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“The idea that the future is unpredictable is undermined every day by the ease with which the past is explained.”

- Daniel Kahneman

Bad predictions are the norm in the investment industry though, to be truthful, forecasting things in the future is not limited to investing. In the 1980's, as cellular phones were becoming a reality, AT&T asked McKinsey, the world's top management consultancy, to estimate the future market size for this product. They estimated the mobile phone market would approach 900,000 subscribers in the US by the year 2000 – the actual number was more than 100 million.

But occasionally, a comment is made with a basis in history. The recent Howard Mark's memo, “Sea Change”, is one of those rare opportunities to gain some insight on history with application to the newly forming market cycle ahead. Marks' contention that accelerating inflation curing 2022 to unexpected and dangerous levels marked the end of four decades of declining interest rates which culminated in a recent zero interest rate policy (ZIRP). As such, investment strategies that worked best over those years may not be the ones that outperform in the years ahead. That, in summary, is his sea change.

We'll go one step farther. Again, based on history, we expect the small cap market will outperform large caps over the next few years. In our analysis of the US markets, there have been five major corrections in the past thirty years. In each case, coming out of the market trough and up to the next market peak, small cap investments provided much better returns than large cap investments.

Why?

Small-cap stocks and large-cap stocks react differently coming out of a market trough. Typically, as small-cap stocks have outperformed to the prior peak, valuations tend to be higher resulting in a steeper decline through to the trough bottom. At the peak, with valuations higher than large-caps, the correction in small caps is sharper and steeper.

In general, as small-cap stocks tend to be more sensitive to changes in market conditions, they can experience larger price swings - both up and down, as mentioned - compared to large-cap stocks. This can result in potentially higher returns for small-cap investments during market recoveries. As market conditions improve and investor sentiment turns positive, increased demand for small-cap stocks result in a continued rise in stock prices.

As the market cycle (out of the trough) lengthens, increasing demand for small-cap stocks also increases their valuation spread to large-cap stocks. Inevitably, as the cycle peaks and begins to decline, investors gravitate to the relative stability and safety of larger companies. At the ensuing trough, smaller caps reach more deeply depressed valuations. The cycle is then set to begin anew.

This investment cycle has been proven time and again. Yet investors, particularly in Canada, tend to shun small cap investing. Again, why? Unfortunately, some of the fearfulness comes from our own industry – the definition of “small cap” is wide-ranging, from the very micro and very illiquid, to cash-poor growth-at-any-cost disasters. Humans are instinctively risk averse. We tend to overpay for insurance and shy away from large but uncertain opportunities.

High-quality small cap companies fall into the latter category. They're often founded by entrepreneurs with a passion for their business and, invested alongside shareholders, are therefore shareholder friendly. They provide exposure to emerging industries or disruption to old industries. And finally, they're frequently overlooked by analysts and investors seeking to identify undervalued companies.

Think of it this way – all great large businesses began as entrepreneurial small companies with a penchant to do something different. Coming out of a trough is a multi-year opportunity to find and invest in great high-quality small cap businesses while their valuations are decoupled from their growth fundamentals.