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INVESTMENT COUNSEL

GLOBAL SMALL CAP SPECIALISTS

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"Quality Is Job One" – Ford Motor Co. Campaign (1981-1998)

Market pundits have expounded upon at length that, with an anticipated a change in the economic cycle, many investors are considering a rotation out of expensive growth into value stocks to reduce potential overexposure to high-priced volatility and advantage themselves as the pandemic gradually subsides.

But what of small cap investors?

The last five years of the bull market - which ended in March 2020 – saw small cap investors dramatically shift into high capitalization (hence more liquid) growth stocks. In our white paper last May, we spoke to the historical resurgence of small cap during the early years of a new cycle and, once again, the past year has, once again, proven historical fact.

In a recent report, Morgan Stanley revised expectations for equities (speaking to the SP500) to return a sobering 4.9% per annum over the next ten years, citing lower growth and inflation expectations. Moreover, despite the very low expectations, they noted that equities would be one of the better-performing asset classes.

Which leaves us to believe small cap investing will have a much longer resurgence from March 2020 than has been the typical 2-3 year rebound shown historically. Smaller companies are nimbler, and those with strong management teams can react or adapt to change faster and are, therefore, advantaged.

Studies have shown that, over the long-term, performance has favoured small cap investing as there are better structural growth prospects compared to large cap companies.

Small cap is an inefficient asset class consisting of a large universe of stocks, relatively under researched. This creates mispricing which enables alpha generation potential through active stock selection. Moreover, it offers diversification benefits to either large cap active, or passive, investments. Small cap is an appealing asset class, with the potential for long- term outperformance, which deserves a strategic allocation in a diversified plan.

But do not blindly extrapolate the potential rotation to value as governing the principles of small cap investing. While they may be more "expensive" by traditional measures, high-quality small cap companies have cash-generative power to reinvest to make themselves worthy contenders in their respective industry milieu.

There are a wide variety of institutional small cap strategies available. Many would be classified "momentum" – high turnover portfolios targeting changes in consensus earnings or price, or both. There are some that could be considered "growth" investing, which target higher beta companies that present attractive returns when markets are rising. A few more could be considered "value" strategies, though inherently value investing is more widely used in larger cap, more liquid names.

Our style preference is called "Quality". The dictionary definition of quality is: "a distinctive attribute or characteristic possessed by someone or something as measured against other things of a similar kind." But what is a quality small cap company?

We believe quality is reflected by well-managed businesses with reasonable growth outlooks, with the financial strength to be investible over the intermediate or long term. In a "quality" company, profitability becomes an analysis of invested capital and cash flow generation as well as a method of valuing a company's intellectual capital. Financial strength is assessed through strong balance sheets, including the appropriate leverage ratios and ability to service debt throughout the investment cycle and cyclicality of cash flows. Certainly, understanding how management is allocating capital to expand its business, including their ability to use equity and debt, is essential. And finally, a company's ability to maintain its advantage in order to protect long-term profits and market share from competing firms is critical. This is most important for maintaining strong fundamentals related to sustainable and predictable growth, stability of cash flows, earnings and capital expenditures.

Quality investments perform especially well during economic downturns or periods of risk aversion. While they certainly rise during periods of extended bullishness, they may well underperform portfolios designed to achieve growth at any cost.