Laurus
INVESTMENT COUNSEL

GLOBAL SMALL CAP SPECIALISTS

MONTHLY COMMENTARY | OCTOBER 2023

"We are bamboozled by biases, fooled by fallacies, entrapped by errors, hoodwinked by heuristics, deluded by illusions." *- Koen Smets, poet*

We humans are shockingly prone to bad ideas, ideas that grow into terrible decisions, and then metastasize into actions that undermine, damage, or might even end our lives. We'd all like to think that we're a lot smarter than the average, and some of us surely are, but an uncommonly large number of us have a consistently bad track record of decision-making and none of us is as good as we think we are.

Worst of all, these weaknesses are largely opaque to us. They leave no cognitive trace.

As humans, we want deductive (definitive) proof, which is rarely available and therefore must settle for inductive (tentative) theories. Induction is the way science works and advances. That's because science can never fully prove anything. It analyzes the available evidence and, when the force of the evidence is strong enough, makes tentative conclusions in an effort to ascertain the best available approximation of the truth.

Case in point. A friend that sits on a pension board was explaining the process used by their investment consultant to measure and propose a "proper" asset allocation. Knowing our firm specialized in small cap equity, he questioned the consultant on why the small cap asset class wasn't factored into the strategy. When challenged, the consultant went on to say the small cap index did not provide sufficiently uncorrelated return streams compared to other asset classes to justify an allocation. Which, of course, to us is heretical.

One of the fallacies built into asset allocation models, is that the index is a good proxy for return characterization. So, we looked to the eVestment database (a database & tools for the institutional asset management community) and found some very interesting facts. Going back to December 1990 and measuring ten-year rolling periods, the median large cap manager outperformed the S&P 500 Index 50% of the time, yet the median small cap manager outperformed the Russell 2000 100% of the time and, in most instances, by more than 250 basis points.

And, over those same periods, the Russell 2000 small cap index only outperformed the S&P 500 33% of the time, yet the median small cap manager outperformed the S&P 500 two-thirds of the time. So why are we using the Russell 2000 return stream to measure return characterization of small cap allocations?

Though a shorter return history, small cap indices outside North America over the same ten year rolling return periods are similar. The MSCI EAFE Small Cap Index exceeded the MSCI EAFE Index 100% of the time. And the median manager also outperformed the small cap index 100% of the time – at times by as much as 400 basis points.

Very clearly, active management in small cap investment outperforms indexation. Also, quite clearly a small cap index should not be used in an asset allocation study.

This is not meant to disparage large cap managers or the investment consultants that continue to tout them. It is simply to suggest we should carefully evaluate evidence. We should develop tentative conclusions. And we should seek and accept disconfirming evidence. "In all affairs, it's a healthy thing now and then to hang a question mark on the things you have long taken for granted," as Bertrand Russell explained. Too often we take expert opinion as fact when our focus should be on making fewer mistakes.

Next month we will introduce the second part of our trilogy, "Rethinking the Small Cap Asset Class". If you missed the first part, it can be found on our website here:

https://lauruscounsel.com/wp-content/uploads/2023/09/Planning-for-the-Extended-Maturity-Cycle-of-Large-Cap-Equity.pdf