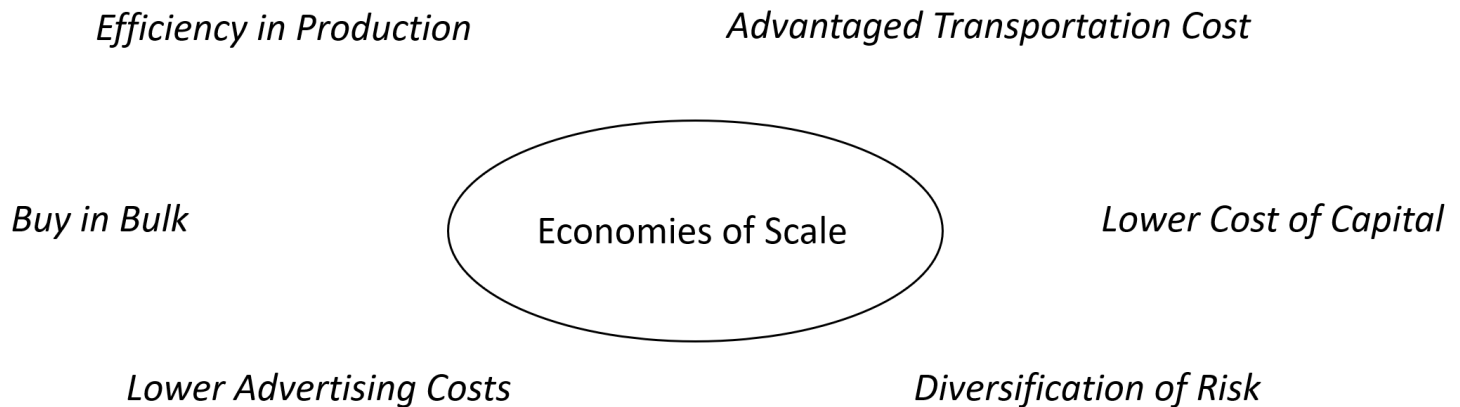


# Seeking Advantaged Economies of Scale

The Lead | April 2024

## Economies of Scale



Source: Sterling Capital.

The purpose of our monthly communication is to share our investment philosophy with current and potential clients to help them make informed investment decisions. Last month, we shared a core mission to seek out what we define as an advantaged company. We illustrated how growing market share can potentially lead to greater profitability for companies and their shareholders.

We'd like to continue with our March Madness analogy as the intense competition continues. The top team needs to win six consecutive games, which we believe demonstrates a sustainable advantaged company versus its opponents. With our strategies, we seek to find companies with sustainable advantages that we believe set them up for success. One important advantage we seek in large capitalization stocks is having dominant market shares that provide economies of scale, which may make a company more profitable and earn higher returns on its capital than its competitors. The benefits are outlined in the graphic above.

Economist Adam Smith told the story of these benefits back in 1776 with his anecdote on pin making, which was a common example at the time. It revealed how the division of labor could enable 48,000 pins to be made by ten individuals versus a maximum of 20 pins a day by one person.<sup>1</sup> The benefits of size can be witnessed in the chart on the following page that compares the operating profit margins and return on investment across company sizes, categorized by Russell.

Just as small-cap investors can rightfully contend that their companies have the potential to grow faster and improve their operating margins, many times at the expense of their larger-cap competitors, we believe it is important to assess whether a company has increasing or decreasing returns. We'd note that Adam Smith was also famous for his term the "invisible hand," where large profits incentivize competitors to drive markets to equilibrium and reduce high profit margins.<sup>1</sup>

<sup>1</sup>Smith, A. (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*.

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Charts are for illustrative purposes only.

