Quarterly Investment Perspective

Sizing Up the Markets

Rebecca Patterson, Chief Investment Officer

When it comes to investing, questions of size can loom large. How do different-sized companies factor into an economy's broader growth trends? What is the link between equity performance and the health of larger versus smaller firms? How does the size of investors' capital or the size of specific financial instruments — looking not just at equities but across asset classes — impact returns?

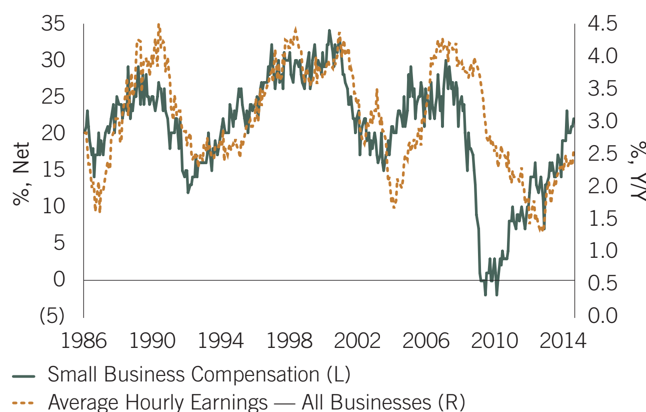
In this *Quarterly Investment Perspective*, we explore size from different perspectives, focusing on the U.S. While our investment process takes into account a number of different variables, we find that size is a critical issue to consider.

Small Companies and Stocks: More Than Meets the Eye

As the largest economy in the world, the United States is driven by millions of small ideas and a unique entrepreneurial spirit. Americans celebrate turning inspiration into profitable businesses. Witness the success of television shows like "Shark Tank," where contestants vie for start-up capital. With that in mind, it is not much of a surprise that half of the country's private sector is employed in a small business, defined by the Small Business Administration as having fewer than 500 employees. Around 90% of those small businesses are truly tiny, with fewer than 50 employees. Small businesses generated nearly two-thirds of the net new jobs in the U.S. between 1993 and 2011, reasonably leading one to conclude that small-business trends should provide clues for the broader U.S. economic outlook.

In many instances, this assumption has proven correct. Trends in small U.S. firms often can be leading indicators for the U.S. as a whole. For instance, small-firm wages historically have led broader U.S. wage inflation (Exhibit 1). Indeed, the recent rise in small-business wages is one reason why we expect U.S. inflation will grind higher into 2015.

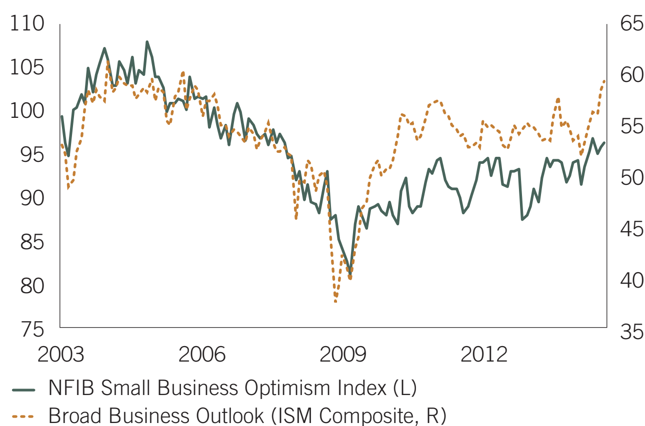
Exhibit 1: Wage Growth for Small Businesses Is a Leading Inflationary Indicator



As of August 31, 2014. Small Business Compensation represents the percent of small businesses that increased compensation in the last three months, minus the percent of small businesses that decreased compensation. Average Hourly Earnings represents production and nonsupervisory workers. Source: Bloomberg, Bureau of Labor Statistics, National Federation of Independent Business

However, sometimes small firms can give "false signals" about the broader economy and temporarily go their own way. Take, for instance, the aftermath of the 2008 crisis. Demand was soft for both small and large firms. What was different, and an additional headwind for smaller firms after the crisis, was the financing backdrop. Many younger, smaller firms are started by family and friends and capitalized primarily from small bank loans and home equity. With home values plunging during 2007 and 2008, and banks tightening underwriting standards, available credit to small firms dried up. Between 2008 and early 2014, the number of loans for $1 million or less held by banks fell about 14%, versus a rise of 9% in the number of loans to businesses of all size, according to data from the Federal Deposit Insurance Corporation. Partly as a result, small-business confidence recovered more slowly after the crisis (Exhibit 2).

