The Myth of Generic Investing in Large Caps and Index Funds as a Risk-Aversion Strategy

by IMCZ Treasurer John Henry Smith

We all have heard from our investment advisors of the generic risks of investing in the stock market, and rightly so. If this sound advice is not heeded by a risk-hungry client, the best the advisor is likely to recommend is an index fund weighted in favor of large caps to reduce the risks that stalk the length and breadth of the market. The advantage of this strategy is based on three strongly defended arguments, namely that:

1. An ordinary investor is not able to consistently reap profits greater than the market return.
2. Any expectation of 'abnormal' returns requires an inverse acceptance of increasing levels of risk.
3. The conventional wisdom of the market dictates that large cap stocks are safer than mid cap stocks that are safer than small cap stocks by virtue of their sheer size and liquidity.

The question to be asked is whether this wisdom has any consistent validity! To make this clear, the following lists the performance of the Dow Jones 30 Industrials over nearly 5 quarters:

The DJ 30 Industrials from July 1, 2008 to September 18, 2009

DJ 30 Companies	Symbol	Large Cap in $ Billions	July 1, 2008 to Sep 18, 2009
JP Morgan Chase & Co	JPM	176.7	28%
Home Depot Inc	HD	48.1	18%
3M Company	MMM	52.1	7%
The Travelers Companies Inc	TRV	26.8	7%
Hewlett-Packard Co	HPQ	109.4	4%
Coca-Cola	KO	124.6	4%
United Technologies Corp	UTX	59.1	3%
IBM	IBM	160.1	2%
McDonalds Corp	MCD	62.2	1%
Cisco Systems Inc	CSCO	135.4	-1%
Johnson & Johnson	JNJ	167.5	-4%
Procter & Gamble Co	PG	167.3	-5%
Kraft Foods Inc	KFT	39.2	-6%
Pfizer Inc	PFE	112.8	-6%
Intel Corp	INTC	109.5	-9%
Microsoft Corp	MSFT	225.1	-9%
American Express Co	AXP	41.4	-9%
Walt Disney Co	DIS	52.9	-10%
Wal-Mart Stores Inc	WMT	193.3	-11%
Verizon Communications	VZ	84.1	-14%
Merck & Co	MRK	67.2	-14%
AT & T Inc	T	159.6	-17%
Exxon Mobil Corp	XOM	336.4	-19%
E.I. du Pont de Nemours & Co	DD	30.5	-21%
Boeing Co	BA	38.5	-21%
Chevron Corp	CVX	145.7	-26%
Caterpillar Inc	CAT	33.2	-28%
Bank of America	BAC	152.5	-28%
General Electric Co	GE	175.3	-37%
Alcoa Inc	AA	13.7	-60%
DJ 30			-17%

The table makes it clear that the DJ-30 component stocks were not altogether immune against some very substantial price declines over the period under review! Needless to say it can be argued that an index fund of this kind has some real benefits, in that losses are the market return and no more, and is certainly better than taking on the risk of individual positions in General Motors, AIG, Citigroup, UBS, BankAmerica/Bear Stearns, Lehmann Bros, Washington Mutual, and the like, all once blue chip companies. However, the downside of choosing a predominantly large cap portfolio as a risk-aversion strategy is the very reason that such stocks may have been recommended in the first place, namely their size! Mesmerized, in 2008 we witnessed the collapse or near-collapse of a long list of large-scale U.S. corporations that were thought of as being too big to fail or even falter; bastions of strength to put your money in; safe havens against any economic storm. Now looking back, we have to ask ourselves whether this advice was right.

My belief is certainly not! The real clue to successful stock market investing is not generic stock selection *per se* that may be based on market capitalization, or anything else, but rather on a stock selection process that identifies the relative inelasticity of demand for a company's products and is the catalyst for its growth. A look at industry groups may help us to identify which sectors are doing well and which are not. Of the 239 Morningstar Industry Groups only 59 groups or 25% are in positive territory, the remainder are below the zero line. Topping the sectors list are:

Industrial Group	Period under Review
Medical Practitioners	78%
Drugs – Generic	53%
Music & Video Stores	42%
Consumers Services	41%
Tobacco Products –Other	41%

whereas at the bottom are the following sectors:

Industrial Group	Period under Review
Shipping	-50%
Long-Term Care Facilities	-53%
Investment Brokerage – National	-53%
Heavy Construction	-56%
Mortgage Investment	-63%

However, the conundrum to this approach is that even within industry groups, some stocks perform better than others. For example, in the Agricultural Chemicals Group, which is down 42% in the review period, Scotts Miracle-Gro Company (SMG) is up 143%. Similarly, the Toys & Games sector is down 6%, but Gaming Partners Intl (GPIC) is up 56%! So again in any evaluation process, an investor or asset manager needs to understand the underlying catalysts driving a stock if he wishes to achieve a satisfactory risk/reward ratio, and not make decisions, or accept advise based on a pre-determined group criteria strategy.

