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GLOBAL SMALL CAP SPECIALISTS

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"Tell the Wolf of Wall Street that the pigeons of San Francisco are going to eat his lunch!"

- Quote from a San Francisco day trader

It has been an interesting beginning to 2021, as millions of amateur traders have taken on the pariah of Wall Street – short sellers – and, for the moment at least, appear to be winning. Using a somewhat juvenile Reddit page, these individual investors have banded together to squeeze a couple of the larger hedge funds. Bitcoin?.. no regulation, no problem. Shopify…no cash, still, no problem. Gamestop, AMC, Tesla, silver…the list goes on and on.

The scenario has been penned as a classic "David and Goliath" – but, is it really?

These shenanigans smack of a typical market mania, not dissimilar to what transpired in the late 1990's with internet stocks. Then, speculative money from retail investors used AOL and chat rooms to talk up the next great internet company and, as happens in any market mania, heavier demand for shares forced stock prices higher. Until they didn't. Presently, despite reactions by facilitators of these trades to limit transactions (brokerages increased margin requirements while Robinhood restricted trades in certain stocks), regulatory oversight is struggling with how to police collusion throughout the process.

And, similar to the tech stock mania in the 90's, this will likely not end well for many small retail investors.

Which leads us to the discussion around "growth" versus "value" investing. We've written on this before, but with the consensus spewing invectives about "rotation to value" and "time for the cyclicals", we thought it worth revisiting the topic.

In the investing world today, many believe growth investing is typified by participating in companies that lack a proven business model. In fact, most academics would suggest growth investments are characterized by lacking profitability or even cash flow to determine whether, in fact, there is any intrinsic worth on which to base an investment. Growth stocks are, therefore, considered much more risky and likely to evaporate your capital if faced with a serious setback.

Value investing, on the other hand, has its roots in Benjamin Graham's "cigar butt" style and is epitomized by participating in companies with low valuation metrics. But low metrics do not necessarily mean a particular investment is undervalued – it could simply mean the company has low valuation metrics and is a "value trap". A company is not undervalued unless it can show future earnings growth is underappreciated by the market or an undervalued balance sheet requiring a catalyst to unlock value; which is difficult in a world where information is readily and quickly available, and competition for an "edge" is fierce.

Seen through another lens – that of the "Efficient Market" hypothesis – growth and value take on a different perspective. If one believes the market is highly efficient, then value stocks are cheap for a reason and growth stocks require a predilection to hyperbole for participation. There simply is no sustainable edge.

Of course, in the small cap arena, the efficient market really doesn't exist. Because a well-run small firm doesn't have the financing requirements to keep the sell side of the Street interested in covering them. Also, because they are small and nimble, innovation and technological advancement can have a far-greater impact on the fortunes of the business. And management is typically first or second generation, highly engaged, with appropriate business dirt darkening their fingernails.

So, value or growth? First, businesses that are truly dominant in their industry are likely to achieve solid, profitable growth in the longer term. Next, with innovation and technology disruption, there is a wide variety of outcomes to any potential valuation model, regardless of how the past is painted. And finally (for the purposes of this note, anyway), the underlying strength of a business – whether competitive or technological advantage or, simply, human capital – is difficult to assess without minute analysis and understanding. This will, at the very least, help minimize loss.

Alternatively, simply toss away your cigar butt, dial up Redditt, and take your chances.