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Small Independent Investors should use their Competitive Edge

The economic and financial environment is constantly changing. That's why it's important to continually challenge conventional wisdom and ideas that have worked in the past and think about how these changes affect us as investors.

In recent years there has been a significant structural change in financial markets, which I believe has created momentum for large caps, was unfavorable for small caps and which could increase volatility:

1. The rise of index funds
2. Consolidation of active fund managers
3. Increase in algorithmic investments

Index Funds

The initial idea of offering an inexpensive solution to investors by investing in a few generic stock market indices has turned into a mammoth industry of exchange-traded funds, where there is an excessively high number of funds (about 5,000 in the United States versus approximately 3,500 publicly traded companies). One of the consequences of this trend, in my opinion, is a distortion in favor of large-cap stocks, since index funds in general automatically invest in larger caps; this creates a vicious circle reinforcing the valuation of these companies. Small caps are generally neglected.

Consolidation of the Fund Management Industry

Faced with the giants of the "passive" index industry, "active" fund managers must find ways to reduce their costs in order to remain competitive. One of the ways is through consolidation to increase economies of scale. This consolidation creates very large investors who are thus more limited to invest in large cap companies. This also strengthens the valuation of large caps.

Algorithmic Investing

A larger portion of investments is now done through algorithms, that is, pre-established formulas managed by powerful computers. The general idea behind this is to subtract human emotions from investment decisions. The relevance and long-term viability of this phenomenon can be debated, but one of the consequences, according to some, is to increase momentum in markets. This would magnify the highs, but also the lows in markets. We should therefore expect very high valuations followed by very low valuations.

Investing in small caps

Small independent investors should use their two main competitive advantages: small size and patience. Their small size makes it possible to invest in solid small businesses without affecting the price, because transaction volume is often low. In addition, smaller firms are less likely to be followed by the financial industry and therefore offer more opportunities for pricing anomalies: there are fewer seasoned investors competing in the space. Independence makes it possible not to incur external or institutional pressures and to be more patient: no quarterly performance reviews, no end-of-year bonus consideration, no risk of job loss, etc.

I have highlighted three institutional phenomena that, in my view, are causing some distortion in the markets, but this is only a starting point for analysis. Of course, the prospect of an end of cycle and a recession has also put pressure on the valuation of small caps, which is a normal phenomenon.

Investing in small caps requires more monitoring, more patience and more tolerance for greater stock market volatility. However, when we focus on the actual business progress of our smaller companies, the higher volatility is an advantage since it allows us to buy at lower prices during periods of great fear. When these investments are made at a price that provides an ample margin of safety (this is the key), generally a well-diversified portfolio will offer long-term returns far superior to large cap returns.

Although there are often price anomalies in large caps, I believe we currently have a good window of opportunity to invest in small cap stocks, provided we research companies:

- Strongly positioned in their niche and operating in a stable and promising sector, less subject to obsolescence and intense competition;
- Whose leadership team is very competent, dynamic and strongly aligned with the long-term interests of the shareholders, preferably deeply invested in the shareholding of the company; we pay close attention to the dynamics of upper management incentives;
- With a level of debt under control and which can withstand the next recession and other headwinds;
- A management team that does not rely too much on a single executive approaching retirement, with a succession plan offering good visibility over the next ten years;
- A truly independent and good quality board of directors.