In the News

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Small cap, large cap, beanie cap

EXCLUSIVE OUTLOOK: Paul Orfalea, Lance Helfert and Atticus Lowe

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An otherwise fine publication from one of the world's best investment authorities ran a spectacularly silly article in its November issue. The article's premise, that large-cap stocks are due to outperform the market because small-cap stocks have been outperforming the market for five years, depends on tired rationalizations and generalizations unworthy of serious investors.

Market capitalization (one method of valuing a company by multiplying the share price by the number of shares outstanding) helps us evaluate whether an individual company is over- or undervalued. But some people view large-cap (typically more than $12Êbillion in value), small-cap (typically less than $1.5Êbillion) and mid-cap companies as market segments of their own, and many fund managers limit themselves to large- or small-cap stocks exclusively. To us, this seems more like a marketing strategy than an investment philosophy.

CONVENIENT CARRYING HANDLES

Marketing executive Dean Zatkowsky points out that when you're selling ideas and services, consumers

need "convenient carrying handles" so they can easily pick up what you offer. Thus, mutual funds and portfolio managers package their services as products with easy-to-remember descriptions: "A large-cap value fund" or a "small-cap growth portfolio."

These products benefit from tenets of conventional wisdom about the respective attributes of large- and small-cap stocks, all of which were mentioned in the article:

1. Large-cap and small-cap segments typically alternate periods of outperforming the market as a whole.

2. In an economic recovery, small caps do better because they are nimble.

3. Post-recovery, large caps perform better for investors because of their earnings capabilities and dividends.

4. By virtue of their size, large-cap stocks are more secure.

5. One should balance asset allocation based on cap size.

Although these statements are generally true, and can certainly help one decide between two funds, they are also dramatic oversimplifications that do not help one choose the most effective investment for one's individual needs.

CONVENTIONAL RESULTS

Packaged investment products based on market capitalization seem more like low-stakes gambling (playing the odds) than investing (choosing quality companies at an attractive price) to us. We would call adherence to the conventional wisdom a lazy man's approach to investing, except that there is no reason even a lazy man would arbitrarily limit his opportunities to companies of a certain size.

A smart lazy man would simply invest in low-fee market index funds and benefit from the long-term performance of the market as a whole. But for anyone seeking superior results from investments, conventional wisdom will not suffice in any case.

A SIMPLE FAILURE OF LOGIC

The lure of "large-cap" and "small-cap" as convenient carrying handles is understandable but misguided. Why would one insist on buying large-cap stocks if there were better opportunities in small- or mid-cap stocks, or vice versa? In a marketplace where opportunities change every day, inflexibility is liability.

Moreover, the conventional wisdom may not be very wise. For example, the security of many large-cap stocks appears to be little more than a self-fulfilling prophecy: Large fund and pension managers believe they must own large-cap stocks for security, so they keep buying them, increasing the demand for shares and keeping the price high, regardless of the company's quality.

General Electric, the largest of the large caps, is an interesting example. With a market capitalization of $375Êbillion and sales of $135Êbillion, growth does not come easily. Their cumbersome organization creates opportunities for entrepreneurial competitors. Even so, it is hard to imagine a large-cap fund not owning GE.

Other giants, like Kodak, held so much market share that there was nowhere for them to go but down. More recent ascendants to the large-cap club, like Cisco Systems, present new challenges for long-term investors. With a market cap of $130Êbillion and a price/earnings ratio of 25, Cisco would have to earn more than $5Êbillion per year for the next 25 years just to earn back a current investment in the company. That might be plausible for a company with sustainable competitive advantage, but Cisco is a technology company; who can say what its market and competition will look like in five years, much less 25?

WHAT DO YOU INVEST FOR?

Knowing market capitalization is important, but one must consider debt and look at the enterprise as a whole. For example, with its market cap and net debt, GE has an enterprise value exceeding $500Êbillion. For that kind of money, one could buy Walt Disney, Automatic Data Processing, Wrigley, Costco, Viacom, Hershey, Tiffany & Co., Apple Computer, Northrop Grumman, Energizer,

Safeway, Xerox, Newell Rubbermaid, Gillette and a small country or two.

Each of these companies has its own problems developing products, finding new markets and expanding market share. In other words, growth is difficult for these icons of industry; imagine how hard it is for GE. But if you buy a large-cap fund, the odds are pretty good GE will be a major component.

On the other hand, if you buy a small-cap fund, you will miss the advantages of well-run, dividend producing giants like Johnson & Johnson. If you invest in both large-cap and small-cap funds, you may earn average market returns, but with higher fees than a simple index fund. What's the point?

JUST BUY THE BEST

Small, custom portfolios of stocks, selected for individual quality and value, have the ability to outperform funds of any kind, and careful investors like Warren Buffett have been proving this for many long years.

We don't care if a stock is large cap, small cap or beanie cap; we use a broad range of criteria for judging its potential risks and rewards. Limiting ourselves to a certain size of company makes little sense to us; we are more interested in the company's valuation, competitive advantage, culture, management, industry, vision, etc. As the saying goes, "It's not the size of the dog in the fight, but the size of the fight in the dog."

A great boxer might be able to win with one hand tied behind his back, but he would certainly perform better with both hands free to do their job. We urge investors not to tie their own hands by getting caught up in convenient handles like "large-cap" and "small-cap."

Reducing our investment philosophy to its simplest terms, we advocate this: "Just buy the best."

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