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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

THINKING SMALL: This Could Be Big?!?

Eye on the Market ("EotM") believes market participants seeking investment ideas out of the mainstream need to think small. In this case, small-capitalization ("small-cap") companies. These are typically companies that have a single line of business or may only focus on a distinct geographical footprint, as they do not have the scale to do business more broadly. With this in mind, EotM will look at what should be considered when allocating to small-cap equity.

BANTAM VS. HEAVYWEIGHT

In a boxing match, very few spectators would wager that the bantam or lightweight fighter would stand much of a chance against a heavyweight. While this may be the case in boxing, the world of investing gives the small-cap company a fighting chance. Not every company will be a star prizefighter, with its name up on the marquee, but there has been historical precedence for small-cap stocks to out-jab their larger brethren. When examining performance returns since 1979, which corresponds to the inception date of the Russell 1000* ("large-cap") and Russell 2000* ("small-cap") indexes, the data is mixed as shown in Table 1. Over the 38-year period, small caps outperformed large caps 53% of the time on a calendar year basis, which implies that the bantam-weight fighter can, and does, beat its heavyweight competitor, but not in a unanimous decision.

Table 1

SMALL-CAPS VS. LARGE-CAPS (Calendar Years 1979 - 2016)	
# Years Small-Caps Outperform	20
# Years Small-Caps Underperform	18
Average Outperformance (%)	8.16
Average Underperformance (%)	-8.55

Source: Morningstar Direct and Raymond James

This does not imply that small caps can't hold their weight. Just as different styles of investing come into and out of favor, small-cap stocks will outperform during certain periods and underperform during others.

*Index definitions can be found on page 4.

MINOR LEAGUE VS. MAJOR LEAGUE

While the performance comparison on the previous page may not be convincing, Chart 1 highlights that a U.S. small-cap investor would have outperformed a U.S. large-cap investor over the last 20 years with the majority of the outperformance occurring between March 2009 and the present (as circled in light blue). It is worth noting that in the late 1990s, large-cap companies outperformed, coinciding with the technology bubble.

Chart 1*

Source: Morningstar Direct and Raymond James.

Investors need to understand that many small-cap companies do not have the same analyst research coverage as larger, more well-known companies. This leads to a possible dilemma and a potential opportunity, given the number of companies in the Russell 2000 Index*. Where does an enterprising investor start? EotM would point to the 2003 book *Moneyball: The Art of Winning an Unfair Game* by Michael Lewis as a suggested starting point. For those EotM readers who are not familiar with the book, the basic premise is that baseball executives used a combination of quantitative data to review and analyze players. The quantitative information was incorporated into the executive's qualitative review in order to make personnel decisions. In a similar manner, many portfolio managers tasked with selecting small-cap companies use a range of quantitative tools to help identify what they believe are positive attributes. This helps them focus on those companies they believe will help a portfolio achieve its objectives. In many ways, this is similar to a baseball team identifying talented players in the minor leagues and bringing them up into the big leagues.

A logical question an investor could ask is, how have non-U.S. small caps faired relative to non-U.S. large-cap companies? As Chart 2 indicates, since the inception of the MSCI EAFE Small-Cap Index* on December 29, 2000, non-U.S. small-cap companies from developed nations have outperformed their large-cap peers in a meaningful way. Just as baseball teams have stretches of good years and bad years, this trend will likely not last forever.

Chart 2*

Source: Morningstar Direct and Raymond James.

SMALL FISH IN A BIG POND OR A BIG FISH IN A SMALL POND

Since active managers within the small-cap space typically focus on companies the average investor is unfamiliar with, many management teams utilize quantitative tools to help screen the universe, as well as rely on meeting with company management personally as part of their evaluation. Having an ongoing dialogue with executives helps the investment managers understand what direction a CEO may be taking the company. Additionally, it helps the investment manager assess the competitive landscape and possibly surface new ideas.

