

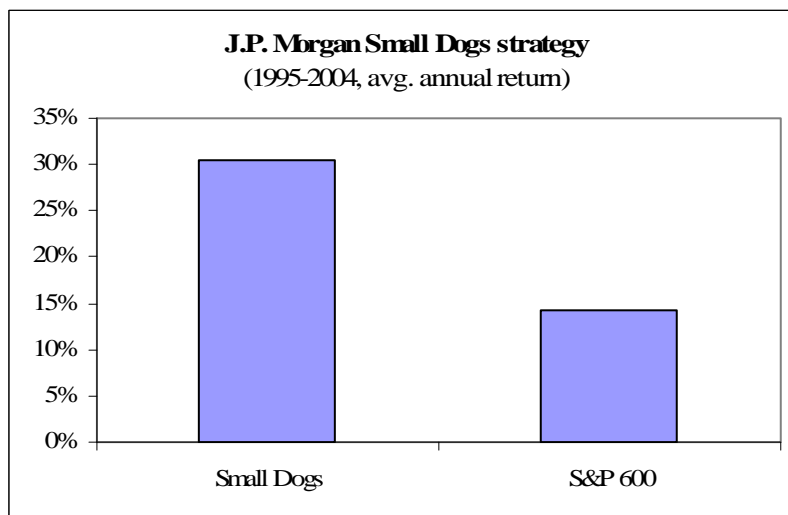
Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points October 23, 2009

The performance gap between small caps (especially small-cap value stocks) and large caps amounts to a permanent arbitrage opportunity. It is a radical inefficiency in the stock market that can be exploited *ad infinitum*. I've wanted to write on this topic for a while but lacked the hard data to prove the point. Then last week I came across a great study by J.P. Morgan showing quite emphatically that small-cap value is the place to be.

J.P. Morgan has created something called the "Small Dogs" strategy. This approach calls for buying the 60 stocks in the S&P 600 with the lowest EV/EBITDA ratios on a trailing 12-month basis. For the 10-year period between 1995 and 2004, the Small Dogs outperformed the S&P 600 by *16 percentage points a year*, returning an average of 30.4%/year (32.5% CAGR), vs. the S&P 600's return of 14.3%/year. (The S&P 500 returned 12.0% over the same stretch.) That's a mind-boggling performance gap for a hands-off strategy – especially given that, in theory, there should be no gap at all.



Source, J.P. Morgan, October 15 piece by Thomas J. Lee, used w/permission

It so happens that the Classical Insights portfolios (developed and emerging markets) both follow strategies similar to the Small Dogs (i.e. small-cap value). The CI portfolios each have posted returns almost exactly in line with the Small Dogs (CI developed up 32%/year CAGR since initiation in December 2002, and CI emerging markets up 33%/year CAGR since initiation in April, 2005).

What is going on here? *Why does small-cap value crush everything else year after year after year?* I have several theories on this:

1) Mutual funds and pension funds are structurally biased against small-cap value – and they've taken an ever-growing share of overall stock market dollars (for reasons discussed further down). The mutual-fund business is chiefly about gathering assets – not about making the highest possible return for clients. Fund companies know that the best way to gather assets on a large scale is to a) avoid *losing* clients' money and b) create an aura of professionalism around one's firm. The best way to combine these two goals is to focus on reasonably successful companies that most people know. That means buying big caps that are doing well *right now* and have overtly good prospects. I can't count the number of fund managers and brokers who have said to

me, "I would love to buy some of your names but my clients/boss/investment committee would go, 'Huh? What is that?'"

This big-cap bias is exacerbated by the fact that most funds pitch themselves as being intimately knowledgeable about the names in their portfolios. It's hard to intimately know 30 names, let alone 100+.

That brings up a related point: As mutual funds grow, the *logistics* of buying small caps get tougher. A manager of a \$1 billion fund generally usually wants positions of at least \$10 million in size – but he won't want to own more than, say, 4% of any particular company. A \$10 million position represents 3.3% of a \$300 million company. That kind of position can take a while to build – and take a while to *sell*. As such, fund managers tend to be leery of owning sub-\$300 million names and definitely prefer \$1+ billion names.

