INVESTMENT COMMENTARY: SMALL CAP Q3 2021

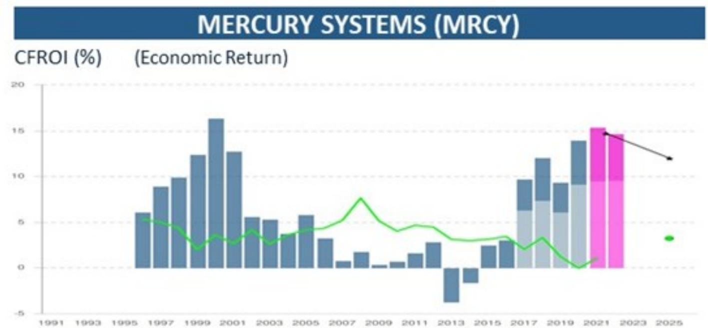
October | 2021

WILL THE FED KILL THE SMALL CAP JUNK PREMIUM?

Small cap stocks underperformed larger companies once again in a turbulent Q3 where robust corporate results were offset by supply chain, growth and policy concerns. The Russell 2000 returned -4.4% while the S&P 500 edged higher by 0.6%.

The Fed stated in September that tapering of quantitative easing (i.e. a slowdown in the pace of asset purchases) will be announced at the November meeting, as expected, and will finish by mid-2022. Meanwhile, the fed funds rate projections now show a faster rate hiking schedule than they did in June. The median rate expectation for 2023 moved up to three hikes from two in June, with three additional hikes in 2024. The shift comes in the context of revised real GDP growth - down to 5.9% for 2021 from the 7% growth estimated in the last meeting - while inflation has risen. The Fed now sees inflation running to 4.2% this year, above its previous estimate of 3.4%.

In small cap land, it's been all about speculation for the past few years. The Fed has rewarded a risk-on market mentality, and investors have gravitated towards the most speculative stocks in the space. Everyone knows the story around Gamestop and AMC, which are two of the top 10 stocks in the Russell 2000. But this theme is not limited to these "meme" stories. The top 20 stocks in the index have below cost-of-capital returns, are over-levered and carry significant default risk (according to the Merton model). As you know, we couldn't be more different. Our investment process focuses on quality above all else, as we look for companies with strong Cash Flow ROIs, low debt and above average growth rates. In the following two charts, we compare the market's top small cap performer year to date (Seaspan, ticker ATCO, $3.5bn market cap, up 950% ytd) to our ***worst*** performing holding (Mercury Systems, ticker MRCY), which is down 39% year to date. As you can see, these profiles are radically different profiles: ATCO is over-levered and carries a 15% default probability, and is still losing money despite being priced to beat its cost of capital within the next 5 years. This is a posterchild for speculation. In contrast, MRCY is already (very) profitable and growing the top line at 10-11% per year. And future expectations (what's "priced in" today) are very low after this year's pullback.



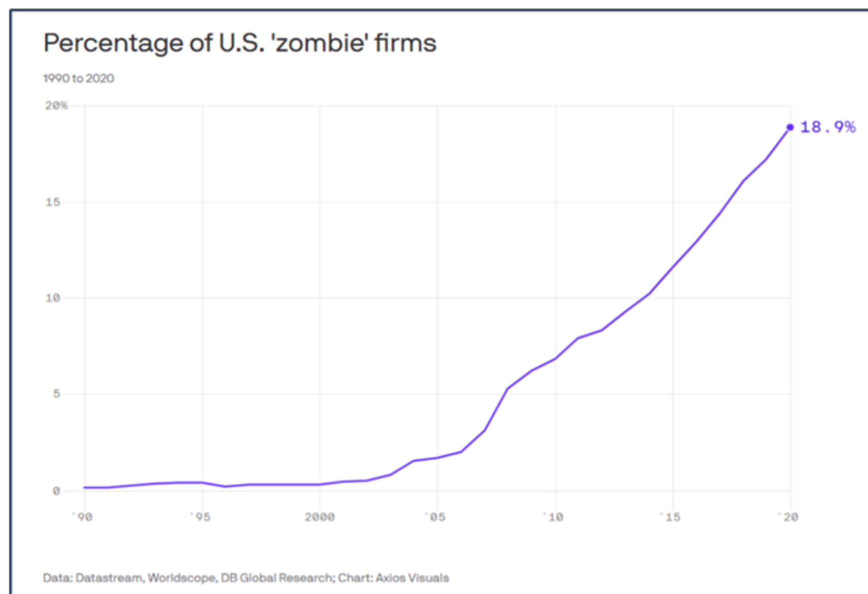
Our process is all about quality. We call it "Growth at A Reasonable Profile" (a slightly different version of GARP) because we invest in companies that are already profitable and are expanding their businesses rapidly. This process has worked well for us over the long term. We will stick to our knitting no matter how much others choose to speculate.