Exhibit 2: Small-Business Confidence Has Lagged During Recovery



As of August 31, 2014. Small Business Optimism is set to 100 in 1986. ISM Composite is a GDP-weighted average of the Manufacturing and Non-manufacturing indices, where a reading above 50 indicates businesses are generally expanding; below 50 indicates that they are generally contracting.
Source: Bloomberg, Institute for Supply Management, National Federation of Independent Business

This year, small businesses are finally starting to feel better, with small-business sentiment breaking above the level considered "expansion" territory in April and gradually rising since. Yet in one of the more surprising market trends so far this year, small-cap (market capitalization) U.S. equities have materially underperformed their larger counterparts, following impressive *outperformance* in 10 out of the last 14 years (Exhibit 3). Indeed, from the market bottom in March 2009 through the end of last year, the S&P SmallCap 600 Index rose by 217% versus "only" 156% for the large-cap S&P 500 Index (total return). Yet this year, small-cap stocks have underperformed the S&P 500 by 12%.

Exhibit 3: Recent Underperformance of U.S. Small-Cap Equities Is Notable

As of September 30, 2014. Represents total returns for the S&P 500 Index and S&P SmallCap 600 Index.
Source: FactSet, Standard & Poor's

Here, it's worth noting the distinction between *small businesses* — firms with fewer than 500 employees — and *small-cap companies*, which are typically considered those with market capitalizations under $2 billion. Technically, many of the firms in the small-cap universe aren't considered small businesses because they have more than 500 employees. That said, while "small cap" is not necessarily synonymous with "small business," we believe both can provide important information to evaluate the U.S. economic outlook.

What Drives Small-Cap Equities?

If small U.S. businesses were struggling after the crisis — facing weak demand and financing pressures — how is it that small-cap U.S. equity prices were doing so well until recently?

In general, smaller publicly traded companies are more nimble, able to respond more quickly to changing economic environments than larger companies. Further, small, publicly traded companies have access to capital that small, privately held companies do not. As a result, they typically grow faster during a recovery attracting investment early in the business cycle. When investors started to take comfort in 2009 that aggressive fiscal and monetary easing would prevent a more prolonged recession and looked for opportunities, they turned to smaller companies. As had historically been the case, investors expected earnings growth to improve more quickly at smaller firms.

Another help for small-cap equities — though only in a rising market — is liquidity (or lack thereof). Limited volumes of small-cap stocks mean that an increase in buying interest can push prices higher quickly.

History supports the view that small-cap equities are in favor early in an economic recovery when risk appetite is improving and investors are more willing to hold less liquid securities. Going back to 1949, small-cap equities outperformed large-cap stocks in the four quarters following the end of the recession nine times out of 10 (Exhibit 4).

Today, the U.S. economy has been growing for more than five years. While we may not yet be at the end of the expansion, clearly the "early cycle" advantage for small caps has passed. So where do we go from here?

We see no reason to abandon small-cap U.S. stocks, even later in the cycle, and would point to at least three supports for small caps in the year ahead.

1. **Smaller U.S. firms tend to benefit disproportionally during active M&A periods.** In the current environment where U.S. firms are cash-rich and borrowing costs remain low, mergers and acquisitions (M&A) deal activity has