2) Why has the money management business gained control over such a large swathe of the investment universe? Because individuals have become increasingly afraid of their own money. For two generations, Americans and Europeans have grown up internalizing an overtly false brand of economics (Keynesianism). When they apply what they've learned to the prediction of economic and market events, *it never works*. In the U.S. and Europe, we are erroneously taught that:

- Inflation is caused by full employment (false);
- The consumer is the driving force in the economy (false);
- Tax rates don't matter all that much (false);
- Big budget deficits push up interest rates and depress growth (false and false);
- The gold price has no important meaning (false).

Most individual investors throw up their hands after a while because economic events never seem to play out as they (or the respected forecasters they follow) think they should. In despair, they turn their money over to an investment professional who supposedly knows more about these things than he does.

3) Another factor fueling the growth of the money management business has been chronic mismanagement of the economy by two generations of Keynesian policymakers. Years of economic mismanagement have created an environment of *perennial economic volatility* – and volatility itself is a spur for individuals to cede control of their money. Even those who do understand the way the world really works frequently don't have time to stay up on policy changes. Prior to 1971, when the world was still on a gold standard, it was much easier to make long-term investments. Today, though, I couldn't imagine using a long-term buy-and-hold strategy. Who knows what the gold price will be two years from now? It could be \$700/oz. or it could be \$2000/oz. *Every aspect* of the global economy will be profoundly affected by what the gold price does. A person can't just buy a portfolio of stocks, go to the beach and assume everything will all work out all right. One must watch everything like a hawk and make changes as the policies change (and as commodity prices move). It doesn't have to be this way, but it is.

4) The Spitzer-era reforms of the brokerage industry also may be working against small caps. Specifically, the rule that barred equity analysts from pitching investment banking deals eliminated an important motivator for brokers to write research on smaller caps. In Canada, that prohibition doesn't seem to exist and there is much more smaller-cap coverage. (I'm not sure on the specifics of the Canadian regs, but I definitely see a lot of Canadian small-cap research written with the goal of getting investment banking business.)

As a result of all these forces, the discount on smaller caps today is huge. Small-cap *value* works particularly well, probably because value investing in general works particularly well. Many studies have shown that low P/E stocks outperform high P/E stocks. Personally, I've always been a big fan of buying low P/Es. It's simple and it works.

I'm always suggesting to clients that they push the envelope at their firms and dig down into smaller caps. The response I usually get is a kind of shrug. "It takes too much time." "It's too hard to put the assets to work." "Our internal rules prohibit it." "We can't exit small positions fast enough." But are these excuses worth 1600 basis points a year???? If we were talking about 200 bps, or maybe 300, I could understand. But at 1600 bps no excuse makes any sense. The risks of not being able to exit a cratering position quickly or not knowing every last detail of a particular company are more than compensated by the extra return one gets from going with small cap value.

Last point here: I've found that one can reasonably follow 100 names by using the 80/20 rule, which holds that 20% of one's effort generates 80% of the reward. In my case, I probably spend 20% of the time crunching an individual stock as does a typical sell-side analyst, but I'll get about 80% of the story. As compensation I'm able to cover five times as many names as a typical sell-side analyst (100 vs. 20) and thereby am able to get a much better feel for the overall backdrop in which each company operates. I think it's a good trade-off.

Mike Churchill

Bullets are archived at www.churchillresearch.com . Please call or email for a username and password.

Churchill Research, Inc.
105 N. Virginia Ave, Suite 200
Falls Church, VA
22046
(703) 241-0274
(703) 340-4726
mike@churchillresearch.com
www.churchillresearch.com

This material is based on information from sources believed to be reliable but its accuracy or completeness is not guaranteed. This report is published solely for informational purposes and is not to be construed as a solicitation or offer to buy or sell any securities. Opinions expressed herein are subject to change without notice. This report may not be reproduced or distributed without the permission of Churchill Research Inc.

The Classical Insights portfolio is Mike Churchill's own brokerage account, held at UBS. The Classical Insights Fund LP is a long/short hedge fund. The Classical Insights Fund LP and employees of Churchill Research Inc. can and do hold positions and trade securities mentioned in this report. We try to inform clients of trades in new positions in the Classical Insights portfolio prior to those being made. Subsequent trades are sometimes done without notice. The Classical Insights Fund will hold positions different from the Classical Insights portfolio.