UNINTENDED CONSEQUENCES

Why are the lowest quality stocks out-performing? For starters, the Fed has had accommodative policies in place for over 12 years now. These policies (lower rates, asset purchases) have made it easier to pay higher multiples for higher growth. And the Big Tech names are the best companies to own, as long as you can afford them. At the same time, these loose policies have allowed lower quality, debt laden companies to not only survive but to thrive. Investors have placed their bets accordingly. Strength and stability in large cap land. And growth and upside in small cap land. The problem is some of these small caps are not tomorrow's emerging winners. They are "zombies."

One of the predominant themes of the last 10 years has been the emergence of the "zombie company." Zombie companies are indebted businesses that, after covering operating costs such as wages and rent, only have enough funds to service the interest on their loans, but not the debt itself. These companies are generally dependent on refinancing their maturing debt and may face solvency risks should interest rates rise or investors withdraw from further financing.

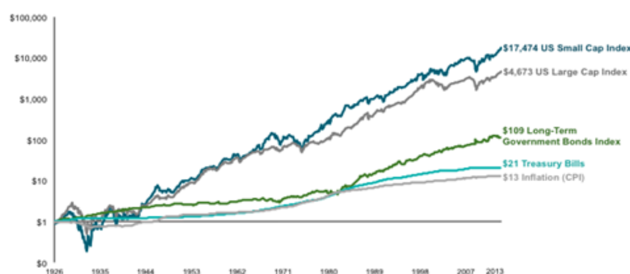
As you can see from the chart below, the percentage of zombie companies in the US has skyrocketed from about 5% pre-financial crisis to 18.9% today. This is not healthy. And the vast majority of zombie companies are small (think Russell 2000, not S&P 500). In fact, 40% of the companies in the Russell 2000 are unprofitable. The percentage of unprofitable Russell 2000 companies is higher today than both the dot-come bubble and the pre-GFC levels of 2007.



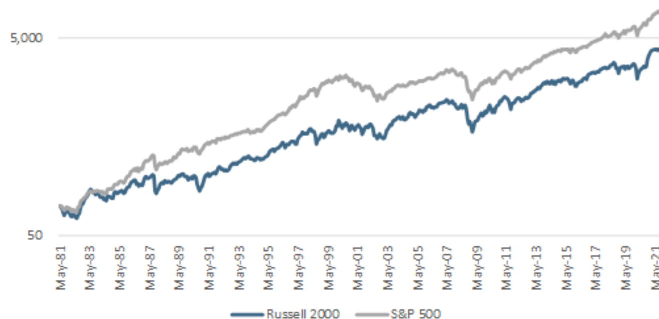
SMALL CAPS HAVE HISTORICALLY WON OVER THE LONG RUN

Small cap equities carry more risk than large caps and, over the long term, have delivered higher performance (nearly 4-to-1 on a cumulative basis, since 1926). But it is perhaps less widely known that large caps have actually out-performed small caps over the past 30-40 years. Small caps fell behind during the 1990s and still haven't come close to making up the ground they lost. Point to point, **large caps have out-performed small caps more than 2-to-1 since 1982**.

Small Caps Have Out-Performed Since 1926



Large Caps Have Out-performed Since 1982



Will small caps regain their dominance? Or are we in a new type of market which will continue to reward the mega-cap companies that arguably are borderline monopolies? We shall see over the coming decade. But we are confident in one thing: quality will win in the end. As inflation picks up and rates begin to rise, the over-levered, unprofitable small caps will struggle. Many will default. And the strong, stable players will win.

PERFORMANCE

Our portfolio logged a 3.1% loss (net) for Q3, compared to -4.4% for the Russell 2000. We believe the quality of our portfolio drove this out-performance. In this type of market, our objective is to keep up when markets are rising and out-perform when they are sideways or declining. Once inflation picks up, we expect to out-perform in most markets as quality once again rises to the top.

Individual highlights are as follows. There was broad representation amongst the top winners and losers this quarter. Houlihan Lokey (HLI) blew through our target price and we sold it. Other than that, we generally trimmed our winners and added to our losers, based on our upside/downside models.

