Danger Zone: Small Cap Blend Investors

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Check out this week's Danger Zone Interview with Chuck Jaffe of Money Life and Marketwatch.com.

We argued at the beginning of the year that small caps were overvalued compared to large caps and would underperform this year. That prediction has been right so far as the Russell 2000 is down 4% while the S&P 500 is up 4% in 2014. We don't see this divergence ending any time soon.

All of the small cap styles earn our Dangerous rating, but Small Cap Blend Investors land in the Danger Zone due to the disproportionately large allocation to the worst funds in the style. Small Cap Blend investors, especially those in ETFs, are putting more of their money into Dangerous funds and less into the few Neutral and Attractive rated ones. Over 72% of investors' money in Small Cap Blend ETFs is allocated to Dangerous-or-worse ETFs, which account for a bit over half of the ETFs in the style. Figure 1 has the details.

Poor Allocation

The stock pickings are slim in the Small Cap Blend style. Only 8% of stocks earn an Attractive-or-better rating. However, portfolio managers and ETF providers are still putting together portfolios that are even worse than one should expect. As Figure 1 shows, just one of 27 ETFs and 10 out of 702 mutual funds in the Small Cap Blend style earn an Attractive-or-better rating.

Figure 1: Small Cap Blend Rating Landscape

	Very Attractive	Attractive	Neutral	Dangerous	Very Dangerous
# of Stocks	67	181	630	1349	391
% of Style	2%	6%	26%	50%	16%
# of ETFs	0	1	11	15	0
% of ETFs	0%	4%	41%	56%	0%
% of TNA	0%	0%	28%	72%	0%
# of MFs	0	10	231	324	137
% of MFs	0%	1%	33%	46%	20%
% of TNA	0%	1%	34%	55%	10%

Sources: New Constructs, LLC and company filings.

Small Cap Blend investors are mostly overlooking the few good choices they have.

The primary causes behind the poor capital allocation decisions of Small Cap Blend investors seem to be trusting the big brand name ETFs and not digging into the holdings.

For instance, iShares Russell Microcap Index Fund (IWC) earns our Very Dangerous rating and allocates only 17% of its assets to Neutral-or-better stocks. On the other hand, First Trust DJ Select MicroCap ETF (FYT) earns a Neutral rating and allocates 33% to Neutral-or-better stocks.

Both IWC and FYT charge the same amount of fees, but IWC has $900 million in assets while FYT has only $60 million. Investors are going with the better-known iShares ETF when FYT offers them better holdings for the same price.

In addition, investors seem to be favoring the wrong major index. ETFs that track the Russell 2000 are attracting far more assets than those that track the S&P SmallCap 600, but the latter index has far superior holdings and therefore, upside. iShares S&P Small Cap 600 Index Fund ETF (IJR) earns a Neutral rating and iShares Russell 2000 ETF (IWM) earns a Dangerous rating. IWM also charges higher total annual costs of 0.22% compared to 0.15% for IJR. Despite this fact, IJR has $13 billion in assets and IWM has nearly $24 billion. Investors are paying more for worse holdings.

Slim Pickings

The other big issue is that there just aren't many good small cap stocks as they, as a group, are significantly overvalued. IJR has a price to economic book value (PEBV) ratio of 4.1, and IWM has a PEBV of 4.5, while the S&P 500 (SPY) has a PEBV of 2.5. Economic book value represents the zero growth value, so essentially the market is currently predicting that the cash flows of the holdings in IJR and IWM are going to increase by more than a factor of four.

One of our least favorite stocks held by Small Cap Blend ETFs is PolyOne Corporation (POL), one of our Most Dangerous stocks for August. POL's after tax profit (NOPAT) is essentially flat over the past eight years while its ROIC has dropped from 8% to 5%. Despite its lack of profit growth, POL's valuation of ~$38/share implies 15% NOPAT growth for 14 years. Low profitability and high expectations make for a risky stock.

POL is a top holding of ProShares Ultra Russell 2000 ETF (UWM), the worst rated ETF in the Small Cap Blend Style. UWM also charges significantly above average total annual costs of 1.06%. Investors might think twice about paying those high fees if they realized UWM has such poor holdings.

Some Quality

There are some places for Small Cap Blend investors to find quality. iShares Enhanced US Small-Cap ETF (IESM) is the only Small Cap Blend ETF to earn an Attractive rating. It allocates over 59% of its value to Neutral-or-better stocks, including one of our Most Attractive stocks, Aspen Insurance Holdings (AHL).

The takeaway is that small caps are very risky, and investing in them right now takes even more diligence than usual. You can't be sure that the big-name ETF you hold isn't going to underperform just as IWM has so far in 2014. There's real profit to be made in small caps, but it takes diligence.

Sam McBride contributed to this report.
Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, or theme.

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