

➤ The Investment Perspective – April 2024



Peter Flannery CFP FA

“Neither the investing method nor the fundamentals of the business are right or wrong because the mood of the market is favourable or unfavourable toward the “stock”. That is because when you really think about it, “stocks” (shares) are all about the financials and the trading price, the share price...the cash up value. What matters more is the economics of the business.”

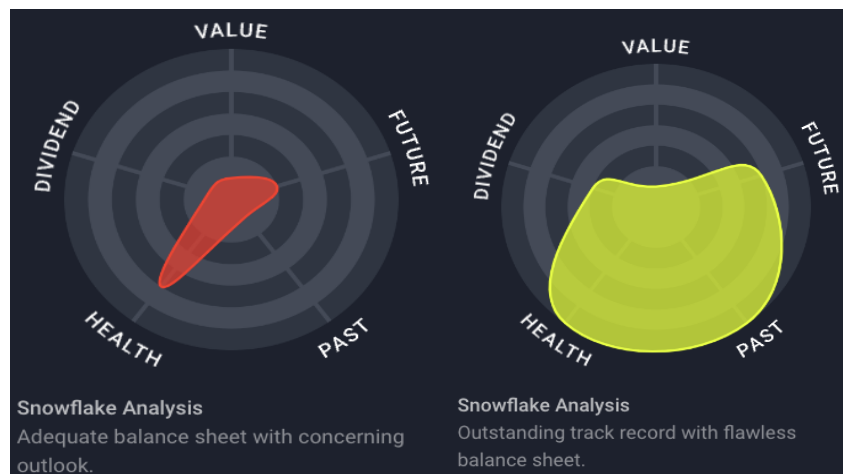
-Peter Flannery

Invest in AI or small caps?

Which way?

The short answer is to invest in the most promising and reliable business rather than the sector.

Here are two examples of promising tech companies (using spider graphs for a quick demonstration of their differences). By the way, these are examples, not recommendations.



The red colour means low quality/reliability. The light green colour represents high quality/reliability.

Both businesses look promising and may benefit from AI developments.

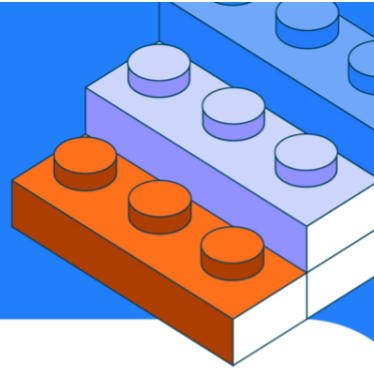
NextDC is the business to the left above (red), based in Australia. \$A8.6 billion market capitalisation, a mid cap. It looks well positioned for growth in the future although reliability is questionable currently.

Napco Security Technologies is the business to the right above (green), based in the US. \$US1.5 billion market capitalisation, a small cap. It also looks reasonably well positioned for future growth, possibly slower than what could be possible with NextDC but with more reliability.



Beyond Big Names

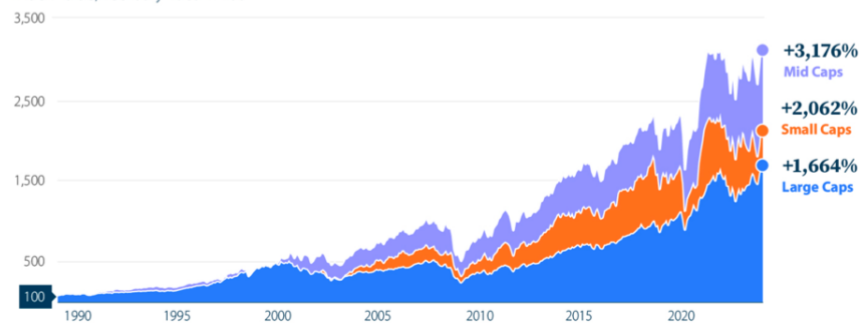
The Case for Small- and Mid-Cap Stocks



Over the last 35 years, **small-** and **mid-cap** stocks have outperformed **large caps**, making them an attractive choice for investors.

Historical Returns of Large Caps, Mid Caps, and Small Caps

Index Value; February 1989 = 100



Yahoo Finance 03/05/2024. Indexed to February 1989 = 100 using monthly data. Large caps represented by the S&P 500. Mid caps represented by the S&P 400. Small caps represented by the S&P 600. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

The above compares mid caps, small caps and large caps since 1989.

Caps is jargon for capitalisation.

Market capitalisation means how large or small a business is, based on the number of shares on issue, multiplied by the share price.

Generally, larger businesses can be more resilient and therefore lower risk, although even big businesses can fail.

