

Small-cap stocks may have underperformed blue chips for years, but fund managers are pulling in assets faster than ever.

Small remains beautiful

By Alyssa A. Lappen

Small-capitalization stocks have underperformed blue chips for five straight years. Last year the sector turned in its worst performance in nearly a decade, with the Russell 2000 equity index losing 2.57 percent, compared with a roaring gain of 28.6 percent for the Standard & Poor's 500.

Here comes the strange part: Small-cap fund managers appear to be flourishing like never before. The evidence abounds. In 1997, the most recent year for which complete data is available, small-cap managers saw net new-client funds increase by 4.1 percent, while large-cap managers had only a 1.3 percent increase (large-cap growth managers lost 17.1 percent). Since 1993 about one third of all institutional searches for money managers have been in the small-cap area; last year, despite the sector's dismal performance, the percentage of such searches increased to 42 percent, according to Eager Manager Advisory Services, a Louisville, Kentucky, consulting firm.

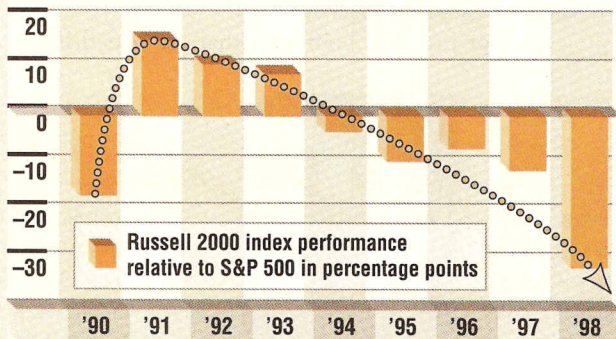
No doubt, some of the movement comes as major pension funds, endowments and foundations rebalance their portfolios, after three years of big gains in large-cap stocks knocked their asset allocations out of whack. But some of the cash is coming from an increase in assets allocated to the sector. Says Eager president David Eager, "There is definitely new money being allocated to small-capitalization disciplines."

A number of factors lie behind the upsurge in interest in the sector. Despite years of weak performance, money managers and consultants can point to research and studies galore indicating that small stocks historically outperform large stocks. Like value investors, small-cap aficionados tend to hold a near-religious belief in their sector, no matter how badly it performs. Many now think small caps' unusually long run of relative market underperformance is ready to reverse.

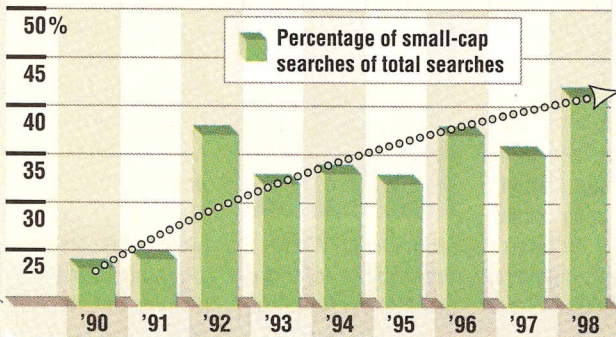
Small-cap portfolios, with their fat fees, can be a license for managers to mint money — not just for their clients, but for themselves. Add to that the fact that many entrepreneurially minded managers want to run their own shops — small caps make sense to run in boutique-size operations — and it's easy to see why so

So much for performance anxiety

Though small-cap returns vs. large-cap returns have declined...



...the search for small-cap managers has increased.



Source: Eager Manager Advisory Services.

Small
remains
beautiful

many managers are hanging out their own shingles.

"Right now, if you look back 20

years, small-capitalization stocks are at the lowest valuations they have had. And when they do come through, the power of small-cap stocks in the next cycle could be significant," says Frank Russell Co. consultant Paul Greenwood, adding that "in the last five years, few if any new firms have opened their doors to manage large-cap stocks, but the number of small-cap managers on our radar screen has increased by 100, more than 80 percent." And those are just the firms of managers whose names or reputations qualify them to be included in searches run by the Tacoma, Washington, consulting firm.

