Casey, Quirk & Associates

RESEARCH INSIGHT

March 2006

Small Cap Spillover:
New Approaches Address Capacity Issues

- **Capacity is a major issue in the small capitalization area.** Many of the top performing institutional Small Cap managers are closed to new assets. This is forcing investors to pursue alternative options to investing in the Small Cap asset class.

- **SMid and Mid Cap products have emerged as viable alternatives to investing in Small Cap.** To deal with the Small Cap capacity issue, institutional investors appear to be allocating significantly more to SMid and Mid Cap products. Interestingly, SMid/Mid Cap products with corresponding closed Small Cap products saw more than twice as much institutional flow as SMid/Mid Cap products without a closed counterpart over the past three years.

- **Indexing has also emerged as an alternative to traditional active Small Cap investing.** Small Cap indexing has grown 10% over the last three years; over the same period, Large Cap indexing experienced a decrease of 17%.

Introduction

Over the past several years, we have seen increased investor frustration and interesting asset flow and performance trends in the small capitalization asset class. When we analyzed the numbers, we observed an asset class that has grown significantly from both strong performance and asset inflow. In fact, there are nearly three times more managers with greater than $2 billion in assets as of Q3 2005 as compared to three years ago. There are 49 products greater than $2 billion and 32 products closed to new investors.

Potentially due to these capacity constraints, investors have begun to embrace at least two alternatives to investing in active Small Cap managers: (1) investing in SMid and Mid Cap products; and (2) investing in index products.

Research Methodology

Casey, Quirk & Associates studies institutional asset flow and performance on a systematic basis. We noted a number of interesting developments evolving in the Small and Mid Cap peer groups over the last three years. As a result, we decided to conduct a closer examination of the asset class. With the hypothesis that 'spillover' due to capacity constraints was occurring, we examined performance and asset flow for the Small, SMid, and Mid Cap universes. Our analysis is based on manager reported data for separate accounts and commingled products that was reported to InvestorForce for the five years ended September 30, 2005.

We created a SMid Cap universe based on manager descriptions of investment process and product names. Our analysis encompasses 315 Mid Cap products, 78 SMid Cap products, and 689 Small Cap products and included core, value, and growth products.

Figure 1

Research Universe
Product Count and Assets Under Management
As of September 30, 2005

	Assets Under Management ($MM)	Number of Products
Small Cap	420,555	689
SMid Cap	53,769	78
Mid Cap	282,998	315
Total:	757,322	1,082

SOURCE: *InvestorForce and Casey, Quirk & Associates*

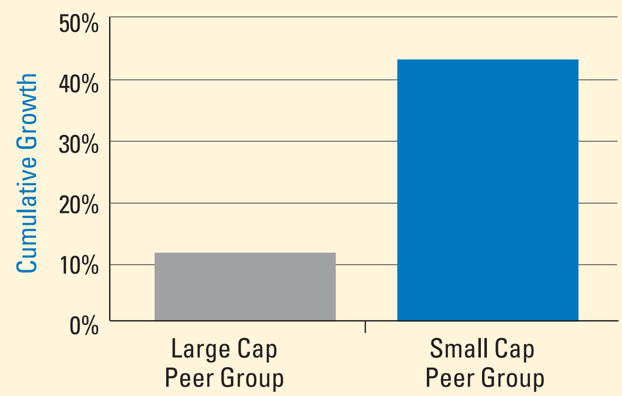
Findings

1. CAPACITY IS A MAJOR ISSUE IN THE SMALL CAP AREA.

The Small Cap universe has grown much faster than the Large Cap universe. Small Cap demand is so strong that, on a relative basis, the small capitalization peer groups have grown faster than Large Caps by a ratio of 4 to 1; and this occurred despite the fact that many strong products are closed to new investors. Small Cap peer group assets have grown 43% *(see figure 2)* over the last five years while the Large Cap universe has grown only 11%.