Higher Returns, Higher Volatility

What would a \$100 investment in small, mid, and large caps made in February 1989 be worth today?

The Trajectory of a \$100 Investment

February 1989 to February 2024



Since February 1989, small caps have returned **23%** more compared to large caps. Mid caps have returned **86%** more.

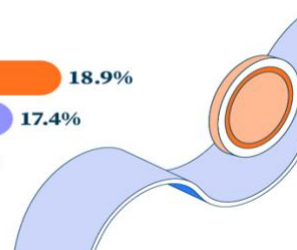
Yahoo Finance 03/05/2024. Large caps represented by the S&P 500. Mid caps represented by the S&P 400. Small caps represented by the S&P 600. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

Small and mid caps earned a higher return historically, but experienced greater volatility.

Historical Annualized Volatility of Large Caps, Mid Caps, and Small Caps February 1989–2024



Yahoo Finance 03/05/2024. Large caps represented by the S&P 500. Mid caps represented by the S&P 400. Small caps represented by the S&P 600. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece. Volatility, calculated as the annualized standard deviation of monthly returns, measures risk by quantifying the variation in returns. Past performance is no guarantee of future results.



The above graph compares returns and the value of \$100 invested in 1989.

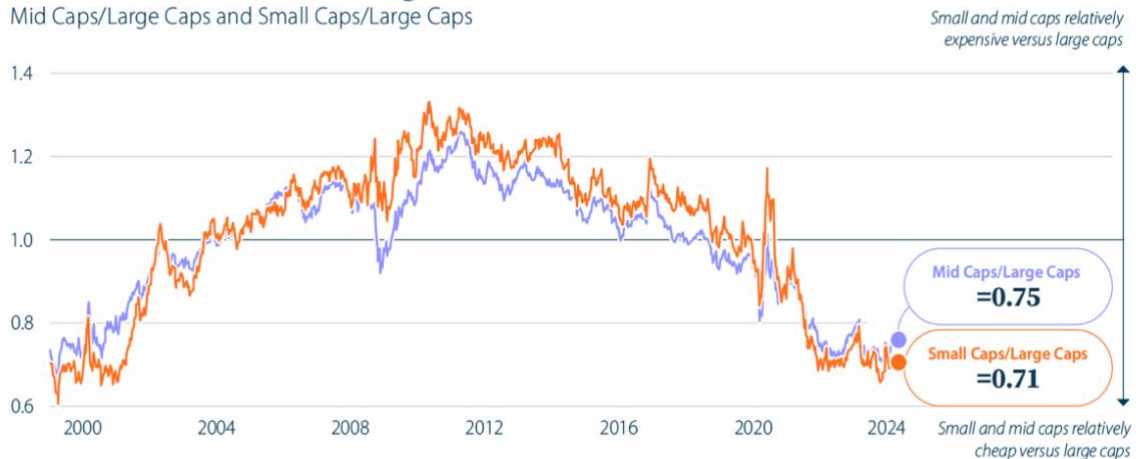


Attractive Valuations

Small- and mid-cap stocks are trading at the steepest discount versus large caps since the early 2000s, presenting a compelling entry point.

Relative Forward Price-to-Earnings Ratios

Mid Caps/Large Caps and Small Caps/Large Caps



Yardeni Research, LSEG Datastream. 03/05/2024. Relative forward P/E ratio of mid caps represented by S&P 400 forward P/E ratio divided by S&P 500 forward P/E ratio. Relative forward P/E ratio of small caps represented by S&P 600 forward P/E ratio divided by S&P 500 forward P/E ratio. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece. Past performance is no guarantee of future results.

The graph above shows the valuation of mid caps and small caps compared to large caps.

Large caps have been favoured by the market over the last few years, particularly those involved in technology. Mid caps and small caps are out of favour by comparison.

Sure, small caps can be problematic and detract from long term performance when they just don't work. Although rare at WISEplanning, they can more readily fail compared to big business too. The rule of five can help us here though. I have lost count of the number of times I have seen the worst-performing investment in a portfolio on the line directly next to the portfolio's best performing holding.

Anyway, this is our opportunity to locate and invest in reasonably priced businesses, especially in the mid cap space. It takes time because we need to 'turn over lots of rocks' to find good ones, as Warren Buffett once said (in response to the question about how he finds good investments).

It takes time for any business to grow too – patience grasshopper 😊

Smaller businesses are generally more volatile but can grow faster than larger businesses over time, especially if we can locate and buy at a reasonable price. We only need one or two, not 10 or 20.

"If you're not willing to react with equanimity to a market price decline of 50% two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you're going to get."

-Charlie Munger [Interview with BBC](#)

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