Small Choices

Advisers find they can make small-cap investments flourish by turning to passive products, like ETFs and index funds.

By Susan Weiner

December 1, 2004- What can you say about small-cap funds? Yes, they are historically one of the first products that financial advisers turn to when attempting to diversify their clients' portfolios away from large-cap core holdings. And yes, while small caps are more volatile than their larger- cap counterparts, they are valuable for their potential to reduce portfolio risk.

Experienced planners have known this for a long time, of course. But there's a new trend today that's affecting portfolio management: index funds and especially exchange-traded funds (ETFs) are fast becoming the investment of choice for advisers in the small-cap world.

Conventional wisdom has long held that actively managed small-cap funds have a better chance of outperforming than their large-cap peers. The market for small-cap stocks is less efficient, so effective managers are able to uncover good stocks before their competitors. Or so the theory goes. But maybe the theory is wrong, especially when planners consider other issues.

For starters, financial advisers like the lower expense levels of index funds and ETFs. Actively managed funds are too expensive, says Darryl J. Jarmosco, CFP and president of Jarmosco Financial Planning in Grand Haven, Mich. Jarmosco uses iShares Russell 2000, an ETF, to fill the small-cap position in his client portfolios.

"A passive or semi-passive approach tends to minimize higher trading costs for these stocks and ensures a high level of diversification for a high-volatility asset class," agrees Mark Gleason, CFA and a senior financial adviser at Wescap Management Group in Burbank, Calif. Gleason cites Bridgeway and Dimensional Fund Advisors (DFA) as examples: Bridgeway, a fund family aimed especially at long-term investors, boasts of its low costs; DFA offers funds that incorporate various sophisticated techniques within a passive strategy.

Tom Taggart, a San Francisco-based spokesman for Barclays Global Investors (BGI), which manages the iShares family of ETFs, explains that from the ETF provider's point of view, it appears that financial advisers are asking themselves, "Where can I go to buy market exposure at a low cost?"

Some of those advisers are then looking for alpha--a return in excess of the market--from active managers. This quest for alpha has spread even further among institutional investors, according to Taggart.

The Barclays' spokesman and some others point out ETFs have some additional advantages-

-not all of which are shared by index mutual funds. They include the following:

Transparency. Mutual funds disclose their holdings only twice a year.

Lack of style drift. This is a trait ETFs share with index mutual funds. Style drift is one of financial advisers' bigger concerns. "Let's face it," Jarmosco says. "[Actively] managed funds do whatever it takes to better the numbers before the end of a quarter or year-end." Other gripes include small-cap managers holding their winners long after they have graduated to mid-cap status or raising cash positions when they can't find any stocks they deem attractive.

Ease of purchase. ETFs can be purchased anywhere that you buy stocks. On the other hand, not all mutual fund families are available from all providers.

Ability to short sell. ETFs allow you to sell small-cap stocks short easily if you believe that they are going to underperform. Such short selling is impossible to do with mutual funds.

Low turnover. Advisers note that ETF turnover, like that of index funds, tends to be low, which can help investors to avoid taxable capital gains.

John Montgomery, the founder of Houston-based Bridgeway Capital Management, sees some of these ETF characteristics as drawbacks, not advantages. "You couldn't get this kind of return in an ETF structure, where you must disclose all of your holdings [in] real time," he claims, referring to the performance of one of his mutual funds.

Montgomery also says ETFs can't be managed specifically for tax efficiency. In contrast, he points to his firm's Blue Chip 35 Fund, which he says has yet to pay out a capital gain. And while many advisers praise the low turnover that has kept ETFs fairly tax efficient in their experience so far, Wescap's Gleason isn't convinced. "It's not clear to us how tax efficient they are going to be in the long run," he says.

Of course, ETFs do have drawbacks. Commissions can eat up a lot of money in an account that does a lot of trading, particularly if lot sizes are small. Also, there are some asset classes for which ETFs do not yet exist.