Exhibit 4: Historically, Small Cap Has Outperformed Early in Business Cycle

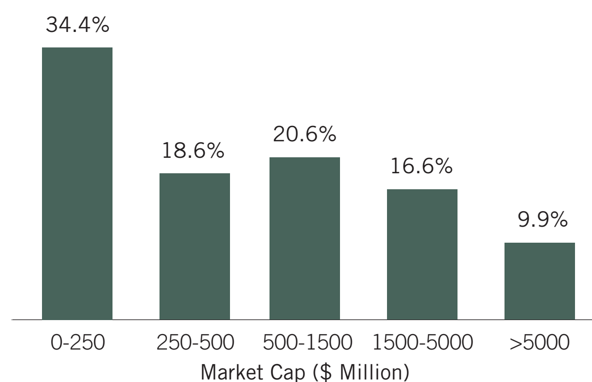
	Next-12-Month Return		
Recession End Dates (Quarter)	**Small Cap %**	**Large Cap %**	**Small – Large %**
October 1949 (IV)	44.6	31.5	13.1
May 1954 (II)	57.1	40.5	16.5
April 1958 (II)	63.8	44.2	19.7
February 1961 (I)	23.3	16.0	7.3
November 1970 (IV)	20.7	21.9	(1.2)
March 1975 (I)	57.7	36.9	20.8
July 1980 (III)	50.9	30.4	20.4
November 1982 (IV)	45.5	27.6	17.9
March 1991 (I)	45.5	22.2	23.2
November 2001 (IV)	(9.6)	(14.1)	4.5
June 2009 (II)	42.5	29.4	13.1
Average			**14.1**

Date indicates the quarter in which the U.S. recession ended, according to NBER. Small Cap represents equal-weighted average returns for the smallest 40% of stocks listed on the NYSE, NYSE MKT, NASDAQ, and Arca exchanges (market capitalization less than approximately $2 billion); Large Cap represents the largest 40% of stocks (market capitalization greater than approximately $5 billion).
Source: Center for Research in Security Prices, National Bureau of Economic Research

picked up. In the first half of this year, global M&A volumes rose more than 40% from a year earlier, according to Dealogic. U.S. activity led the way, with volume doubling from the same period last year to more than $815 billion. We expect the trend to continue for the foreseeable future, and to benefit smaller firms that tend to be "easier" targets for acquirers to digest. Since the start of last year, firms with market capitalizations less than $500 million have accounted for 53% of all U.S. M&A targets (Exhibit 5). Expectations for further M&A should help support valuations of small caps.

Exhibit 5: Small-Cap Firms Are Attractive M&A Targets

U.S. M&A Targets by Market Cap (2013–2014)



As of September 17, 2014. Reflects publicly traded targets with market capitalization as of that particular deal's announcement.
Source: FactSet, Strategas Research Partners

2. **Smaller U.S. firms tend to benefit more from a strengthening dollar environment.** U.S. small caps tend to generate more revenue domestically than larger counterparts. Large-cap stocks get nearly 40% of sales today from outside North America; that figure is closer to 15% for small caps. As we look ahead, we believe slowly rising U.S. interest rates and a narrowing current-account deficit will support the dollar, already up around 6% since end-June on a trade-weighted basis (for more on our dollar outlook, please see our July *Quarterly Investment Perspective*). Companies with more foreign exchange exposure will have the additional headwind of managing earnings around currency risk.

3. **Small-cap companies are often less understood, providing opportunities for investors.** Generally speaking, large-cap stocks are more likely to be covered by research analysts because larger firms generate more investment banking and trading-related fees, and many larger investors do not want to bother with small individual holdings in a portfolio. This backdrop creates instances where companies may be misunderstood and hence mispriced. In our view as an active equity manager, this is a perennial reason to consider holding some allocation to small- and mid-cap equities: the ability to generate returns through thoughtful stock selection.

