the small cap environment.

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