The new firms range across the spectrum of age and experience, style and size. Robert Kern, 63, of New York's Kern Capital Management has, for example, been investing in small caps for decades (he helped pioneer the discipline in 1969), but he struck out on his own for the first time two years ago, primarily to work with his son David (see box above). Father and son manage \$450 million, with hopes of growing to \$1.5 billion. Others, like Scott Sterling Johnston of the two-year-old Sterling Johnston Capital Management, have toiled in boutiques for years (see box below). Now managing \$55 million and competing fiercely in searches, he's on his third start-

BIG PLANS IN SMALL CAPS

Most small-cap investment firms are like the stocks they track: small. But when Robert Kern opened his own shop, Kern Capital Management, in New York City in September 1997, he had big plans and a big client, Bechtel Group—founded Fremont Investment Advisors, which put \$200 million under Kern's management. Today Kern Capital manages \$450 million, some \$250 million of it in three Fremont mutual funds. And Kern intends to keep growing.

Kern has earned his relationships: In 1969, while he worked for Chase Investors Management, he was one of the first managers to distinguish small-company stocks as a unique asset class. Bechtel's profit-sharing plan became one of his clients in the class in 1980.

Kern did so well for Bechtel that in 1982

its trustees asked him to set up a microcap account to invest a profit-sharing fund in fledgling public companies. On this pioneering idea Kern would score several knockout years: In 1991, for example, he returned 77.41 percent, versus 46 percent for the Russell 2000; in 1995, 54 percent; and in 1996, 52 percent.

No surprise that in 1994, when Bechtel's Fremont launched its U.S. Micro-Cap Fund, the company named Kern as its manager. Today the \$150 million fund charges a steep 188-basis-point expense ratio, 100 basis points of which goes to Kern Capital. Last year it returned 2.86 percent, compared with a 2.55 percent decline for the Russell 2000. The same year that Kern opened its doors, Bechtel converted its microcap account into the \$53 million Fremont Institutional U.S. Micro-Cap Fund, a lower-cost clone of its re-

up in a decade of terrific investing returns but bad business luck. Then there are Thomas Press and Donald Longlet, who left Jundt Associates in January to start Minneapolis-based Next Century Growth Investors. They've got \$17 million so far and are wearing out the buttons on their phones dialing for more (see box, page 48).

It's not just new boutiques that are benefiting from the

STERLING'S OPPORTUNITY

Scott Sterling Johnston can only hope the third time proves the charm. At 54, he has been in business 30 years, 23 of them managing other people's money. Now more than two years into his third start-up, San Francisco-based Sterling Johnston Capital Management, Johnston has racked up some nifty performance numbers over time but suffered from some bad luck and lousy timing in his business ventures.

As a manager, Johnston has few peers. Funds he and his teams managed in his small-cap growth style earned an average 22.9 percent annually for ten years (11.4 percent ahead of the Russell 2000 and 5.2 percent ahead of the Standard & Poor's 500) and 20.1 percent annually for five years (8.25 percent ahead of the Russell and 0.4 percent ahead of the S&P).

Johnston has consistently looked for companies in strong industries. His picks — names like Laser Vision Centers, Frontier Airlines and surf- and snowboard-wear maker Quiksilver — all sport accelerating earnings, strong and improving financials, high relative price strength and, importantly, low institutional ownership and limited brokerage sponsorship. In the last six months, his 20 top-performing stocks have each risen more than 50 percent, more than offsetting declines in other names. Through March 19 he has returned 1.87 percent, compared with the Russell 2000's 5.3 percent decline.



Johnston: "We're basically sucking up [costs] and working for sweat equity"

After earning his MBA at the University of Southern California in 1969, Johnston began working as a consultant at Arthur Andersen before becoming an institutional salesman at Smith Barney, where he developed an interest in managing money. Switching fields in 1976, he made a name for himself at San Diego Trust & Savings Bank, where he helped pioneer earnings momentum investing. After four years at Security Pacific Bank, he went out on his own in 1985, opening Sterling Financial Group. But the 1987 crash killed interest in small caps,



David Kern with father, Robert: "We didn't want to be competitors anymore"

tail microcap fund; it charges 125 basis points and last year returned 5.53 percent.

Now 63, Kern decided to open his firm in 1997, largely to go into business with his son. David Kern, now 35, had put in eight years at Founders Funds and

veteran trader, as well as five staffers in operations, business development and client service. The elder Kern says the firm's assets under management could grow to as much as \$1 billion to \$1.5 billion. "This is a business opportunity," he says. "Many larg-

Delaware Asset Management. "We didn't want to be competitors anymore," says David, Kern Capital's executive vice president and small-cap manager.

