Educated Investing

Sweating the Small Stuff

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Despite relatively smaller assets under management, the MPSIF Small Cap Fund is faced with the same daunting decisions as professional and amateur investors alike: everyone seems to agree that the market has gotten ahead of itself... but what should we do about it now? Sit on the sidelines and wait for the “expected” market correction, or just get back in and avoid missing the next leg up? As a fund, our goal is simple: produce absolute returns by investing in Small Capitalization companies and collectively outperform our benchmark. While the mandate is clear, the “how to get there” part is not quite as simple.

From 2002-2007, earning returns in the stock market seemed pretty easy. The S&P did not return less than a positive 4.8%, and the VIX was consistently low. Earnings quality was very strong across sectors and characterized by high demand, largely driven by a free-spending consumer (who was obviously, a little too free). In sum, stocks tended to go up more than they went down, and the end result was a multiple-year bull market that essentially implied most securities, no matter how complex, could still make investors money—even with little due diligence prior to pulling the trigger. As portfolio sizes grew, so did the need to “rebalance” and “reallocate” into even riskier asset classes for greater diversification benefits.

Given this pre-crisis mindset, the effects of skyrocketing unemployment, weak consumer confidence, and the ongoing pain of deleveraging has had a severely negative impact on manager and investor psyche. Last year, the flight to “quality” (or the tendency for managers to invest in large, established, “safe havens”) meant many managers simply shifted into larger capitalization companies, only to discover more risk and less return (think GE… or even better… GM). This is the primary reason why we believe MPSIF Small Cap is uniquely positioned this year. In our view, “thinking small” can generate outsized returns going forward.

Great small companies are characterized by agility, flexibility, and adaptability, with minimal bureaucracy and-- most importantly-- innovation. From 1927 to 2007 Ibbotson Associates has cited Small Cap stocks as outperforming Large Caps by more than 7%. Though this is not a risk adjusted measurement, one can surmise that the future success of the U.S. equity markets and overall economy will rely heavily upon this country’s ability to spend the time sweating the small
stuff—by finding and supporting the small companies that truly define the U.S. competitive position. If there is one characteristic of our economy that distinguishes it from other developed and developing countries, it’s the ability of our workforce to remain flexible and continually innovate.

So—when do we start innovating as a fund? In order to understand how Small Cap should position itself going forward, it is important to understand where we stand today. Like everyone else, the Small Cap psyche has been pummeled too. As a result, we’ve seen our cash position increase to almost 65% of total fund assets since last semester. Though this “cash drag” has lead to some short term underperformance against our Russell 2000 benchmark, it creates a tremendous opportunity for the fund to reevaluate current market conditions and strategically deploy our capital to capture long-term gains. Over the coming semesters, the fund will be making real time decisions as to which companies can best capitalize on their intellectual ability to innovate.

Small Cap’s success will depend also on our analyst’s ability to innovate. We will use traditional bottom up analysis for corporate governance, ownership, financials and valuations but apply our own unique metrics. A top down methodology will overlay our analysis via thorough sector coverage teams. We will be thinking like venture capitalists, diversifying across niches, focusing on strong cash flow, and challenging each other daily with the same questions that investment committees around the world are considering in these challenging times. Our task is to focus on fundamentals that have been overlooked consistently over the past years.

Though the markets have shown tremendous resiliency over the past 5 months, we will re-enter the market with prudence and fiduciary responsibility. We remain convinced that great things come in small packages.