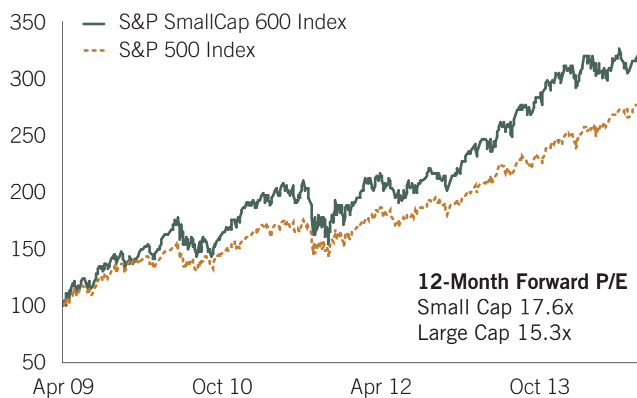
The Case for Large-Cap Stocks

While this sounds like a pretty rosy small-cap outlook, a lot of optimism is already discounted in valuations. The price-earnings ratio for U.S. small-cap stocks (S&P 600) is now around 17.6 times estimates for earnings over the next 12 months, up from 13.5 in the third quarter of 2011 and well above the 15.3 ratio for the S&P 500 today. So while there are valid small-cap supports, we believe that extended valuations, together with where we are now in the economic cycle, are likely to limit return potential from here. Historically, larger firms have performed better late in an expansion, in part because they have been better able to pass through

rising prices to customers. These issues drove our decision to reduce U.S. small-cap exposure earlier this spring (Exhibit 6).

Exhibit 6: Valuations Leave U.S. Small Caps Relatively More Vulnerable to Shocks

Total Returns Since Stock Market Trough



As of September 30, 2014, with April 1, 2009 indexed at 100. P/E is based on Bloomberg estimates for next-12-month earnings.
Source: Bloomberg, Standard & Poor's

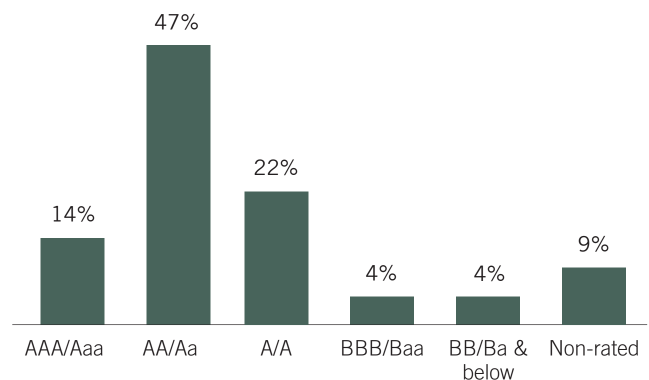
While we are incrementally less bullish on U.S. small cap, we remain constructive on equities broadly, given still-ample global liquidity, slowly improving global growth, strong corporate balance sheets, and "under-owned" equity markets (the latter based primarily on equity and bond flows since 2008). We are comfortable with our overweight exposure versus the benchmark, but see more value in large-cap stocks where valuations are less stretched (and within that, are tilted towards the U.S.).

Beyond Stocks: In Search of Small

The idea that value can lie unnoticed or unappreciated in small-cap stocks can hold true for other investments as well. Municipal bonds are particularly interesting from this perspective. When a municipality issues debt, it can pay a ratings agency to rate the bond. At times, this cost can be warranted, as many investors will only buy rated bonds and often the rating itself can help bring down the yield of the bond (which benefits the issuer). There are occasions, however, when the bond size doesn't justify the cost of getting a rating, especially if the bond may be lower rated to begin with. As of August, nearly 10% of municipal bonds were non-rated (Exhibit 7).

Exhibit 7: Non-Rated Bonds Are a Potential Area of Opportunity

U.S. Municipal Bonds by Market Rating



As of August 31, 2014.
Source: Municipal Market Advisors

Unrated Municipal Bonds

Unrated munis oblige the investor to do more legwork to understand the risks of the bond and whether the pricing is attractive. But like small-cap stocks, this area of the bond market can provide opportunities for security selection and, in general, higher yields.

Here is one (tongue-twisting) example: the Montachusett Regional Transit Authority General Obligation Revenue Anticipation Notes. These notes are an established annual financing vehicle for the state of Massachusetts' mass transit authorities, providing operating funds in anticipation of annual federal, state, and local payments. A long-established state statute requires the Commonwealth of Massachusetts (rated in the upper double-A category) to pay any principal and interest due on the notes if authority funds are insufficient for such purpose.

