A NEW INVESTMENT CYCLE

WHITE PAPER ON AN HISTORICAL SMALL-CAP INVESTMENT OPPORTUNITY

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Abstract

The bull market that began March 9, 2009 is officially over. As we look back at the last cycle and those before, it becomes apparent that a considerable amount of alpha is generated in the early months and years of a developing cycle. Capital allocators tend to stay defensive through and out of a market nadir, where appropriate equity concentration should be formed around small-cap companies. Our analysis shows that fifty percent of equity price growth was obtained in the first two years of the last cycle, which lasted almost eleven years. And during that initial two-year period, small-cap stocks provided dramatic out-performance relative to large-cap stocks.

A New Investment Cycle

The ten-year bull equity market ended abruptly in February 2020 as investors started to appreciate the health care, economic, and financial implications of COVID-19.

From the peak on February 20th, global equity markets have been on a roller coaster ride, as prices experienced a steep, sharp drop, then clawed back more than half of the loss in the following six weeks. Having lived through market crises in the past, we are wary of assuming this one is done. However, we have survived enough of it to be able to start thinking about what the next cycle will bring us.

Generally speaking, owning only large-cap stocks limits an investor's opportunity. Larger companies are typically more mature with fewer opportunities for significant growth, while smaller companies may provide investors with exposure to newer developing goods, technologies, or services. Nevertheless, from the mid-point to end of a market cycle, investors prefer the liquidity and corresponding perceived safety of large-cap stock ownership.

That said, large-cap stocks generally outperform later in a bull market cycle. One of the factors is liquidity – as we move later in a bull cycle, bears begin to snarl and investors tend to look for more defensive, typically dividend-bearing securities. In the past cycle, passive index products drove the large end of the market even higher, given large-cap stocks are a much heavier aggregate index weight.

In fact, considering the bull market from March 2009 to February 2020, there were two different investment allocation opportunities:

- For the two years between March 31, 2009 and March 31 2011, the Russell 2000 Small Cap Index had an annualized compound return of 43.09% versus the SP500 Index return of 31.61%. That differential would provide an additional $31,536, or $15,768 per year, for every $100,000 invested in <u>small-cap stocks versus large-cap stocks over the two years</u>; and,
- For the period between March 31, 2011 ending December 31, 2019, the Russell 2000 Small Cap Index returned 9.61% versus the SP500 Index return of 13.04%. That differential would provide an additional $69,301, or $7,901 per year, invested in <u>large-cap stocks versus small-cap stocks</u>.

In fact, although credible small-cap indices were really not available prior to 2000, there is recent historical evidence illustrating the strength of small-cap investing

	INTERNET BUBBLE		FINANCIAL CRISIS		2015 CORRECTION		2020 CORRECTION	
	Period leading to trough: 07/01/2001 through 10/11/2002	Period recovering from trough: 10/11/2002 through 05/30/2003	Period leading to trough - 11/30/2007 through 03/09/2009	Period recovering from trough: 03/09/2009 through 12/31/2009	Period leading to trough: 06/26/2015 through 02/09/2016	Period recovering from trough: 02/09/2016 through 12/30/2016	Period leading to trough: 02/15/2020 through 03/27/2020	Period recovering from trough: 03/27/2020 through ???
Russell 1000® Index	*-24.60%*	*22.10%*	*-44.40%*	*67.80%*	*-12.20%*	*24.20%*	*-25.30%*	*TBD*
Russell 2000® Index	*-25.60%*	*32.40%*	*-45.90%*	*80.40%*	*-24.20%*	*42.00%*	*-32.80%*	*TBD*

Figure 1

arising from a market correction, as Figure 1 illustrates below.

Clearly, following prior drawdowns, small-cap markets have been very attractive during the subsequent economic rebound. Why is this so?

From history, the small-cap premium was among the earliest anomalies uncovered by researchers in the 1970s and it came from the recognition that small market capitalization stocks earned higher returns than the rest of the market, after adjusting for risk. That premium has become part of financial practice, though allocations have been reduced somewhat over the past few years.

We suggest small-cap strategic allocations have lowered for at least three reasons: a) liquidity fear - despite strong results coming out of the Great Recession, excessive pessimism from the length and depth of that correction reduced the risk appetite of equity investors ; b) fear of loss - the length and extent of the recent bull cycle created angst among investors that active managers could add no value to market indices leading to greater passive investing; and c) fear of the unknown - the expanding use of governance parameters like ESG does not lend itself well to small-cap equities as data is either unavailable, or minimal.

And, of course, there is always that old saw about capacity constraints. The benefits of having a global opportunity set may be outweighed by the practical difficulties in developing sufficient depth of coverage to add alpha. Investment managers simply do not invest in team depth for small-cap fundamental analysis.

Avoiding the active/passive debate for the moment, there is strong evidence pointing to pricing inefficiencies in smaller companies. Many companies are not closely followed by traditional sell-side analysts (who are reacting to needs of capacity-constrained large-cap managers) leaving much of the leg-work to the investor and creating potential alpha opportunities for skilled managers.