Kern Capital hired two seasoned analysts, a senior portfolio manager and a

er firms devote limited resources to microcap and close at \$200 million."

But most of all, it's the stock selection opportunities in the sector that motivate the father-and-son team. "This is the most inefficient area of the stock market," says Bob Kern, "where less fundamental research and coverage mean real opportunity for high returns." For example, the Kerns have invested in Pacific Sunware of California, an Anaheim-based maker of teen casuals, which doubled in price to \$30 per share since December; Cytoc Corp., maker of an improved Pap smear test, which has risen 30 percent above Kern's cost in the stock last year; and Imulex Corp., a storage area network firm, which last year tripled to \$30 per share.

So far, so good. Last year Kern's third fund, the \$10 million Fremont U.S. Small Cap Fund, returned 17.63 percent. — **A.A.L.**

growing interest in the sector. Established firms are adding or expanding small-cap offerings. Putnam Investments, for example, closed its \$914 million small-cap growth fund in 1997 but took in more than \$33 million in new small-cap value accounts last year. "It's easier to add value in small cap," says Putnam small-cap manager Edward Shaddek.

Veteran small-cap boutique Royce & Associates, which al-

ready had \$2.9 billion in small-cap value mutual fund business, last April recruited Buzz Zaino from Trust Company of the West to manage its commingled fund for institutions in the small-cap value arena. "We will take another \$500 million in the institutional business," says Jack Fockler, a managing director for Royce, "and that's it." The idea: to expand distribution and cash in on the trend.

But that doesn't mean there aren't opportunities in growth funds, too. Neuberger Berman, the value-oriented money manager, jumped on the bandwagon last October with a small-cap growth offering it calls the Millennium Fund; to date it's raised \$30 million. To run the fund Neuberger recruited Michael Malouf from San Francisco-based Dresdner RCM Global Investors. Neuberger already had an eight-year-old small-cap value fund. But except for a \$1.2 billion midcap offering shifted into the growth style in mid-1997, the firm was a one-trick pony. "At \$55 billion, it made no sense to run Neuberger as a value boutique," explains its executive partner Richard Cantor. "That's not a good strategy, and in small-cap growth we were running without an entry."

Small-cap stocks, in general, remain the last bastion of an inefficient market in equities. That means that skillful active managers are more likely to beat the indexes than their big-cap brethren. Some

and the market for his style dried up.

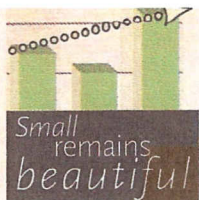
By 1992 he was ready for his second shot at a start-up. Together with fund marketer Jerry Apodaca Sr. and portfolio manager Jerry Apodaca Jr., he formed Apodaca-Johnston Capital Management. For the firm to qualify as minority-owned and thereby attract public fund clients, the Apodacas held 66 percent of the stock. Johnston's stellar performance helped pull in \$540 million in 22 institutional accounts. But in the summer of 1996, he and his partners had a falling-out. Within 60 days Johnston decamped, attracting Florida Power & Light Co.'s \$46.7 million account to come with him.

In November 1996 he reactivated Sterling Financial as Sterling Johnston, subsequently hiring three former stockbrokers as partners. Two long years later he has

as clients a \$3 million microcap account that gained 23 percent last year, a \$2 million hedge fund that was up 87 percent in 1998 and FPL. Winning new institutional clients remains a struggle, partly because no one wants to be first and partly because pension trustees and consultants like to see stability. "It's a question of which comes first, the chicken or the egg," Johnston complains, although his team is now in three finals.

Johnston says he's learned some lessons the hard way: Timing counts. And so does ownership, which is now in his hands — and those of his portfolio managers. But with a staff of four and two independent contractors, 1 percent fees barely cover Johnston's costs. "We're basically sucking them up and working for sweat equity," he says.

— **A.A.L.**



75 percent of active small-cap managers outperformed their benchmarks over the past three years, compared with a mere 22 percent of active large-cap managers who outperformed the S&P 500 during

that time, according to Frank Russell Co.

"It's true that the small-cap indexes have not done well for the last five years," admits Richard Charlton, president of New England Pension Consultants in Cambridge. "But small cap remains an extremely inefficient marketplace. As a rule, active managers whop the index."

Equally attractive from the manager's point of view are the hefty fees. At a boutique the standard 1 percent can go a long way. "You don't need size and resources to run small-cap port-

folios," says one pension fund consultant. "You can just hang out a shingle and make a lot of money. You raise \$1 billion, charge 1 percent management fees and make \$10 million, which for a firm with ten people is a nice business."