Given the small deal size and non-rated aspect of the offering, many buyers will not commit the time required to evaluate the notes. Therefore, regional transit authority one-year notes typically yield 0.40% (given the bond's tax-exempt nature, for a high-income taxpayer, this would be the equivalent of a 0.65% yield on a taxable Treasury bond). This comes in a market environment where one-year high-quality paper is sold at yields closer to 0.15%.

While 2014 so far has challenged our view that U.S. interest rates are biased higher, we continue to believe that a slowly improving U.S. economy and a Federal Reserve headed towards its first rate hike in 2015 will overcome a drag on yields from overseas (particularly in Europe and Japan). We want to hold our underweight to fixed income.

Rising yields do not mean a quick return to pre-crisis levels, however. For now, we remain in a world where yields have effectively collapsed. A pickup of 0.25 percentage points through a small, unrated municipal bond can make a real difference.

External Managers

Another area where size can matter is with external investment managers. Bessemer uses a hybrid approach when building a portfolio. Where we believe we can be "best in class," we invest capital directly, including equities, fixed income, commodities, and currencies. We believe managing some client capital in-house provides important benefits — we are in the market every day, which helps us better evaluate external manager performance; we also make more timely, thoughtful decisions on asset allocation based on the information we receive from investing internally.

That said, we want to use external managers if we believe they have an expertise that we do not in an area that will benefit portfolios. In recent years, for instance, we have partnered with external managers to invest in U.S. non-investment-grade debt, small-cap emerging-market equities, and non-agency mortgage-backed securities, as well as hedge funds, real estate, and private equity.

Are we better off with established, large managers with long track records of good performance, or smaller, more recently launched managers? The short answer here is, "It depends."

A study published in May by Novus Partners, focusing on hedge fund managers, found that, in general, smaller funds (defined by assets under management and often referred to as "emerging managers") see better returns. According to the study, size was seen to impede returns in a few ways, including the following two:

- With more capital to invest, managers may increase the number of positions held, so attention to each position may decrease — which means that some positions may be held with less confidence than others.
- Managers with more capital to invest may be inclined to buy larger, more liquid securities, which may not offer the same opportunities as smaller, less followed securities.

We would broadly agree with Novus Partners' conclusions, and add two additional factors to consider. Smaller, less-established hedge fund and long-only managers may have a heightened focus on risk controls and performance in early years to establish a track record. This isn't to say that larger managers do not care about risk or performance, but that, if they already have a helpful track record, that need may not be as pressing. Further, as managers grow and get more clients, they are more likely to have to leave their offices to visit those clients. We want to ensure that, whatever manager we hire, their primary focus is on the portfolio, and that compensation is based on performance rather than size of assets managed.

This is not to suggest that new managers with very little in assets under management (AUM) are always a better option. Ideally, one wants to find a new or "emerging" manager who has proven him or herself previously (that is, there is a relevant track record at a prior firm or in another strategy to examine). Further, a new manager still needs to have a strong back office: As we research possible managers for our portfolios, we care as much about accounting, compliance, and risk control as we do investment acumen. In some cases, emerging managers do not yet have the resources to have a sufficiently robust back office. At Bessemer Trust, the median age of a given long/short hedge fund when we first invest in it is 43 months: long enough for the manager to have started building a track record and a strong back office, but early enough that the fund's AUM is sufficiently small ($190 million at the time we invest, on average) to be nimble and focused on high-conviction ideas.

One caveat to the manager-size bias is activist investing. In this case, the ability of a manager to take larger stakes in a company and exert more influence often requires more capital. Here, a larger manager may have an advantage that can help performance. Another manager area where bigger may be better — at least in some cases — is private equity. Research shows that larger, top-performing venture capital firms tend to stay top performers over time for several reasons. First, their success may cultivate stronger relationships with entrepreneurs, companies, and industries, which gives them earlier access to "deal flow" that in turn can uncover more attractive investment opportunities. Second, strong managers in this space may be successful in part because they provide strong management or advisory inputs along with their capital. It's not surprising, then, that persistently high performance in turn attracts more capital — which means that the best venture capital funds tend to grow bigger and bigger.

