small is beautiful

A STUDY OF INVESTMENT MANAGEMENT
AS IF PEOPLE MATTERED

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The Speaker :

Jeffrey Bronchick, CFA | Cove Street Capital Co-founder, Chief Investment Officer

Mr. Bronchick co-founded Cove Street Capital in July 2011. He was the Chief Investment Officer and a lead principal of Reed Conner & Birdwell, LLC, a Los Angeles based investment manager that he joined in 1989. For 22 years, Bronchick ran research-driven, concentrated, value-based strategies across all market capitalizations and led extensive credit work throughout the corporate capital structure. He was one of the first columnists for the TheStreet.com in the 1990's and then moved on to a similar role with Grant's Interest Rate Observer's first online effort. Prior to RCB, Mr. Bronchick worked in research and trading roles at Neuberger Berman, Bankers Trust and First Boston. He attended the London School of Economics and graduated from the University of Pennsylvania.

"Eminently qualified to speak about the behavioral dynamics of large and small investment firms which can help or hinder investment performance and the rational functioning of a firm and its culture."

What is behind the math of a variety of studies that suggest that smaller investment managers outperform their larger brethren?

Not a recent phenomena:

- Northern Trust 2011
- FIS 2011
- Journal of Investing 2007
- Greycourt 2004
- Journal of Portfolio Management 2001

What do we really mean when we say "Small Manager"?

"Under $2 to $3 billion in assets"?

A BETTER DEFINITION:

An experienced investor with a public track record (current or former firm) who works in a self-designed environment with a selective group of assets and people that provide enough infrastructure and resources in order to effectively apply a focused investment philosophy to produce outperformance.

“Never, ever, think outside the box.”

A top ten list of what makes small better:

1. We eat what we kill…or “the interests of emerging investment managers are aligned with those of clients, as owners have significant financial stakes in their investment disciplines, firms, or both.”
2. Culture is easier to define…and maintain.
3. An investment firm that can be run by investment people, not marketing.
4. No room for bureaucrats in the home office.
5. A higher likelihood of attracting like-minded clients who self-reinforce sensible thinking.
6. Strategy focus is possible and leads to outperformance.
7. It is possible to concentrate on high conviction ideas—crucial in a high correlation world.
8. Small is easier than ever—the internet and research | cloud based solutions versus upfront fixed costs | huge variety of custody, brokerage, processing systems, reporting, analytics solutions available.
9. “Small” is certainly better for small cap.
10. Sir John Templeton said “*It is impossible to produce superior performance unless you do something different than the majority*.” Almost by definition, you become the majority with sizable assets.

The Pitfalls of Small:

A. Being a good investor has nothing to do with running a business and the skill set is likely to be inversely correlated. You had **BETTER** hire or partner with a highly competent business person.

B. Much of the world has a very different DNA than you do.

C. No free candy from the sell-side.

D. “Scaling anxiety” is real and tricky.

Last Thoughts:

Should I be concerned about being a large percentage of your asset base or a high percentage of a strategy's assets?

To avoid an obvious and self-serving no, let me again steal from Howard Marks at Oaktree Capital who runs $90 billion in assets and for who this question probably doesn't come up much anymore:

I've heard committees say, "we don't want to represent more than x% of a managers assets under management or of the fund's total capital." But why not? Is the goal better performance or is it safety in numbers?" If you're considering investing $10 million with a manager, why does it matter how much money she manages? Why is investing $10 mm safe if she manages $1 billion but risky if she manages $50 mm? If a manager is unusually skillful, aren't you better off as her client if she manages less money than more? And if a manager was really good, wouldn't you prefer that she managed only your money?

My most specific and most heartfelt advice is this: The surest way to achieve superior performance is by investing significant amounts with individuals and firms that can be depended upon for investment skill, risk control and fair treatment of clients.