TOP 5 PERFORMERS

		Return	Description	Actions
PLUS	ePlus	21.3%	Supply chain technologies	*Trimmed in Q3*
HLI	Houlihan Lokey	17.2%	Investment banking	*Sold in Q3*
FCFS	First Cash	15.2%	Pawn shops	*Trimmed in Q3*
FIZZ	National Beverage	11.2%	Sparkling waters, juices, sodas	
AX	Axos Financial	11.1%	Internet banking	

BOTTOM 5 PERFORMERS

		Return	Description	Actions
TLRY	Tilray	-37.5%	Cannabis	
JAZZ	Jazz Pharma	-27.2%	Pharmaceuticals	*Added in Q3*
LHCG	LHC Group	-21.7%	Pawn shops	*Added in Q3*
MRCY	Mercury Systems	-19.4%	Sparkling waters, juices, sodas	
PAAS	Pan American Silver	-18.9%	Internet banking	*Added in Q3*

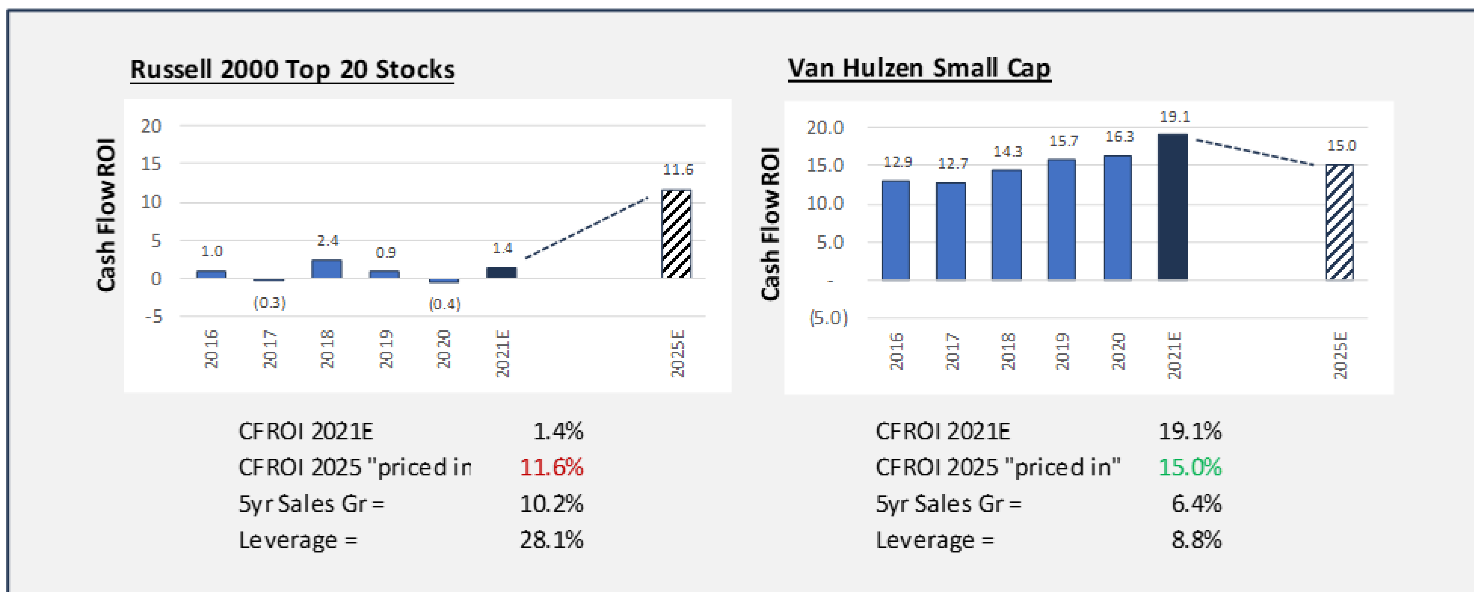
Past performance may not be indicative of future results. Please see the end of this article for additional information.

CONCLUSIONS

Today's market is not healthy. The Fed has actually done a very good job battling deflation over the past 10 years and preventing another Great Depression. But there will be no free lunch in the end. At some point, rates will have to rise. Lower quality companies will have to fail. And speculators will get hit hard. We believe it's more important than ever to insist on quality.

The Russell 2000 is the most widely used small cap benchmark, and so it is the benchmark for our core small cap strategy. But let's be clear, our strategy is the antithesis of an index fund. It is a completely different animal. We do not invest in "zombies" or "specs." We do not even invest in companies with negative earnings, unless there is green on the imminent horizon. We **do** invest in strong, stable small caps with profitable businesses and competitive advantages, above-average growth rates and low financial leverage.

