Palisade
CAPITAL MANAGEMENT

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SMALL CAP EQUITIES AND THE CASE FOR CORE

Mitigating the perils of concentration risk and overdiversification

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As institutional investors continue to search for solutions to help meet their risk and return objectives, small cap equity strategies remain compelling. However, once an investment program decides to invest in the small cap asset class, allocation decisions within the small cap universe can have a significant impact on a portfolio's risk profile and returns. The small cap universe is very broad and encompasses both active and passive strategies, a spectrum representing deep value, aggressive growth, and everything in between. Traditionally, the small cap universe is segmented into three style categories – growth, core, and value – in addition to the active/passive dichotomy. If the allocation decision among these styles is not made properly, an investment program may be exposed to unintended risks, as well as risks that may not have been considered.

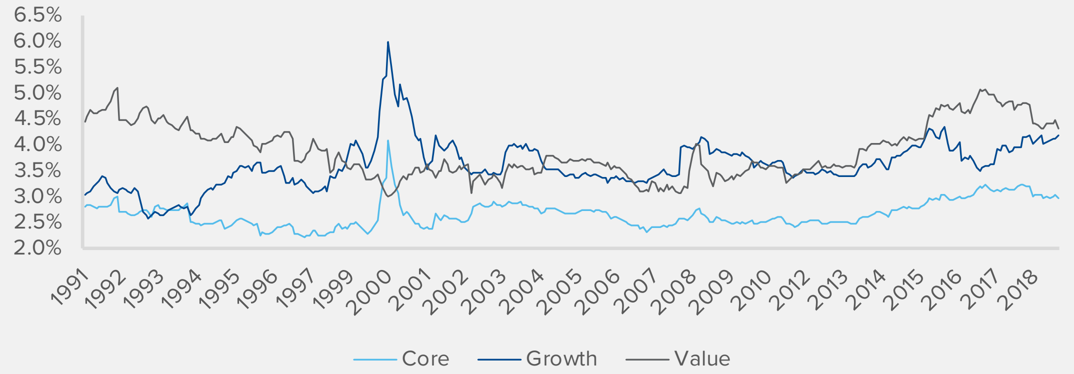
The composition of the growth and value benchmarks within small cap equities has evolved and created an often-overlooked pitfall – the potential for unwanted industry concentration and portfolio exposures. We believe that active small cap core equity investing, which incorporates stocks with both value and growth characteristics, represents a better solution. By combining the benefits of growth and value investing, along with the diversification and alpha potential of actively investing in smaller companies, we believe active small cap core equity could represent the best of the small cap universe. Active small cap core offers a compelling solution for institutional investors seeking to streamline the number of strategies in their portfolios, limit difficult allocation decisions within the small cap universe, maintain an effective level of diversification, and meet their risk–return objectives.

HOW TO AVOID AMPLIFYING CONCENTRATION RISK

According to our analysis, institutional investors may be subjecting their portfolios to both industry concentration and volatile changes in exposures by committing to a growth- or value-style small cap equity strategy. We first look at a three-decade view of historical trends in the Russell 2000® Index and its growth and value counterparts. Figure 1 below represents the standard deviation of industry group weightings in small cap growth, value, and core on a historical basis. In Figure 1, a higher standard deviation indicates a wider level of dispersion amongst industry group weightings, implying a greater concentration in certain industry groups. This figure demonstrates that the industry group weightings in core have less dispersion, less concentration, and more stability over time. Growth or value investors may be unaware of the potential hazards posed by their choice of style and, as a result, could be at risk from unintended and fluctuating industry concentrations.