At Bessemer, whether we are looking at long-only external managers, hedge funds, or private equity, we will consider both small and larger firms, taking into account these broad issues but also appreciating that every manager and investment strategy can be different and should be evaluated on its own merits.

Goldilocks?

Investors may benefit from considering size when thinking about specific parts of a portfolio, but what about wealth managers themselves? A small boutique firm can make a client feel special and offer a high level of personal service. A large organization may have more resources to support the client's needs. Is there a right answer?

Frankly, the right answer will likely depend on the family or individual in question. Nonetheless, we believe Bessemer's size does provide it with some important advantages that work to the benefit of our clients.

We are small enough to be nimble. While Bessemer has grown over the years, we are not so large that we are constrained: We can look at smaller securities for portfolios; we do not have to rely heavily on large external managers just because we have a lot of money to invest. We can change portfolio asset allocations within days when needed.

That said, we are not too small. The size of our firm — and critically important, our size alongside our longevity and reputation — makes us an attractive partner to trading firms and external managers. The access this affords us allows us to invest in top managers and conduct deep global research, even without having dozens of offices around the world.

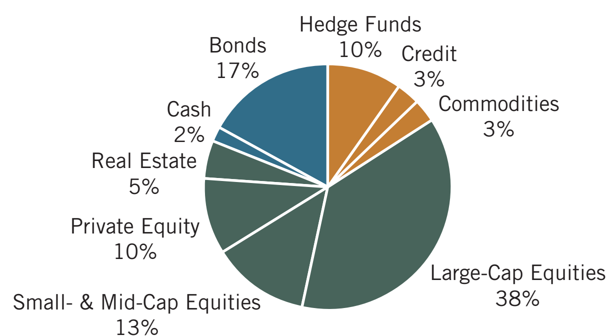
Investing Alongside Our Clients

Perhaps as important as size, in our view, is alignment of interest. Our owners and employees — including the Investment Department — invest side by side with clients. We eat our own cooking. And what are we serving up as we head closer to 2015? Exhibit 8 provides a snapshot of a recommended diversified (70-30) portfolio as of late September, including hedge funds.

- As noted earlier, we remain overweight equities, with a growing bias towards larger-cap stocks. Within equities, we are overweight the U.S. and underweight developed Europe.
- We remain underweight traditional fixed income, looking for slowly rising U.S. yields to weigh on returns in the months and quarters ahead.
- We are neutral commodities — we see rising U.S. interest rates and a stronger U.S. dollar as headwinds, but offset by still-attractive valuations (crude oil and some agriculture prices stand out as we enter the fourth quarter) and slowly improving growth.

Our goal is not to be the biggest wealth management firm. Instead, it is to deliver consistently strong risk-adjusted returns through teamwork and objective, deep analysis of the global macroeconomic landscape as well as individual securities.

Exhibit 8: Bessemer's Outlook and Positioning



As of September 30, 2014. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets exposure with target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors.

Alternative investments, including Bessemer private equity, real estate, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

Past performance is no guarantee of future results. This material is provided for your general information. It does not take into account the particular investment objectives, financial situation, or needs of individual clients. This material has been prepared based on information that Bessemer Trust believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. This presentation does not include a complete description of any portfolio mentioned herein and is not an offer to sell any securities. Investors should carefully consider the investment objectives, risks, charges, and expenses of each fund or portfolio before investing.

Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation. The mention of a particular security is not intended to represent a stock-specific or other investment recommendation, and our view of these holdings may change at any time based on stock price movements, new research conclusions, or changes in risk preference. Index information is included herein to show the general trend in the securities markets during the periods indicated and is not intended to imply that any referenced portfolio is similar to the indices in either composition or volatility. Index returns are not an exact representation of any particular investment, as you cannot invest directly in an index.

Atlanta • Boston • Chicago • Dallas • Denver • Greenwich • Houston • Los Angeles • Miami
Naples • New York • Palm Beach • San Francisco • Seattle • Washington, D.C. • Wilmington • Woodbridge
Cayman Islands • New Zealand • United Kingdom

Visit us at www.bessemer.com.

Copyright © 2014 Bessemer Trust Company, N.A. All rights reserved.