Figure 2

Large and Small Cap Peer Groups
Five-Year Growth
Period Ended September 30, 2005



SOURCE: *InvestorForce and Casey, Quirk & Associates*

This growth has been due to a combination of asset inflow and performance. Over the five years ended Q3 2005, Small Cap grew 15.1% by net asset flow, while Large Cap grew only 11.5% due to asset inflow. During this same period, the median Small Cap manager returned 10.6%—much higher than the median Large Cap manager, who returned -0.1% over that same five-year period.

Figure 3

Small Cap Manager Universe
Open/Closed Fund Performance Quality
As of September 30, 2005

	Number of Products	Average CQA Performance Quality Score
Small Cap Manager with >$2B	49	3.50
Other Small Cap Managers	640	2.96
Total:	689	
Closed Small Cap Managers	32	3.36

SOURCE: *InvestorForce and Casey, Quirk & Associates*

Exacerbating the challenge to investors, many quality managers are no longer accepting new assets. As of Q3 2005, 49 Small Cap products *(see figure 3)* had at least $2 billion under management compared to only 19 products three years ago. In addition, 32 products are closed to new investors. On average, these closed managers have better performance. Using CQA's performance quality score, products with greater than $2 billion in assets scored an average of 3.5 out of a possible 5.0, and closed products scored an average of 3.4. A median manager can be expected to receive a score of 3.0. (CQA's performance quality score is a single proprietary measure ranking institutional products on several key metrics: return, risk adjusted return, and risk and style consistency.)

Consequently, the remaining open managers are on average poorer performers than closed managers. Given these conditions, investors appear to be pursuing at least two alternatives to selecting active Small Cap managers.

2. SMID AND MID CAP PRODUCTS HAVE EMERGED AS A VIABLE ALTERNATIVE TO INVESTING IN SMALL CAP.

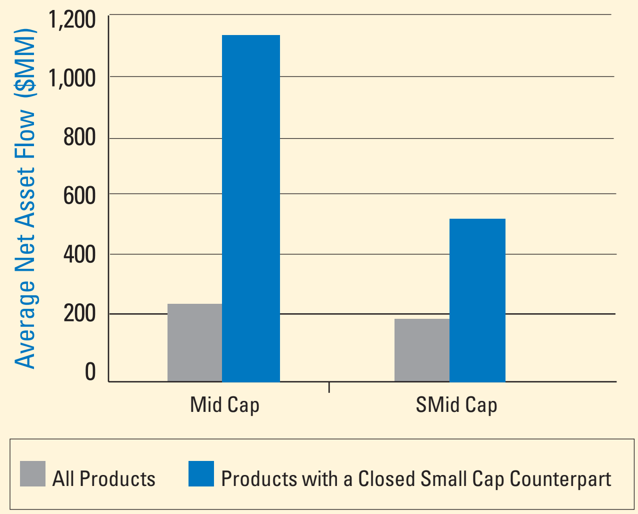
Over the last three years, both the Mid and SMid Cap asset classes have grown considerably. Mid Cap is now a significant peer group with over $280 billion of institutional assets, while SMid Cap products have $79 billion. Mid Cap has grown 103% over the last three years, and SMid Cap has grown over 120% during that same period.

Interestingly, Mid and SMid Cap products that have closed counterparts in Small Cap have won a disproportionate amount of asset flow over the last three years *(see figure 4)*. SMid Cap products with closed Small Cap counterparts won three times more flow than the average products in their peer group. The trend was even more pronounced for Mid Cap managers, with four times the asset flow.

