The Small Idea: Risky Business

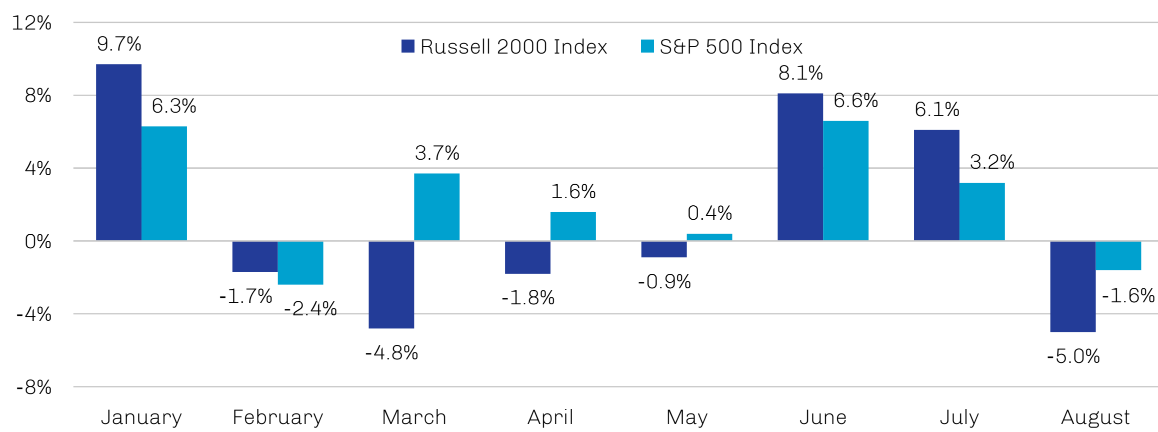
As most of the country continued to swelter through a hot summer, a chill fell over the small cap market during August.

After a very strong June and July during which the Russell 2000 Index outpaced the S&P 500 Index by more than 400 basis points (shown below), August performance for the small cap market swung deeply negative. While it can be unnerving, such volatility is consistent with the Rusell 2000's historical patterns, both in 2023 and over the long term. To wit, annualized standard deviation of monthly returns over the past 10 years for the Russell 2000 stands at 21.0% compared to 15.5% for the S&P 500.[1]

From our viewpoint as active, fundamentally driven investors, however, the small cap market's volatility is not a bug, but a feature.

Pronounced Swings in Performance Are Nothing Unusual for Small Caps

Monthly Returns, Year-to-Date 2023



Source: FactSet; data as of August 31, 2023.

1. Source: FactSet; data as of August 31, 2023.

This edition of *The Small Idea* was written by Bill Hench, head of the Small Cap team and portfolio manager.

Volatility ≠ Risk

Having spent my entire 20-year portfolio management career in the small cap space, my experience has been that high levels of volatility are either currently present or soon to begin—pretty much like an episode of *Seinfeld* on cable. Because of the consistent inconsistency of the market in which we invest, the team and I have grown accustomed to certain questions emerging whenever performance whipsaws lower: How do you think about volatility? How should we think about it? What can be done?

> While some may choose to ignore the small cap market because of its volatility, count us among those looking to exploit that volatility.

While the amount of volatility that constitutes too much volatility is within the purview of each investor, the only way to avoid the relatively high volatility inherent in small cap investing is to not invest in small cap stocks. That is not our idea of fun; more important, it denies investors exposure to what has been the most profitable segment of the equity markets going back to 1927.[2] Further, by accepting our view that the greatest risk investors face is not day-to-day market volatility but the permanent impairment of their capital, it seems likely that perhaps the best way to deal with volatility is to accept it, prepare for it and make it work for you.

We sometimes think of volatility much the same way that Winston Churchill must have thought of alcohol when he said, "I have taken more out of alcohol than alcohol has taken out of me." Sure, the team has had days or weeks or even months when we were ready to forswear small caps and go cold turkey. But then we look back on these periods of heavy volatility in the small cap markets, however unpleasant they may have felt at the time, and recall fondly the attractive investment opportunities we gained access to as a result.

As Churchill is not necessarily our go-to for investment wisdom, let's turn instead to someone who knows a thing or two about finding value in the stock market: Warren Buffett. In a 1994 letter to Berkshire Hathaway shareholders, Buffett referenced the unpredictable and often illogical behaviors of the allegorical "Mr. Market," as introduced by Ben Graham in *The Intelligent Investor*, concluding that "…a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses."[3] As the most Mr. Market-y cohort of US equities, small cap stocks have closely followed the volatile pattern Buffett described, and in doing so have presented chances for disciplined active managers to identify individual names they believed were temporarily trading below their normalized valuation and potentially could drive index-beating performance in the future.

To continue the quote above, Buffett goes on to decouple volatility from risk, saying "it is impossible to see how the availability of such [irrationally low] prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly."[4] While some may choose to ignore the small cap market because of its volatility, count us among those looking to exploit that volatility.

2. Source: Kenneth R. French data library; data as of August 31, 2023.
3,4. Warren E. Buffett to the Shareholders of Berkshire Hathaway Inc., March 1, 1994.

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All investments involve the risk of loss of principal.

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and micro-size companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Active management is an investment management approach in which an investor, a professional money manager or a team of professionals tracks the performance of an investment portfolio and makes buy, hold and sell decisions about the assets in it.

Volatility is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

Indexes are unmanaged and one cannot invest directly in an index.

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

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

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