FIGURE 1: SMALL CAP CORE ENJOYS MORE STABLE INDUSTRY WEIGHTINGS

STANDARD DEVIATION OF INDUSTRY GROUP WEIGHTINGS IN SMALL CAP CORE, GROWTH, AND VALUE

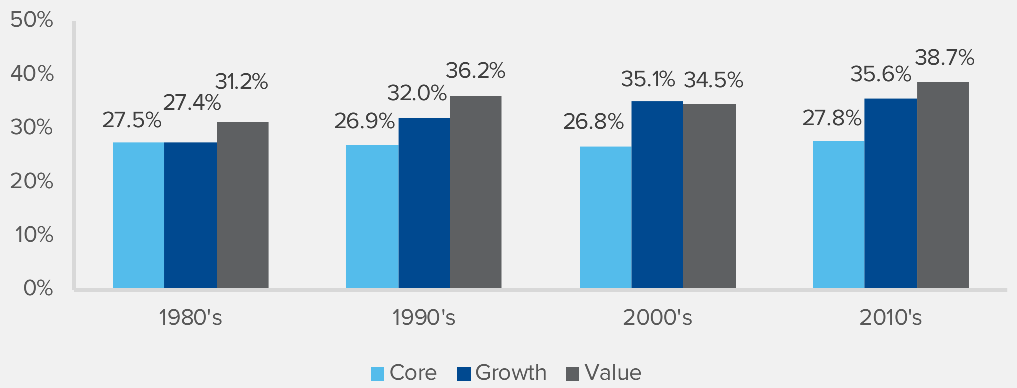


Source: Furey Research Partners and FactSet, as of March 31, 2019.
Small cap core equities represented by the Russell 2000® Index. Small cap growth equities represented by the Russell 2000® Growth Index. Small cap value equities represented by the Russell 2000® Value Index.

Concentration risk in small cap growth and value is even more apparent when analyzing the aggregate weight of the top three industry groups in the core, growth, and value indices. Figure 2 below evidences heavier industry concentrations in growth and value, which could place portfolios at greater risk from overexposure to just a few dominant industry groups. Moreover, while the level of industry concentration in small cap core has remained fairly level over the past four decades, concentration levels of the top three industry groups in growth and value have continued to climb, with no indication that this trend will cease in the near term. Again, growth or value investors may be unaware of this hazard and, as a result, could be at risk from these unintended industry bets.

FIGURE 2: CORE LESS VULNERABLE TO INDUSTRY CONCENTRATION RISK

AVERAGE AGGREGATE WEIGHT OF TOP THREE INDUSTRY GROUPS IN SMALL CAP CORE, GROWTH, AND VALUE



Source: Furey Research Partners and FactSet, as of March 31, 2019.
Small cap core equities represented by the Russell 2000® Index. Small cap growth equities represented by the Russell 2000® Growth Index. Small cap value equities represented by the Russell 2000® Value Index.

Our analysis of industry concentrations also underscores some of the inherent biases within certain styles. Not surprisingly, the Information Technology and Health Care sectors are dominant within the growth style, whereas the Financials and Real Estate sectors are disproportionately represented in the value index.[1]

Industry concentration has concrete effects on performance. Figure 3 below, an analysis of returns over the past decade, indicates that the top three contributing industry groups in the small cap growth and value indices account for a significantly greater proportion of each indices' respective returns. Again, this suggests that an investor's exposure to small cap growth and value styles by themselves could increase concentration risk and industry-specific sensitivities in an institutional portfolio. If an investor wanted to exploit fluctuating concentrations and time their allocation decisions between value and growth based on particular points of inflection, there are myriad potential challenges, such as transaction costs and how to determine the optimal time to make such a move.

FIGURE 3: GROWTH AND VALUE RETURNS MORE RELIANT ON TOP INDUSTRY WEIGHTS

PROPORTION OF RETURNS FROM TOP THREE INDUSTRY GROUPS – 10-YEAR PERIOD FOR SMALL CAP CORE, GROWTH, AND VALUE

Source: Furey Research Partners and FactSet, as of March 31, 2019.
Small cap core equities represented by the Russell 2000® Index. Small cap growth equities represented by the Russell 2000® Growth Index. Small cap value equities represented by the Russell 2000® Value Index.

THE PERILS OF OVERDIVERSIFICATION

Based on the empirical evidence presented above, one might conclude that if reliance on small cap growth or value strategies by themselves increases concentration risk, the antidote should be to enhance diversification by increasing the number of strategies represented in the portfolio. However, such a move could expose the portfolio to another source of risk: overdiversification.