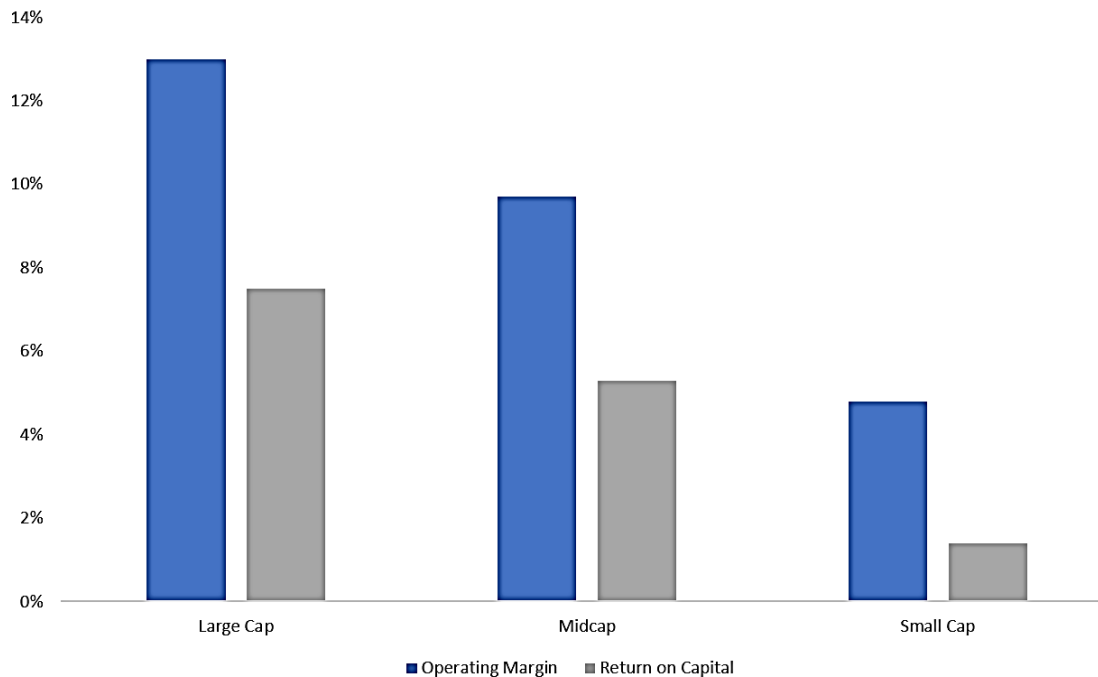


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## Comparison of Russell Indices by Size



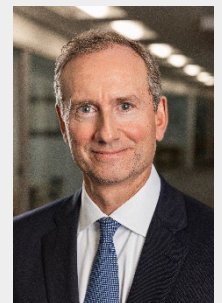
Note: Large Cap refers to The Russell 1000® Index, Midcap refers to the Russell Midcap® Index, and Small Cap refers to the Russell 2000® Index.  
Source: Bloomberg L.P.

We believe it is possible to identify companies that gain scale, market share, and returns at the expense of competitors. Their continued progress makes entry for new competitors difficult. Companies with economies of scale that have already conquered a market and reinvested those profits so that they have a cost advantage make it even more difficult. Even if a new entrant makes inroads, it may never be able to have the established benefits outlined on the previous page.

As we have stated for close to two decades as part of our investment philosophy, we believe size usually translates to cost advantages in production, marketing, and research and development expenditures that can be re-invested back into the business, making such advantages sustainable. Our pursuit of creating portfolios of advantaged companies for clients continues.

As always, thank you for your interest and trust managing your investments.

**Charles J. Wittmann, CFA®**, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is Co-Portfolio Manager of the Equity Income strategy. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation and served as President of CFA Society Virginia from 2012-2013.



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# Important Information

## Disclosures

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

**The Russell 1000® Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the U.S. market. The Russell 1000® Index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are included.

**The Russell Midcap® Index** measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap® Index represents approximately 31% of the total market capitalization of the Russell 1000® companies. The Russell Midcap® Index is constructed to provide a comprehensive and unbiased barometer for the mid-cap segment. The index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid-cap opportunity set.

**The Russell 2000® Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Dividend-focused strategies may underperform strategies that do not limit their investment to dividend-paying stocks. Stocks held strategy may reduce or stop paying dividends, affecting the strategy's ability to generate income.

**Technical Terms: Dividend Risk:** Dividend yield is one component of performance and should not be the only consideration for investment. Dividends are not guaranteed and will fluctuate. This report should not be regarded by the recipients as a substitute for the exercise of their own judgment. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. **Dividend Yield:** a financial ratio that measures the annual value of dividends received relative to the market value per share of a security. In other words, the dividend yield formula calculates the percentage of a company's market price of a share that is paid to shareholders in the form of dividends. (Technical definitions are sourced from Corporate Finance Institute and Investopedia.)

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

Since we began publishing The Lead in 2015, our primary purpose has been to communicate our investment philosophy and process as an investment advisor in the context of changing markets. In creating portfolios that differ from our benchmarks by focusing on characteristics that have a long term history of attractive relative returns according to Ned Davis Research, the portfolios are different from the benchmarks and as a result there can be periods where results differ including below benchmark performance. Since strategies are oriented toward the long term characteristics, if those characteristics are out of favor over a period of time, the given strategy's performance could be challenged in terms of relative performance. While Sterling believes active professional investment management that employs a consistent process with a long term orientation and aligned with client interests offers benefits, management fees to support the active approach can be higher than certain alternatives. When hiring an investment manager we believe it is important to monitor the investment risks taken including sector concentrations, portfolio turnover, and the impacts of dividend policy changes.