And believers in actively managed small-cap funds still exist. But some of the best actively managed funds frustrate financial advisers.

"I still subscribe to the thinking that a good small-cap fund manager has a better chance of beating the benchmark than a large-cap manager, " says Warren McIntyre, CFP and principal at VisionQuest Financial Planning in Troy, Mich. "The biggest issue I see with actively managed small-cap funds today is that the best ones keep closing," he adds.

The frequent closings of actively managed small-cap funds is a problem peculiar to that asset class. After a small-cap fund's assets exceed $1 billion, performance tends to suffer because of lack of liquidity in small-cap stocks, says Andrew Clark, a senior research analyst with New York-based Lipper.

"We like to close our funds early in order to preserve the opportunity to be more nimble with investment choices," Montgomery says. Bridgeway's two top performers--Aggressive Investors 1 and Ultra-Small Company funds--closed at levels below the industry norm. However, Montgomery notes that "our two new funds--Small Cap Value and Small Cap Growth--are designed to hold significantly more capacity."

Some advisers are feeling the strain of frequent small-cap fund closings. "I am now considering utilizing an index fund," says F. Dennis De Stefano, CPA, CFP, and founder of De Stefano Wealth Management in Maui, Hawaii. "It's not that I prefer them to actively managed funds, but it's hard to find quality small-cap funds, and it takes me a lot of time to

perform the due diligence on any new funds." In addition, De Stefano still has to track the closed funds that he retains in taxable client accounts due to capital gains issues. This requires the investment of even more time.

Some advisers cover their allocation to small caps with an index or a blend fund. It is probably more common to cover small caps than large caps with one fund, especially in the smaller accounts. That's because small caps typically represent a small percentage of a portfolio compared to large caps.

Other financial advisers like to cover the Morningstar style boxes by combining small-cap value, growth, and blend funds. Making a bid to make this task a little bit easier for interested advisers, Barclays Global Investors has included the Morningstar Small Value, Small Growth, and Small Core Index products in a recent launch of nine iShares Morningstar Index ETFs during the summer of 2004. The new product sounds like a

natural for the financial adviser market, but the response so far has been slow, according to BGI's Taggart.

Some advisers prefer small-cap value to small-cap growth. De Stefano Wealth Management recently switched from a balanced allocation to a 60%-40% split between value and growth stocks. "We believe that the current and foreseeable future investment environment right now favors risk management—essentially value stocks," De Stefano says.

Small-cap growth investing seems to be too risky to some. "The asset class doesn't have sufficient long-term return to justify the increased risk," says Adam Leavitt, president of Red Rock Financial Advisory in Tulsa, Okla.

Others prefer to explore the broader reaches of small-cap investing. Gleason, for example, says that he prefers microcap over small-cap stocks and considers investing in small-cap foreign stocks as part of the small-cap allocation. "While several small-cap ETFs exist, there are none for microcaps or small-cap foreign stocks, so ETFs aren't much use to us." Unfortunately, the challenge of creating these ETFs means they're not high on BGI's "to-do list."

Sherman Doll, CPA/PFS, a partner in Capital Performance Advisors in Walnut Creek, Calif., also favors the smaller stocks. "The Fama French three-factor equity model shows an expected excess return above the market of 3.77% for the Russell 2000 index, but an even greater 4.71% excess return for [the stocks in the ninth and tenth deciles of market capitalization]," his marketing materials say.

So how small are those small stocks? According to Barry Simorangkir, senior database researcher at the University of Chicago's Center for Research in Security Prices at the University of Chicago, those stocks falling within the ninth and tenth deciles of market capitalization are microcaps with a market capitalization of roughly $500 million or less as of September 2004.

Indeed, two ultra-small Bridgeway funds are among the top four small-cap fund performers over the past five years (see "Small Funds, Big Performance" below). "We like to say ultra-small stocks are as statistically different from microcaps as microcaps are to the S&P 500," Montgomery says.

Small Funds, Big Performance

Here are the top 25 small-cap funds, ranked according to their five-year rate of return.

