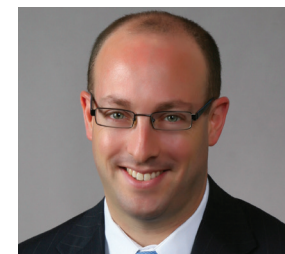


# INSIGHTS

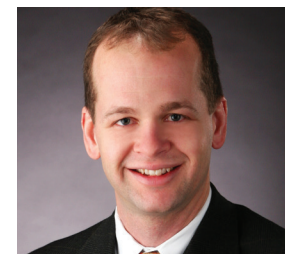
## INVESTMENT

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# Small caps: Blending quant and fundamental management to get better outcomes



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**S**mall-cap stocks have been tracking with their large-cap brethren for much of the market's rally over the last couple of years. Some analysts think that if President Donald Trump's steel and aluminum tariffs touch off a trade war, small caps could outperform. Whatever happens, the small-cap universe is large and so it's risky to paint them all with the same brush. At BMO Global Asset Management, portfolio managers David Corris and Tom Lettenberger said blending quantitative and fundamental analysis can provide investors with better opportunities in any environment.

**Pensions & Investments** | *What accounts for the higher returns of small caps?*

**David Corris** | There are two competing explanations. Some argue that it's a risk premium: The higher return is compensation for taking higher risk. The other is an alpha argument: Small caps typically have higher growth, and by investing in unrecognized companies when valuations are still reasonable, you can achieve alpha through earnings growth paired with multiple expansion.

**P&I** | *The tax reform bill seemed to give small caps a boost at the end of the year relative to large caps, but will valuations, potentially tight credit and increased volatility keep any gains limited?*

**Tom Lettenberger** | Improved capital investment, aided by tax reform, should benefit small caps. We don't think these benefits have been fully reflected in valuations. Also, small-cap companies on average pay higher tax rates. As we go forward in 2018, tax reform will be a big reason why small-cap earnings growth will finally start outpacing that of large.

**P&I** | *What impact might the Fed's rate policy and hikes have on small caps this year? In general, how do macro-factors impact small caps?*

**Lettenberger** | As long as rate hikes coincide with an accelerating economy, this should be good for small caps because they tend to be domestically focused companies. Periods of rising interest rates are periods when small caps have historically stood out.

Though small caps certainly can have periods of higher volatility, companies tend to be less caught up in broad market moves and more driven by their own performance.

**Corris** | Macro tends to have more of an impact in large caps, while in small caps risk tends to be more stock specific. Our process is designed to recognize that.

**P&I** | *Tell us more about your process and why it is distinct.*

**Corris** | The core value proposition that really differentiates BMO in small caps is the way we've blended quant and fundamental investing. Neither style is perfect; each has limitations. Quant and fundamental investing complement each other when paired properly, and this is especially powerful in small caps.

For starters, to help with small-cap investing, quant has four components that fundamental investing typically doesn't offer.

The first is that the small-cap universe is very large and does not have a lot of analyst coverage. For both reasons, quantitative methods tend to work very well. Second, liquidity and transaction costs are incredibly important in small caps. Quant managers can quantify those and build them directly into their process. Third, risk is highest in small caps, and quants do a particularly good job of managing risk. And fourth is portfolio construction: Quants view building a portfolio as a scientific process rather than buying a collection of stocks they like.

On the flip side, fundamental investing mitigates some of the risks of quant investing. By its nature, fundamental understands individual companies and reduces the risk of data mining. So you lessen the quant-side risks of being fooled into data mining — which can lead to models that don't work well out of sample — and reduce the risks of not necessarily knowing well the companies you're investing in.

Our view is you do much better by combining these styles — and there are not a lot of firms doing this well.

**P&I** | *Why don't more managers blend fundamental and quantitative?*

**Corris** | The reason something that seems so obvious doesn't happen more often is that it's very hard to implement in practice. Quant and fundamental investors have very different cultural beliefs, and they typically don't work well together.

Because of this cultural mismatch, firms that have tried forcing the two groups together have ended up with one

team getting the upper hand and the other being subjugated. We've fully integrated our team so that quant and fundamental are equal partners at the table.

**P&I** | *What happens when quant and fundamental indicators are moving in opposite directions?*

**Lettenberger** | Just because a company looks attractive in the quantitative model, it does not mean that we add it to the portfolio. That's where the fundamental review comes in.

We look to reduce risks, to make sure that we don't have companies in the portfolio where the quantitative process may be missing something material. That's one of the risks we look for in our fundamental review.

**P&I** | *What role can small caps play in an institutional investor's asset allocation?*

**Corris** | The case for small caps as part of your strategic allocation is very strong because of the ability to generate higher returns. There's a small-cap premium, a beta. But they also offer greater alpha. It's generally accepted that the small-cap market is more inefficient.

Also, we believe this inefficiency is likely to grow, as European regulation may lead global investment firms to scale back their fundamental investment coverage of small-cap names. This situation is ideally suited to managers like us who rely more on quantitative tools than on sell-side research.

**Lettenberger** | As David mentioned, there are more inefficiencies within small caps, which can generate alpha. We believe the market for small caps will become less efficient going forward: Small caps generally have much lower institutional ownership than large caps, and they also have much lower analyst coverage.

**P&I** | *How would you sum up the opportunity in small caps?*

**Corris** | Small-cap investing is an important part of investors' portfolios. Our view is that every investor should be thinking about their small-cap allocation and using active management due to the inefficiencies in the market. We think our integrated quant-fundamental approach is ideally tailored to the nuances of small caps.

**Lettenberger** | Small caps appear to be attractive as investment opportunity. An accelerating U.S. economy, rising GDP growth and favorable tax reform all play into the notion of small caps outperforming large caps over the short and intermediate term. ■

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