While diversification is a vital element of institutional investment programs, the asset management industry is increasingly aware of going too far in pursuit of that principle. Recent studies show that many institutional portfolios are in fact overdiversified, with some programs now looking to streamline their holdings. There are numerous hazards associated with overdiversification, such as:

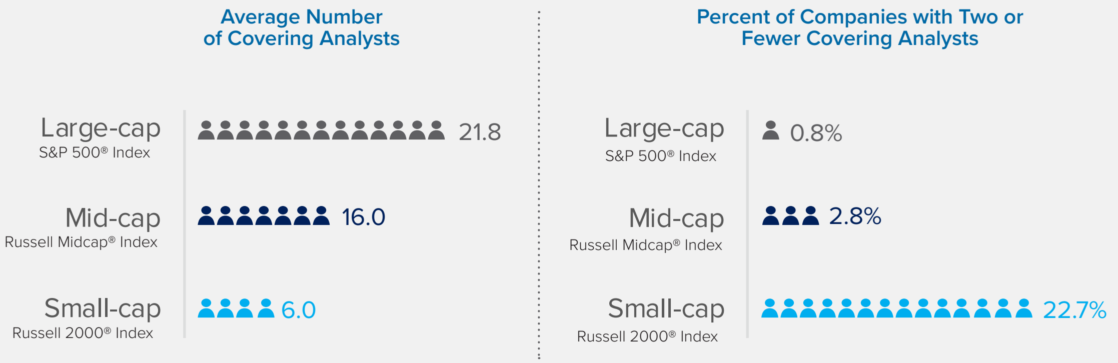
- **Weaker performance:** Some studies show that using diversification to reduce active risk may only be effective up to a certain point. The portfolio's ability to outperform its benchmark then becomes impaired.[2]
- **Correlation of returns:** Overdiversification can lead to undesired correlations, as human and factor biases of the allocators can come into play to create a portfolio of too-similar investment strategies.[3]
- **Costs:** While many studies show that the active risk and active share of a portfolio decline as additional strategies are added, lower fees are not a by-product of this decline in risk. Therefore, investors can potentially expect less productive fee ratios as a result of overdiversification.[2]

THE SIGNIFICANCE OF AN ACTIVE OVERLAY

Lastly, it is important to remember the critical role that active management plays in small cap equity strategies. As smaller issuers generally occupy an area of the equity market in which there is greater inefficiency, we believe that security selection based on bottom-up fundamentals and specialized expertise is critical to alpha generation. As demonstrated in Figure 4 below, there is a relative under-coverage of small cap equities by analysts, creating significant opportunities for small cap specialists to identify potential sources of alpha.

FIGURE 4: SMALL CAPS REMAIN STRUCTURALLY INEFFICIENT, IDEAL FOR ACTIVE MANAGERS

LACK OF ANALYST COVERAGE MEANS UNDISCOVERED OPPORTUNITIES



Source: Furey Research Partners and FactSet, as of March 29, 2019.

Furthermore, the analysis of all three investment styles in the following graph (Figure 5) reveals that exposure to stocks of non-earning (or loss-making) companies in each index is elevated as compared to historical levels. Loss-making stocks have demonstrably higher downside capture ratios than those of stocks of profitable companies. Consequently, we believe that investing in a passive index is not the optimal solution for small cap equity investors, particularly in an environment of high volatility. A skilled and experienced active manager with a fundamental research-based and bottom-up approach can identify overlooked opportunities regardless of market conditions, while maintaining a strategic focus on risk management.