> *"... investing in small-cap companies is best suited for active management, as there is a range of inefficiencies that can either be exploited as opportunities or avoided as potential risks."*

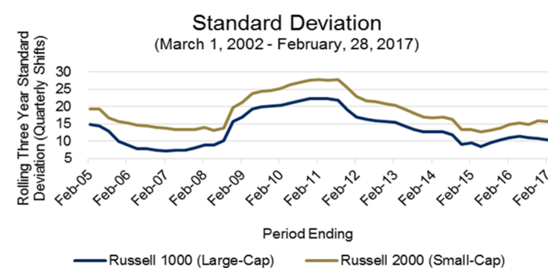
*Index definitions can be found on page 4.

To that end, MFRM believes that investing in small-cap companies is best suited for active management, as there is a range of inefficiencies that can either be exploited as opportunities or avoided as potential risks. Given the large number of small-cap companies – both domestically and internationally – having a repeatable process in place is key for active managers to understand what drives revenue growth, how a company is managing expenses, and how all of this impacts earnings.

One of the risks small-cap managers face is liquidity risk, as this may impact how challenging it is to purchase or sell an individual stock. For example, an investment manager may believe that ACME Inc. is a great company, but if she cannot buy and/or sell shares in a timely and efficient manner, ACME would likely not be included in the portfolio. An additional challenge around liquidity pertains to those small-cap strategies that take in a sizeable amount of money, which could severely limit how effective a manager is at implementing those cash flows. As her portfolio becomes larger in terms of assets, she will find it more challenging to buy additional shares of these smaller companies.

Another consideration for small-cap investors is that they are more volatile (as measured by standard deviation) than their large-cap peers, as shown on Chart 3. This matters, as investors often become more risk averse when markets are declining. In the event that our investor has holdings in a small-cap portfolio, it could decline more meaningfully than the broader markets. An attraction of investing in small-cap stocks is that the upside deviation is higher, which can lead to outperformance versus the broader market.

Chart 3*



Source: Morningstar Direct and Raymond James.

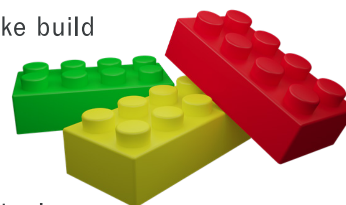
Each of the aforementioned factors are important and must be taken into consideration for both professional and armchair investors. Those that get it right can find themselves being the big fish in the little pond.

LIGHT AND NIMBLE

As an investor considers which manager to choose, particularly among active managers, EotM would emphasize she remain focused on the four **P**s: **P**eople, **P**rocess, **P**hilosophy, and **P**erformance. With these in mind, she should be able to identify portfolio management teams that have demonstrated the ability to navigate portfolios through a variety of market conditions by sticking to their process. Furthermore, having a sound investment philosophy should help them weather most storms.

SIDE NOTE

Just as investors build portfolios with individual elements, children and adults alike build things with Legos®. By combining individual pieces, creations of varying sizes can be constructed. The smallest Lego® piece is the 1x1 round or square tile. In 2013, a life-sized X-Wing Fighter was assembled out of 5,335,200 individual Lego® bricks. The structure was almost 11 feet tall, 43 feet long, and weighed nearly 46,000 pounds. With a little patience, putting many small things together can result in the next big thing!



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RUSSELL 1000 INDEX – offers investors access to the extensive large-cap segment of the U.S. equity universe representing approximately 92% of the U.S. market. The Russell 1000 includes the largest 1000 securities in the Russell 3000.

RUSSELL 2000 INDEX – offers investors access to the small-cap segment of the U.S. equity universe. The Russell 2000 includes the smallest 2000 securities in the Russell 3000.

MSCI EAFE INDEX – a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. It is maintained by MSCI Barra, a provider of investment decision support tools; the EAFE acronym stands for Europe, Australasia and Far East.

MSCI EAFE SMALL CAP INDEX – an equity index which captures small cap representation across Developed Markets countries around the world, excluding the US and Canada. With 2,224 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and ETFs before investing. The prospectus contains this and other information about mutual funds and ETFs. The prospectus is available by contacting the fund family and should be read carefully before investing.

Indices are not available for direct investment.

Diversification and strategic asset allocation do not ensure a profit or protect against a loss. The process of rebalancing may carry tax consequences.

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