The economics can work for bigger firms, too. "Given capacity constraints, we hold the line on fees and wait and take the accounts willing to pay," says Putnam product specialist David Wonn.

Big asset management firms, by contrast, find it more difficult to run small-cap portfolios. Their high overhead demands heavy trading volume and substantial assets under management; the economics of small-cap trading don't work as well for them. According to Mark Hurley, a former Goldman, Sachs & Co. investment banker who in late 1997 formed the Dallas-

NEXT CENTURY OR BUST

It takes a good money manager to succeed in small-cap investing, but it takes something more to build a successful investment firm. Just ask Thomas Press and Donald Longlet, who opened up Minneapolis-based Next Century Growth Investors with high hopes in January.

Press, 43, and Longlet, 53, have some track record. At Jundt Associates the pair racked up an eye-popping average annual composite return of 20.14 percent from 1996 through 1998; by contrast, the Russell 2000 gained an average 11.58 percent annually for that period. That performance caught the eye of Richard Strong, chairman of Strong Capital Management, who put up some cash (he owns a minority stake) to get the two started on their own.

But despite their record and Strong's backing, Next Century has raised just \$17 million so far, \$9 million in a new Strong fund. The pair, who aim to eventually run \$1 billion, are willing to grow slowly, but they're getting a tad antsy.

"We've been to see eight pension funds, but no one wants to be first," admits Press. "We probably need \$50 million just to break even, but our feeling is that if we stick to our discipline, the money will come, because most managers are not doing quite as well."

The team, which searches out small companies generating top-line growth of at least 15 percent a year but more often growing about 50 percent, owns 57 names in its \$17 million portfolio. Current favorites are GeoTel Communications Corp., a call-routing company whose stock grew 370 percent last year, and Concord Communications, a network management firm whose stock has

doubled in the last year to \$57 per share. Next Century never puts more than 3 percent of assets, at cost, into any one stock or more than 30 percent into any one sector.

Disciplined investors, Longlet and Press always watch the earnings. "If they miss a quarter, the stock will be gone very quickly," says Longlet. "We do not sit around and wring our hands." In January they sold Documentum, an enterprise document management company, and Visio Corp., a graphics software firm, although they had bought them only two weeks earlier. "Corporate attention shifted from enterprise document management to Y2K and the Internet, buyers deferred spending, and these stocks got hit — but after we sold them." The result: Through March 18 the managers were up 11.5 percent for the year, compared with a loss of 1.56 percent for the Russell 2000 growth index.

Press began his career as an institutional sales manager for Salomon Brothers and Morgan Stanley & Co., watching clients like money manager James Jundt trade. In 1991 Press switched to the buy side, joining Investment Advisors, Inc. in Minneapolis to start a small-cap fund. He switched in 1993 to Minneapolis-based Jundt Associates,



Press (right), with Longlet: "We're seasoned. But right now I'm smiling and dialing"

where he teamed up with Longlet, who had joined in 1989 after 14 years managing trusts at Norwest Bank Minnesota and seven years managing portfolios at Fortis Advisers.

But each manager always wanted to start his own firm, and shortly after Jundt opened a hedge fund, which the pair felt less comfortable managing, Strong gave them an opportunity they couldn't refuse. "I'm bald, and Don's got white hair," jokes Press, who for now both manages and markets the funds. "So we're seasoned. But right now I'm smiling and dialing."

—A.A.L.



based firm Undiscovered Managers, small-cap funds that grow past \$800 million in size lose 7 percentage points from their average alpha, or outperformance. "There is a fundamental conflict of interest between a client and his manager," says Hurley. "The client wants the best return, and the manager wants more assets. In the future clients will insist on hiring only managers willing to close their funds."

Further boosting the opportunities for small-cap start-ups, the best-performing funds tend to close their doors to new investment before they get too big. Former Strong Capital Management managers Andrew Ziegler and Carlene Murphy Ziegler, who opened Milwaukee-based Artisan Partners in early 1995, closed their institutional and retail small-cap growth offering at \$600 million in 1997 and plan to close the \$200 million small-cap value offering when it reaches \$800 million. "Scale in small cap can be a disadvantage, causing some managers to close," explains Andrew Ziegler. "That creates scarcity, as opposed to another asset class like bonds, where scale is an advantage."