Figure 4

Net Asset Flows into SMid/Mid Cap Products All Products vs. Products with a Closed Small Cap Counterpart

Three Year Period Ended September 30, 2005



SOURCE: *InvestorForce and Casey, Quirk & Associates*

3. INDEXING HAS ALSO EMERGED AS AN ALTERNATIVE TO TRADITIONAL ACTIVE SMALL CAP INVESTING.

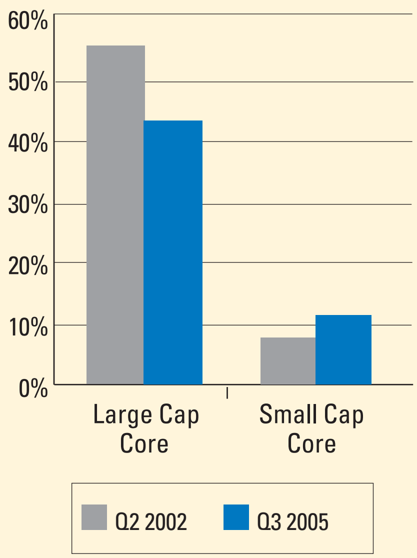
Small Cap indexing has grown in popularity, while allocations to Large Cap indexing have decreased. Over the last three years, assets in Small Cap index products have grown from 3% of the asset class to 12.5% *(see figure 5)*. Over the same period, Large Cap index products dropped from 60% of the peer group to 44%.

Returns have likely played a role in investors' increased comfort with indexing—the median Small Cap manager outperformed the 75th percentile Large Cap manager over the past five years *(see figure 6)*.

Figure 5

Indexing as % of Total Peer Group Assets
Large Cap vs. Small Cap

Five Year Period Ended September 30, 2005

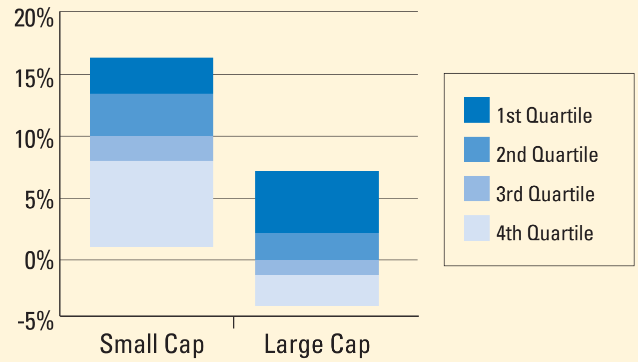


SOURCE: *InvestorForce and Casey, Quirk & Associates*

Figure 6

Small Cap vs. Large Cap Returns
Annualized Peer Group ROR Quartiles

Five Year Period Ended September 30, 2005



SOURCE: *InvestorForce and Casey, Quirk & Associates*

Concluding Thoughts

We have several concluding thoughts from our research:

- The increased popularity of the Small, SMid, and Mid Cap areas is almost certainly due in part to investors' need for returns. Investors have likely been drawn to the area for both its alpha and beta opportunities.
- Development and rapid growth of SMid Cap products supports the idea that investors are loosening their historical adherence to style-box investing. Small Cap managers have apparently convinced some investors that selling a company at an artificial capitalization ceiling may, in fact, be "leaving money on the table."
- Mid Cap has come into its own as an asset class. Historically, domestic equity investments were oriented around Large Cap and Small Cap allocations. Now it appears that Mid Cap has a place among them.

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Casey, Quirk & Associates

John F. Casey, Chairman

David J. Bauer, Managing Director

Jeb B. Doggett, Managing Director

Kevin P. Quirk, Managing Director

Casey, Quirk & Associates (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in developing business strategy, enhancing investment practices, and crafting distribution plans. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

Casey, Quirk & Associates periodically publishes *Research Insight* on topics of interest generated by its ongoing industry research. To discuss this CQA *Research Insight*, please contact:

Christian Strzelecki
Senior Associate
z.strzelecki@cqallc.com
203-899-3001

Yariv Itah
Director
y.itah@cqallc.com
203-899-3010

Kevin P. Quirk
Managing Director
k.quirk@cqallc.com
203-899-3033

Casey, Quirk & Associates
19 Old King's Highway South
Darien, CT 06820
(T) 203-899-3000
(F) 203-656-8124
www.cqallc.com