Active small-cap management lends itself to highly experienced individuals or teams who know their regional market very well. With a disciplined small-cap investment process, an experienced manager with have developed extensive networks of local brokers, company contacts, and peers from which wo gain an informational edge.

Returning to the small-cap premium, there are two things worth noting:

- First, market capitalization is an imperfect proxy for size in small-cap companies, not a reflection of revenues or earnings. Thus, you can have a young company with little or no revenues and large losses with a large market capitalization and a mature company with large revenues and a small market capitalization; and,
- Second, to define a small-cap stock, you have to think in relative terms, by comparing market capitalizations across companies. In fact, much of the relevant research on small-cap stocks has been based on breaking companies down by market capitalization into deciles and looking at returns on each decile. One reason that the small-cap premium resonates so strongly with investors is because it seems to make intuitive sense; it seems reasonable that small companies, with sustainable business models, yet less access to capital and greater key person risk, should be riskier than larger companies but provide stronger growth

Looking at small-cap value equities from a buy low, sell high perspective shows that we are at a potentially historical level of attractiveness for these stocks. A recent report by O'Shaughnessy Asset Management compared the earnings yield of the cheapest small-cap stocks to the most expensive large-cap stocks using this metric. The spread between the two was at a level only seen 1.7 per cent of the time throughout history, with earnings yields on small-cap value stocks a massive 21 per cent higher than expensive large-cap stocks.

But is small-cap investing about valuation? We argue that investing must actually reflect the realities of a changing world. Business needs to be dynamic and nimble as the time it takes to define success or failure is more compressed than ever before. According to a report by Mellon Bank in the US, in 1958 the average lifespan of an S&P 500 company was approximately 60 years. That figure has fallen to less than 20 years today. Viewed through a different lens, 52% of Fortune 500 companies in 2000 no longer exist due to bankruptcy or acquisitions.

In today's world, investors speak about "disruptors" - generally entrepreneurs, outsiders, and idealists, rather than industry insiders or market specialists, who create a product, service, or way of doing things which displaces the existing market leaders and eventually replaces them at the helm of the sector. Most people think of technology businesses as the principal sources of disruption, but disruptive innovation does not refer to one product or service, but to the evolution of a disrupter within any market arena over a period of time.

While a relatively new colloquialism, these types of innovative, small-cap businesses have been plentiful over the years, as the following examples show:

- Forty years ago, a young entrepreneur recognized traditional convenience stores would be better positioned as part of a combined offering – like purchasing gasoline – rather than stand-alone entities. Ten years later, Metro-Richelieu (now Metro Inc.) agreed, and sold Alain Bouchard their 60 convenience stores in Quebec. ***Alimentation Couche-Tard*** went public on the Canadian exchange in August 1998 as a $200 million (CAD) small-cap company. Twenty-one years later, at $46 billion (CAD) market cap, this business is one of the preeminent global franchises dominating their market;

- In 1997, five employees in a small duplex in Redwood City, California, developed a simple concept - how to leverage technology to straighten teeth. In January 2001, ***Align Technology*** went public in the United States as a $500 million (USD) small-cap company. Now a $19 billion (USD) market cap company, Align is a global medical device company that has reinvented the way orthodontic and restorative treatment is presented and delivered to millions of people around the world;

- In 1983 an employee of Proctor & Gamble realized the increasing use of personal computers would eventually replace paper-and-pencil personal accounting. Ten years later, ***Intuit Inc***. went public at $390 million (USD) to raise capital to purchase a tax-preparation software company, Chipsoft. Today, as a $73 billion (USD) business, Intuit helps consumers, small businesses, and the self-employed prosper by delivering financial management and compliance products and services.

These are but a few of many, many examples. In fact, most today's world-class organizations were "small cap" businesses just a few years ago. We analyzed companies in the SP500 index, and found there were currently 286 companies with market capitalizations above $20 billion USD (at December 31, 2019). Of those, 261 companies were in existence ten years earlier (December 31, 2009). Further, of those there were 104 businesses with a market capitalization less than $10 billion (USD) on December 31, 2009 – these 104 businesses, on average, grew their market capitalization by 20.3% per year over that ten-year period.

Investing in smaller companies is an art. Small-cap companies are more susceptible to economic shock (like what we are currently experiencing) and poor management decisions than their larger brethren. Discerning tomorrow's great companies requires considerable qualitative work focused on the unique franchise of the business model combined with the strengths of the management team. True, there are some momentum-style investors that have profited in smaller companies on behalf of their clients, but understanding quality business factors and their competitive moats avoids placing client monies in poorly structured businesses.

Market downturns simultaneously create historic opportunities to buy stocks at lower prices, but also pose increased risks as companies with questionable accounting and business models are exposed. It is risky to indiscriminately buy small-cap stocks during market downturns. Again, this emphasizes the need for a strong, capable team focused on small-cap investing disciplines.