Just look at the contrasting profile of the top 20 Russell 2000 companies (left) vs our small cap strategy (right).



A very important datapoint in this graphic is the 2025E CFROI. That is the "market implied" ROI, or the ROI level that is currently "priced into" a stock based on its current valuation. As you can see, the top Russell names are "priced" to improve nearly 8x from a 1.4% ROI in 2021 to an 11.6% ROI in 2025. There is no indication (or track record) that these names are capable of that level of improvement, which is why we categorize this profile as speculative. In contrast, our portfolio holdings have shown strong ROIs, well above their cost of capital, with continuous improvement over the last 5 years. And these names are currently "priced" to decline over the next 5 years. But these names have strong competitive advantages, stable/improving margins, and are projected to grow at ~7-8% per year, on average. In our view, this disconnect between what's priced in and what's achievable (even *likely*) represents the opportunity.

Some prospects look at our growth profile and immediately label us a growth strategy. But the valuation disconnect described above lends itself to a value categorization. The reality is we are both. We call it "Growth at a Reasonable Profile," which means we want growth, but only profitable growth. For us, it's all about quality. Most institutions put this type of hybrid in the Core category.

There are of course periods where the junk will win. The Fed has made sure of that. But we believe quality will always win in the end. Our track record has built up slowly and quietly. It now sits at nearly 6 years. Our performance was GIPS-verified in 2018. Since our inception in 2015, we have out-performed the Russell 2000 by an average of 1.7% per year, at 13% *lower risk* (as measured by standard deviation). This translates to an **annualized alpha of 3.3%** versus the Russell, as shown below:

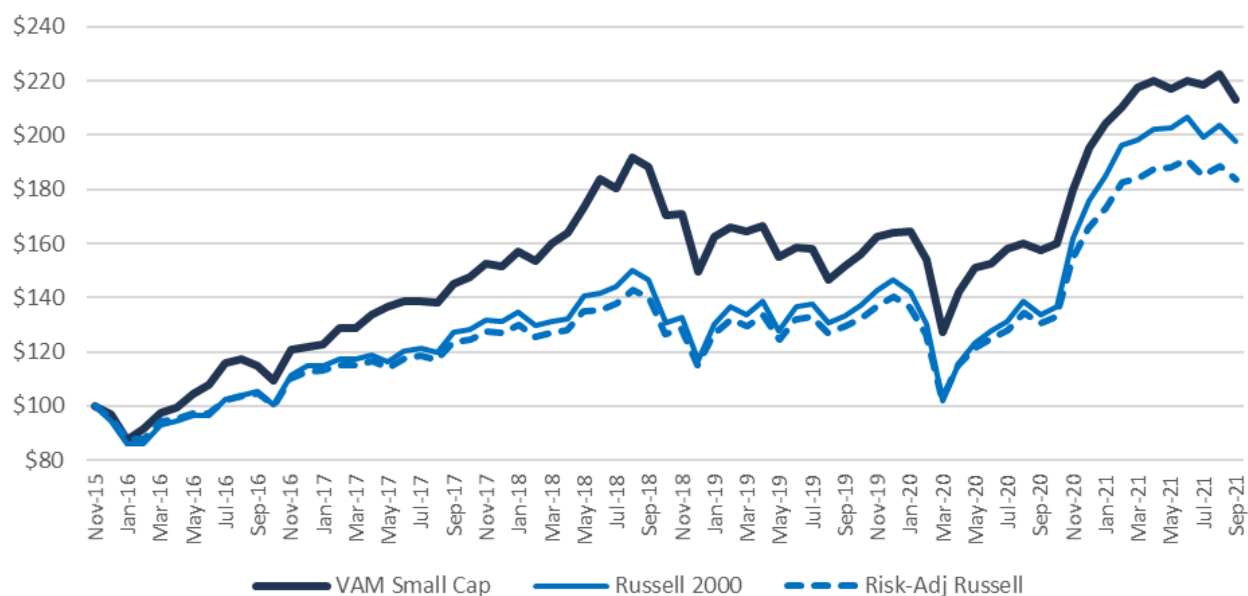
Alpha

a = Rp – [Rf + (Rm – Rf) ß]

Where:

Rp = Realized return of portfolio	14.1%
Rm = Market return	12.4%
Rf = risk-free rate	0.1%
ß = Beta	0.9
Alpha (relative to Russell 2000)	3.3%

LONG TERM PERFORMANCE (net of fees)



