

The Three (Two) Musketeers

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Investing in Small Cap Companies

Based on our previous presentation to leverage the DA Davidson Fund, our group has been interested in finding a strategy that increases upside potential while not also increasing downside risk of the fund. It has proved challenging to find a way to do that, but we found an option worth exploring: investing in small cap stocks. We know small cap stocks tend to outperform large cap stocks, so we decided to run some analysis on this with the goal of developing a set of parameters to yield small cap stocks with higher returns than our benchmark (SPY) while keeping in mind the risk preferences of the fund.

Our initial research pointed to some key parameters to be aware of: market cap, PEG ratio, operating cash flow, and debt to equity. Though the market cap of small cap stocks typically ranges from 250M-2B, we set our market cap parameter to include stocks ranging from 500M-2B to be conservative and ensure the companies we invest in have grown and existed for some time. We chose to use the PEG ratio to compare a stock's P/E to its growth. We set our parameter to have a PEG ratio between .5-1 to measure companies that are undervalued but are growing at a reasonable rate. Furthermore, we wanted to ensure the small cap companies we invest in are financially stable. Therefore, we wanted to ensure that they have a positive operating cash flow and capital structure with 20% or less debt. These parameters resulted in a portfolio of companies that outperformed SPY by 139%, over 10 years. In our backtesting on Bloomberg, we only looked at stocks on major US exchanges, rebalanced annually, and equally weighted the stocks we invested in.

We are proposing to invest \$20,000, \$4,000 per stock, in the School Fund by selling SPY shares. The companies were determined using the parameters above. They are A10 Networks (ATEN), Openlane (KAR), Kelly Services (KELYA), Ligand Pharm (LGND), and Timkensteel (TMST).

Limitations: One challenge we will face is convincing future SIF classes to maintain this strategy. The portfolio performs best when held for a long time.

Sources:

<https://www.forbes.com/sites/investor/2022/11/17/how-to-find-sustainable-small-cap-growth-stocks/>

<https://www.investopedia.com/insights/understanding-small-and-big-cap-stocks/>