	Category	YTD Return	1-Yr. Return	3-Yr. Return	5-Yr. Return	10-Yr. Return	Net Assets ($MM)
CGM Focus	Blend	7.5%	29.7%	26.8%	32.7%	N/A	851.53
Bridgeway Ultra-Sm Co	Blend	1.8	18.8	32.1	30.4	23.3%	100.21
Wasatch Micro Cap	Growth	-2.6	10.0	17.7	25.4	N/A	518.58
Bridgeway Ultra-Sm Co Mkt Fd	Blend	3.6	22.0	32.0	24.9	N/A	711.36
RS Partners	Blend	16.4	36.0	30.1	24.6	N/A	1,672.19
Bjurman, Barry Micro-Cap Gr	Growth	-10.8	4.2	14.2	24.1	N/A	609.01
Hotchkis & Wiley Sm Cap Val I	Value	12.2	34.3	30.0	24.0	15.8	609.34
Turner Micro Cap Gr	Growth	7.1	23.5	16.8	23.8	N/A	366.53
Boston Partners Sm Cap Val II Inv	Value	2.3	18.0	17.5	23.5	N/A	466.24
N/I Numeric Inv Sm Cap Val	Value	7.5	26.1	23.5	23.2	N/A	221.00
Schneider Sm Cap Val	Value	7.7	46.0	32.5	22.6	N/A	50.31
Perritt Micro Cap Opp	Blend	2.2	20.0	27.3	22.5	14.7	187.26
Wasatch Sm Cap Val	Blend	4.3	19.7	14.7	21.7	N/A	734.37
Buffalo Sm Cap	Growth	12.0	25.5	17.5	21.3	N/A	1,688.48
Pacific Capital SmCap A	Value	8.8	29.6	22.0	19.8	N/A	135.88
Strong Advisor Sm Cap Val Z	Blend	7.5	29.7	20.5	19.5	N/A	1,967.58
Royce Capital Sm-Cap	Blend	12.3	26.7	20.3	19.5	N/A	78.61
Royce Capital Micro-Cap	Blend	2.9	17.2	17.9	19.1	N/A	288.88
Am Century Sm Cap Val Inv	Value	8.4	24.2	15.5	19.0	N/A	1,856.61
Royce Opportunity Inv	Value	2.3	22.6	21.2	18.9	N/A	1,789.68

Source: Morningstar; returns through Sept. 30, 2004. Three- and five-year returns are annualized figures.

There's always room to debate what the future holds for small-cap stocks. Small caps' winning streak may now be winding down, according to recent comments by Preston Athey, manager of the T. Rowe Price Small-Cap Value Fund, speaking to the Boston Security Analysts Society on Sept. 27.

Historically, the outperformance of small caps over large caps has lasted an average of 5.6 years. That's just about as long as the current cycle. Small-cap valuations aren't attractive relative to large-cap stocks. Finally, the economic cycle suggests it's time for large caps to outperform. The leadership of small-cap stocks coming out of a recession or market correction may have run its course.

Some advisers agree. "Late last year, we trimmed our small-cap positions to a neutral weighting, in anticipation of a leadership change," notes Mark Tarbox, CFP, CPA, and vice president at Tarbox Equity in Newport Beach, Calif.

Louise Yamada, managing director and head of technical research at Smith Barney, takes a different view. "Small- and mid-cap stocks are still outperforming in what we believe is a multiyear structural outperformance cycle similar to 1975-1983," she wrote in the Sept. 16 edition of the *Smith Barney Portfolio Strategist.* In an interview, Yamada adds that small- and mid-caps stocks have led the advance-decline line to new highs. Moreover, as of Oct. 29, the S&P 600 and S&P 400—unlike the S&P 500—hadn't broken their 18-year uptrend.

Could this outperformance run eight years—into 2009—as did the cycle that started in 1975? Yamada is on the lookout for deterioration in this trend, but sees none so far.

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