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FEATURE INVESTMENT

Capturing the small cap premium and the danger of concentration

John Looby looks at the issue of concentration in small cap portfolios

AT A GLANCE

- There are thousands of funds in the small cap index so it is a challenge to put them into credible groups
- To move away from the danger of concentration, the conventional case against diversification – it stymies potential alpha – must be debunked

No matter how talented the investor, in time they will inevitably suffer the challenge of bad luck. The recent experience of some of the most talented investors in the world, in the US pharmaceutical stock Valeant, is one example.

Valeant Pharmaceutical was a favoured holding and stellar performer for the likes of the Sequoia Fund, and Bill Ackman – the billionaire activist investor at Pershing Square. For Valeant, a business model of aggressive expansion via acquisition, coupled with a slashing of traditional research and development costs, seemed to be a formula for super-normal returns.

On 21 September Democratic presidential hopeful Hillary Clinton focused unwelcome attention on the business models of some pharmaceutical companies by stating her determination to tackle their 'price gouging'.

A month later, the falling Valeant stock price began to crumble. The company remains mired in controversy.

Of the roughly $7.5bn (£5.2bn) in the Sequoia Fund, 29% was invested in Valeant. Bill Ackman disclosed last March that Pershing Square had a materially large exposure to Valeant as the third largest shareholder, with a stake of almost 6% though this was then increased to 9.9%.

For the stock investor, this is the unavoidable danger of exposure to a concentrated portfolio.

Individual small cap stocks are generally riskier than their larger cap counterparts. The unavoidable danger of concentration is therefore magnified

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The small cap premium

The existence of the 'small cap premium' has been convincingly established by many historical studies. While the case for having exposure to small caps to benefit from this premium is compelling, the challenge of achieving this exposure is daunting.

The universe is vast. There are currently more than 4,300 stocks in the MSCI World Small Cap Index. Breaking this down into a credible group of potential investments is just the first step.

With their more limited access to capital markets, individual small cap stocks are generally riskier than their larger cap counterparts. The unavoidable danger of concentration is therefore magnified.

The diversified and dividend oriented solution

In order to move away from the danger of concentration, the conventional case against diversification – that it stymies potential alpha – needs to be debunked. The downside protection benefits of broad diversification can actually be enjoyed without giving up the potential to harvest lots of alpha.

This is illustrated by the chart below, which shows the 24 MSCI industry groups and their performance in the small cap universe over the past three years:

The white boxes show the index or market-cap weighted returns for each group. Most managers spend a great deal of time tilting between these boxes in the hope of capturing alpha. In doing so, they are necessarily becoming more concentrated in their exposure.

Now consider the dark blue lines showing the dispersion of returns within each industry group – in every case, this is markedly greater than the differences between them. This confirms the tantalising prospect of being able to construct very broadly diversified portfolios, benefitting from all of the downside comfort implicit in that, while also being able to harvest lots of potential alpha.

Small caps don't (or can't) issue bonds to the same extent as large caps. When they do, their credit ratings are generally lower, making the cost of this debt generally higher. Indeed, small caps often have little alternative than to get shareholders to fund them, regardless of the prevailing cost of equity.

For these reasons, a process with a very definite dividend orientation is particularly beneficial. By enforcing greater capital discipline and management focus on returns rather than size, a dividend-oriented process is likely a greater necessity and benefit in constructing small cap portfolios.

Range and Index Returns – latest three years (cumulative return) – (axis capped at 250 for ease of display)