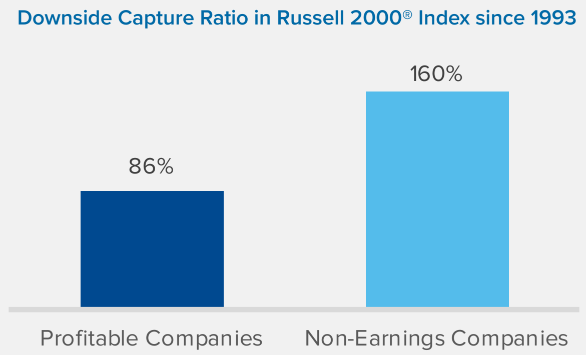
FIGURE 5: STOCKS OF NON-EARNERS WELL REPRESENTED IN PASSIVE INDICES

AGGREGATE WEIGHTING OF NON-EARNING STOCKS IN CORE, GROWTH, AND VALUE SMALL CAPS

Source: Furey Research Partners and FactSet, as of March 31, 2019.
Small cap core equities represented by the Russell 2000® Index. Small cap growth equities represented by the Russell 2000® Growth Index. Small cap value equities represented by the Russell 2000® Value Index.

FIGURE 6: STOCKS OF NON-EARNERS CAPTURE MORE DOWNSIDE

DOWNSIDE CAPTURE RATIO OF STOCKS IN NON-EARNING COMPANIES VS. PROFITABLE COMPANIES



Source: Furey Research Partners and FactSet, as of March 29, 2019.

BENEFITS OF SMALL CAP CORE

Palisade believes that investors attempting to reduce portfolio risk, generate alpha, and streamline their investment programs to prevent overdiversification should focus their small cap allocations in active small cap core equity strategies, which provide an attractive risk–return profile and inherently mitigate some of the hazards inherent in value and growth. As previously underscored in this paper, the small cap core equity index generally exhibits less dispersion within industry group weightings and more stability in composition than its growth and value counterparts. By combining the benefits of growth and value investing, along with the diversification and alpha potential of actively investing in smaller companies, active small cap core equity strategies represent the potential best of the small cap universe. We believe these core strategies offer a compelling solution for institutional investors seeking to streamline the number of strategies in their portfolios, maintain an effective level of diversification, and meet their risk–return objectives.

REVISIT YOUR SMALL CAP CORE EQUITY ALLOCATION

As our analysis illustrates, allocations within the small cap universe could expose institutional investors to unintended risks, including industry concentrations, overdiversification, and downside risks associated with passive investments. Institutional investors should evaluate their investment programs, in particular their allocations within small cap equity, and consider consolidating their small cap allocations into small cap core to mitigate certain risks.

DISCOVER THE BENEFITS OF SMALL CAP CORE EQUITY

CONTACT US TO LEARN ABOUT THE PALISADE APPROACH

Founded in 1995, Palisade has built its business around developing and managing specialized investment strategies for individuals, families, corporations, pension plans, and other institutions. We are fundamental investors with a long heritage of actively managing investments across various asset classes, including small cap core equity. We seek to generate alpha and competitive, risk-adjusted returns through a research-intensive methodology. Our disciplined investment process is based on rigorous, bottom-up, fundamental company analysis that drives a conviction-weighted approach to portfolio construction. Guided by this investment philosophy, Palisade has managed small cap core equity portfolios for institutional investors since the company's inception.

For more information on Palisade and its small cap core equity strategy, please contact our institutional services team:

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Footnotes:

1. Bloomberg, 4/1/2009–3/31/2019. Small cap core equities represented by the Russell 2000® Index. Small cap growth equities represented by the Russell 2000® Growth Index. Small cap value equities represented by the Russell 2000® Value Index.

2. Shawn McKay, Robert Shapiro, Ric Thomas, "What Free Lunch? The Costs of Overdiversification," Financial Analysts Journal: A Publication of CFA Institute, 2018.

3. Gerald Garvey, Ronald N. Kahn, Raffaele Savi, "The Dangers of Diversification: Managing Multiple Manager Portfolios," The Journal of Portfolio Management, Winter 2017.

References:

The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stocks listed on the NYSE or NASDAQ. The S&P 500® Index does not have a defined investment objective, nor does it charge fees and expenses.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index. The Russell 1000® Index is a compilation of the largest 1,000 publicly traded U.S. companies.

Important Information:

Past performance is no guarantee of future results.

The performance and volatility of the Palisade strategies described herein will be different than those of any index.

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