THE REWARDS OF ACTIVE INVESTING

vs. Passive Management in Small Cap

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The investing community has witnessed an increasing shift towards passive investment strategies in recent years, due to the proliferation of low-cost index funds and ETFs. While passive strategies may serve investors well in certain markets and asset classes, they can be problematic in the realm of small cap equity investing.

Here are some reasons why passive investments in small cap can fall short:

Active Small Cap Manager Research, Flexibility and Insights Contribute to Performance

A significant body of research suggests that active managers, particularly in the small cap space, have a better record of outperforming their benchmarks compared to those in large-cap spaces.

A study by the Financial Times in 2020 found that over a ten-year period, a majority of actively managed small-cap funds in both the US and Europe outperformed their passive counterparts. This can be attributed to several reasons:

1. **Better Information Access and Utilization:**

   In the small cap universe, there is often less analyst coverage, leading to situations where not all investors have the same information. Active managers, with their dedicated research teams, can seek out and exploit these inefficiencies better than a passive strategy which simply tracks an index.

2. **Flexibility Leads to Capturing Opportunity:**

   Active managers can quickly adapt to changing market conditions, rotating sectors, or exiting positions that no longer offer value. This dynamism can be especially valuable in the volatile world of small cap investing.

3. **Stock Picking Insights:**

   The ability to select potential 'winners' and avoid 'losers' can make a significant difference in the performance of a portfolio, especially in the small cap space where company fortunes can change rapidly.

> **"...Active managers, particularly in the small cap space, have a better record of outperforming their benchmarks compared to those in the large cap spaces...."**

Active Managers Exploit Mispricing in Small Cap Markets

Unlike large cap stocks, which are widely researched and followed, small cap stocks are often under-researched. This lack of coverage means there is a higher chance of mispriced securities existing in the market. Active managers, with their research capabilities and expertise, are in a better position to take timely advantage of these inefficiencies and potentially provide better returns.

Reducing Sector Risk with Active Investing

Passive investing in small cap equity has the potential for significant overconcentration in particular sectors within small cap value and small cap growth benchmarks. This is mainly because these indices are market-capitalization weighted, meaning larger companies in the small cap universe have an outsized influence on the benchmark's performance.

For example, if the small cap sector is dominated by specific industries, such as biotech, technology or financials, passive investors could find themselves overly exposed to these industries, amplifying sector-specific risks. This concentration can be especially pronounced in smaller cap benchmarks which are typically less diversified across sectors compared to their larger capitalization counterparts.

Overexposure to a specific sector can increase risk, especially when that sector undergoes volatility or a downturn. For passive investors who assume they are gaining broad exposure to the small cap universe, this can come as an unwelcome surprise.

> "...Active managers can quickly adapt to changing market conditions...."

Conclusion

Passive investments can be an important part of a larger portfolio, offering lower costs and a straightforward way to invest in diverse styles and market capitalizations, but it is essential for investors to understand where these strategies might fall short. In the realm of small cap equity investing, the overconcentration risk and the consistent outperformance of active managers make a compelling case for an active approach.

Incorporating an active strategy does not mean forsaking the principles of diversification or cost efficiency. Instead, it means embracing a more nuanced approach to portfolio construction, one that recognizes the unique challenges and opportunities presented by the small cap universe. As with all investment decisions, it is crucial for investors to assess their risk tolerance, time horizon, and investment goals when choosing the right strategy for them.