Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Micro Matters

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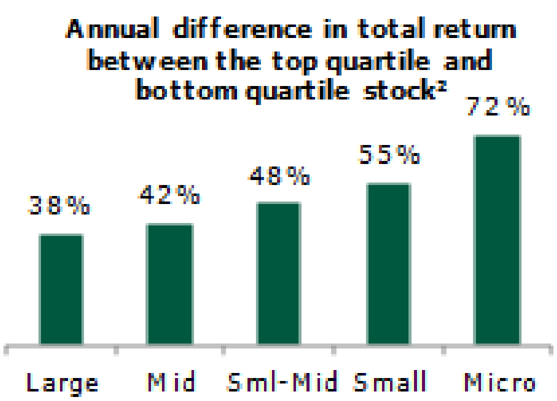
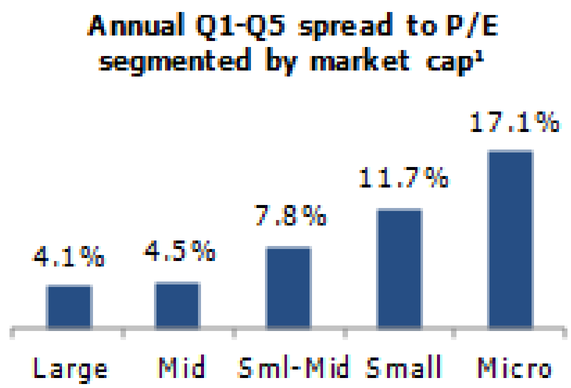
One of the most important considerations when developing new strategies is determining where your investment process has the greatest advantage in producing performance to meet client expectations. There are numerous variables that affect performance but if your investment goals are focused on generating large returns then small size defined by market cap is most likely where you should focus your attention. Focusing on smaller market stocks greatly enhances both the magnitude and consistency of returns. We have many theories as to why this occurs but I tend to center around the fact that smaller cap companies generally have a much larger range of returns in their universe than larger companies. In addition, since most money managers require a certain level of assets in order to generate a minimum level of fee income they often exclude smaller, less liquid stocks leaving considerable market inefficiency intact.

One way of measuring the difference in return potential is what we'll call the inter-quartile range of returns. This calculates the difference between the 25th percentile and the 75th percentile stock as measured by total return. This difference essentially illustrates what annual return would be possible if, using perfect foresight, you went long the top quartile stock and shorted the bottom quartile stock.

The chart below displays the typical range of annual returns of the largest 3000 stocks segmented into five baskets based on market capitalization. The 72% return potential is considerably higher for microcap stocks than even for small stocks at 55%. Extending this analysis to evaluate the performance potential to one of the most



commonly used generic investment metrics, price/earnings ratio, yields an even greater spread. As the top right chart details, the same pattern emerges when evaluating the performance spread between high and low P/E stocks. The method of measurement varies slightly, however, the magnitude of return spread in micro cap stocks is nearly four times as high as those in the large cap universe, a clear advantage.



Not only does the magnitude of return increase as you move down the cap spectrum but the consistency of return also greatly increases (as illustrated in the two charts on page 2). Using only P/E as an investment strategy in large cap stocks would likely have produced a very erratic return pattern over the past 16 years. However, the same P/E strategy using microcap stocks as the investment universe would have theoretically produced sizable returns for nearly every calendar year since 1998 (bottom chart). The consistency of return in microcap stocks is rather striking, given that we are using the exact same methodology for selecting stocks as in large cap while only modifying the investment universe.

[1] Average annual difference between 1st and 5th quintile returns for Russell 3000 stocks sorted into quintiles by size and by price/earnings ratio during the period 1998—2012

[2] Average annual difference between 25th and 75th percentile returns for Russell 3000 stocks sorted into quintiles by size during the period 1998—2012

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It's important to note that investing in microcap stocks bear increased risks relative to large cap stocks both in terms of volatility and in the ability to implement the strategy, given low trading liquidity of these names. That being said, finding creative ways to invest in the smallest segment of the market can yield tremendous benefits in achieving performance goals.