As Figure 2 on the following page illustrates, certain valuation metrics on the Russell 2000 small-cap index are at various historical troughs. While valuations in

2020 are somewhat higher than other periods, this is a result of our historically low interest rates – another benefit to the smaller business.

Statistic	10/11/2002	03/09/2009	02/09/2016	03/31/2020
Price/Earnings	*15.2*	*9.6*	*16.9*	*14.1*
P/E using FY1 Est	*12.6*	*9.6*	*14.8*	*13.3*
P/E using FY2 Est	*10.6*	*8.5*	*14*	*11.7*
Price/Cash Flow	*5.6*	*3.9*	*8.1*	*6.2*
Price/Book	*1.3*	*0.9*	*1.7*	*1.5*
Price/Sales	*0.5*	*0.6*	*0.9*	*0.8*
Est 5yr EPS Growth	*15.0%*	*14.8%*	*12.8%*	*12.5%*
Subsequent Two-Year Return	*34.3%*	*92.4%*	*59.4%*	*?*

Figure 2

The compelling long-term returns of small-cap stocks, however, have come with some drawbacks—notably the perception of being more "risky." Modern portfolio theory, for all of its flaws, defines risk as volatility, or the variation in return patterns over time. Examining the volatility of small-cap stocks relative to large-cap stocks shows that the former has indeed been more volatile over every major time period.

Of course, volatility is only one form of risk and, while it provides a basis for an academic measure of risk, it does not address other (and perhaps more tangible) forms of risk. From an investment point of view, perhaps the most basic form of risk is the possibility of losing capital. When examining risk from this perspective, while past performance does not guarantee future results we can make an interesting observation: small-cap stocks had positive performance over every rolling 10-year period starting in June of 1930 (Source: Morningstar, small-cap stocks represented by IA SBBI U.S. Small Cap Stock Index compared to large-cap stocks represented by the SP500 index).

Returning to the active vs. passive debate, why active management? While it is possible to select a number of small-cap ETFs or passive vehicles, active management in small-cap investing has three principle benefits:

a) the lack of analyst coverage tends to make small-cap stocks a less efficient portion of the market, presenting more opportunities for mispricing. Despite the sheer volume of companies to analyze, an experienced portfolio manager with appropriate resources can profit from these mis-pricings to deliver longer-term alpha;

b) Measuring the US small-cap index against active managers in peer comparative charts illustrates the index remains below the 50th percentile – so more than 50% of active managers outperform the index (Source: MercerInsight at March 31, 2020). Of those small-cap managers who outperformed their benchmarks, the average level of outperformance tended to be much greater than that of large-cap managers; and,

c) Avoiding the weaknesses of index construction. For example, at this writing the Canadian S&P/TSX Small Cap Index or its more institutionally commercial BMO Small Cap Weighted Index, is poorly structured with over 40% of the index held in commodity (energy and materials) stock. And four sectors comprise 70% of the index! (source: FactSet)

Why Small-Cap Stocks Now?

There are a number of reasons that small- and mid-cap stocks are particularly compelling in today's market environment:

1. **Small-cap stocks have performed well coming out of recessions** – While not yet "officially" in a recession, in addition to the compelling return potential small-cap stocks offer, they also have historically performed better than large-cap stocks coming out of market downturns. Small-cap companies are generally more nimble and able to modify their strategies and reposition products quicker than larger corporations. As a result, small-cap companies can quickly add to their work force and increase production when economic activity begins to improve.

2. **Small-cap stocks have performed well in inflationary environments** - Historically, small-cap stocks have performed well relative to other asset classes during times of high inflation. From 1974 through 1981, the last period when the U.S. economy experienced high inflation, small-cap stocks were able to offset inflation's impact on returns. Most economists are not currently concerned about inflation. However, the US Federal Reserve, in an attempt to stabilize and stimulate the U.S. economy through the pandemic period, has engaged in significant quantitative easing that has created more money, and in doing so, can potentially dilute the purchasing power of the U.S. dollar thereby creating the potential for future inflation.

3. **Investors are under-invested in small-cap stocks, especially global small-cap stocks** - Despite the merits of global small-cap investing as discussed earlier, investors have allocated only a tiny sliver of their portfolios to these strategies. According to Lipper at year-end 2019, small-cap investments make up less than 1% of global equity weightings. Although it is difficult to identify the reason, it seems plausible that many investors remain overly committed to large-cap stocks based on two primary factors: familiarity and the perception of lower risk.

Small-cap investing has historically produced solid long-term investment results relative to large-cap stocks. Going global has only amplified those results. We realize that past performance does not guarantee future results, but the historical data is nonetheless compelling. Despite this outperformance, however, investors have been underinvested in small-cap stocks, often dramatically, as evidenced by the tiny sliver of assets that global small-cap funds have attracted.

We advise investors with time horizons longer than three years to reflect on whether their portfolios are adequately exposed to small-cap stocks, given both the attractive cyclical positioning, and alpha potential from active management.