From the discussion so far, one could argue that there is no place to hide when the market turns sour and thus verifies the hypothesis that ordinary investors cannot swim against market currents, and should not even try when the large caps are floundering. But of course such an attitude is wrong! The following is a list of 30 top small and mid cap companies that were not caught up in the tempest of falling stock prices. Their performance instead reflects the treasures that can be found beneath the surface when one looks beyond the price action of large caps and index funds. The shocking truth is that the DJ-30's performance lost 17% while these small and mid caps returned an aggregate of 88%! So where were the greatest risks? It deserves careful thought, doesn't it?

Selection of Grail Stocks Companies	Symbol	Small & Mid Cap in $ Billions	July 1, 2008 to Date
Human Genome Sciences	HGSI	2.7	276%
SXC Health Sol Corp	SXCI	1.2	233%
Fuqi Intl Inc	FUQI	0.8	196%
Stec Inc	STEC	1.5	187%
Green Mountain Coffee Roasters	GMCR	1.7	162%
Pegasystems Inc	PEGA	1.2	146%
Netease. Com	NTES	5.7	119%
Emergency Medical Services	EMS	2.0	106%
Healthcare Information Service	QSII	1.6	101%
Starent Networks	STAR	1.8	95%
VistaPrint	VPRT	2.0	88%
Cubic Corp	CUB	1.0	82%
Netflix Inc	NFLX	2.7	77%
NVE Corp	NVEC	0.2	73%
Autonation Inc	AN	3.2	72%
Jos A Bank Clothiers	JOSB	0.9	72%
Buffalo Wild Wings	BWLD	0.7	67%
Rock-Tenn Co	RKT	1.9	64%
Corinthiam Colleges	COCO	1.6	58%
PetMed Express Inc	PETS	0.4	51%
WMS Industries Inc	WMS	2.1	44%
Aeropostale Inc	ARO	2.9	37%
Watson Pharmaceuticals	WPI	3.9	37%
New Oriental Edu & Tech Corp	EDU	3.0	33%
Lance Inc	LNCE	0.8	33%
Priceline.com Inc	PCLN	6.9	31%
Syntel Inc	SYNT	1.9	31%
Life Technologies Corporation	LIFE	8.6	26%
United Natural Foods Inc	UNFI	1.0	22%
Open Text CP	OTEX	2.1	22%
Selection of Small and Mid Caps			88%
Small Cap: Up to $2 Billion			
Mid Cap: Between $2 Billion and $10 Billion			

I have always believed that stock-picking based on healthy earnings growth is the best way to uncover stock value. I appreciate there are different styles of investing from concentrating on the blue chip names to buying momentum stocks and all that lies in between, but given that market risk is the prime foe of the equities market, more than ever the imperative is not accept significant losses in the belief that large caps are the paragon of safe havens and other stocks further down the capitalization ladder are riskier. Of course there are stocks in all classifications that will perform badly no matter what kind of market is ruling, but generic index-based funds are not the answer. Their sanctity in 2008 has been proven to be just a myth in the flow of misinformation investors have to deal with daily.

The way to making significant profits is to look for stocks that simply are immunized against bearish forces because their products are in strong demand. If their growth potential is sustained they will one day reach large cap status, like stagnating Microsoft, but hopefully not too soon, so that their growth rates will continue to enable us to reap the kind of handsome returns that smaller but faster growing companies can offer.

Investment Forum: 28 Brains

by IMCZ Treasurer John Henry Smith

The first session of the IMCZ Investment Forum took place on September 1, 2009, at the Parkhotel, our 'Stammplatz'. The whole evening was fully interactive and the 28 participants were divided into three groups. The first activity was a case study about the massive explosion of the U.S. money supply. Each group was given a possible solution; their tasks were to justify the answers provided and this took 1.5 hours, whereby the last half an hour was given over to intensive and productive discussion. After a much needed break, in the second exercise, each group had $200 to spend, with which to select stocks from a list of 30 top companies, each group getting an up-to-date set of reports to work with. As the photo below shows, after an intensive 30 minutes, the selections were placed onto portfolio forms and will be tracked over 3 months. Every member of the group that beats the market and the other two groups will win a trophy. As with all glories, they will only keep their prizes until new winners are announced after the next competition.

28 Members' brains working together

At the next meeting, we will evaluate the performance of the three portfolios in an effort to determine the drivers of their performances. There will be an introduction to stock derivatives by a member of the planning group as well as another activity to be decided up!

If you wish to know more about the Investment Forum, please contact John, your Treasurer, or better still why don't you take the risk and invest in some fun-by-learning and sign-up for the 2nd exciting session, scheduled for October 6, 2009 at 7 p.m. in the Parkhotel. You won't regret it!

More detailed information and any changes will be notified to all members by email well in advance.

Members sweating over their tasks