TOP TEN HOLDINGS

Our median market cap is approx. $3.6 billion. As of September 2021, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Axos Financial (AX)	Internet banking	6.0%	3,200
JAZZ Pharma (JAZZ)	Pharmaceuticals	5.1%	8,500
CSW Industrials (CSWI)	Building products	4.9%	2,100
Lumentum (LITE)	Optical equipment	4.8%	6,200
LHC Group (LHCG)	Home health services	4.6%	4,500
Qualys (QLYS)	Cyber Security	4.1%	4,400
Gibraltar Industries (ROCK)	Solar racking	3.7%	2,300
Focus Financial (FOCS)	Investment management	3.7%	4,100
Marten Transport (MRTN)	Temperature controlled trucking	3.6%	1,300
Rogers Corp (ROG)	Engineered materials	3.4%	3,400

APPROACH

The strategy uses a “Growth At A Reasonable Profile” approach, which basically means we are not speculative. Just like you’ve come to expect from us in the large cap space, our focus is on quality first. But in the small cap space, we are just as open to growth and momentum stocks as we are value stocks. A “reasonable profile” means the business must be established and already profitable, earning returns above its cost of capital. Beyond these simple parameters, we look for companies that are leaders in their industries, expanding rapidly (2-3x the market), and consistently beating expectations for growth.

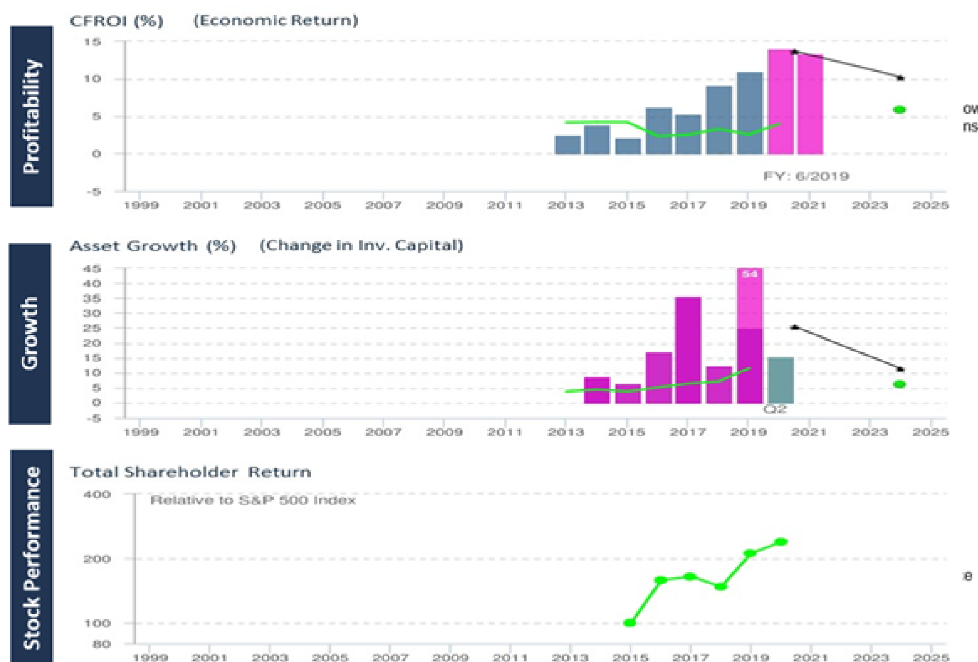
Portfolio Construction

Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with market caps between $500 million and $3 billion and have a below average portfolio turnover profile.

Fundamental Analysis

Fundamentals come first. Always. But we also incorporate technical analysis into our investment process, to provide key downside/support levels and also to provide confirmation of buy/sell signals. Small-cap stocks can be volatile and technical analysis provides information into position sizing, entry and exit decisions and can trigger due diligence reviews.

We’d like to highlight one of our core portfolio holdings (LITE) to demonstrate our investment approach. Lumentum (LITE) manufactures optical and photonic products for the communications sector, enabling the transmission of video, audio & text data over high capacity fiber optic cable. It is a market leader and a very profitable business that is growing 10-12% per year. The company has impressive momentum in its Cash Flow ROIs and a great track record of positive earnings revisions.



Key Points

- Market cap: $5.9 billion
- ROI improved from less than 2% to 14% over past 5yrs
- ROIs above the cost of capital
- Analysts expect 10-12% sales growth & improving ROIs
- Has beaten estimates 5 of the last 6 quarters (by an average of 12%)
- Rated BUY by 9 analysts

- Current stock price reflects low expectations (low green dot in top panel)

- Shares have out-performed nearly 3-to-1 over 5 years
- We believe the shares are still undervalued

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