If booming demand for small-cap funds delights entrepreneurial money managers, it can cause headaches for institutional investors. In small caps, unlike any other U.S. equity discipline, managers often close to new clients well before they have a five-year track record, much less a stable, healthy business. Institutions, therefore, have to take a deep breath and jump in early. "If you wait until a manager has a five-year track record, you are going to lose out," says one consultant. "And if, after five years, they are still open, there is something wrong. It's like musical chairs. The chairs keep getting taken away."

Gardner Lewis Asset Management, which opened its doors in 1990, grew to \$1.25 billion in assets in four years before turning away new small-cap investments. Turner Investment Partners, also founded in 1990, closed to new small-cap clients in August 1997, after reaching \$500 billion in small cap, and has since grown to \$750 million. GlobeFlex Capital, opened in San Diego by former Nicholas-Applegate Capital Management managers Robert Anslow, John Pihlblad and Marina Marrelli in 1994, shut its doors to new funds in 1998, after reaching a target \$500 million.

If consultants helped create the miniboom in small-cap investing by evangelizing about the imminent upturn in the sector, small-cap managers are, not surprisingly, no less enthusiastic. "Small-cap price-earnings ratios are traditionally higher than those for large companies," explains W. Whitfield Gardner of Gardner Lewis. "But last October small-cap multiples fell below the one-to-one ratio, and now they're at an all-time low." Notes T. Rowe Price Associates small-cap manager Jack Laporte, "The New Horizons Fund is selling at a discount to the market for only the third time in 38 years."

Other hopeful signs abound, managers insist, including the absolute and relative earnings of small-capitalization companies. "Earnings on the S&P 500 last year fell, while small companies' earnings are expanding," says Gardner, who with his partner, John Lewis, and nine other analysts talked to executives from or visited some 3,000 small companies last year. "But we haven't seen any multiple expansion to reward the earnings growth. Last spring small-cap stocks in

their portfolios traded at 17 times earnings, and at the market trough on October 8 they were at 12 times."

And according to Royce & Associates' Fockler, the fact that there are 8,000 companies with market values of less than \$1 billion means huge potential if money should start flowing into the sector. "A shift of money into the small-cap sector would really drive the market," he says.

The managers also have academic research on their side. Back in 1978, while writing his dissertation at the University of Chicago, a Ph.D. student named Rolf Banz discovered that

"If you wait until a manager has a five-year track record, you are going to lose out."

small stocks had outperformed large stocks over the long term; his idea was further researched by the University of Chicago's Eugene Fama, the Robert R. McCormick distinguished service professor of finance, and his associates at Dimensional Fund Advisors, as well as Yale School of Management professor Roger Ibbotson.

"Small stocks on average get higher returns than large stocks, and those returns are predictable," says Ibbotson, who notes that, in the last 73 years, small stocks returned a compound 12.4 percent annually against 11.2 percent for large stocks. Since 1925, he says, a \$1 investment in small stocks would have returned \$5,116 through the end of last year — more than two times the \$2,350 return for the same \$1 investment in large stocks.

Of course, outperformance comes only over time. And Ibbotson and others admit that the cycles can be brutal. Small stocks outperformed large stocks every year from 1974 through 1983, underperformed in six out of the seven years from 1984 through 1990, outperformed from 1991 through 1994 and tanked again, relative to large stocks, from 1995 through 1998. But based on small-cap performance in November, December and January, Ibbotson believes the cycle may now be reversing once again.

Of course, there are plenty of naysayers. "Extended periods of small-cap leadership start at the end of bear markets and the start of bull markets," says Charles Blood, the chief strategist at Brown Brothers Harriman in New York. "This bull market is old. Small stocks are not even participating." Through late March this year, as the S&P 500 rose a further 7 percent, the Dow Jones industrial average gained 9 percent, and the Nasdaq soared 12 percent, the Russell 2000 fell 5.5 percent before dividends. Adds James Paulsen, chief investment officer of San Francisco-based Wells Capital Management, small caps have done well during predominantly inflationary periods but fared poorly during periods of deflation like the one we are in now. "When prices are rising, small companies can always do what the big guys did for less," he says. "Now the only way to make money is through constant cost reduction, something the lean and mean little guys can't do."

Small-cap performance may rise again, or it may not. Either way money managers trading the stocks seem increasingly likely to clean up. ■