SMALL CAP | VOLATILITY

Volatility and opportunity in small caps

By: Mike McLean, CFA | & J. Griffith Noble, CFA | April 23, 2020

Boston - Along with tremendous humanitarian concerns, the COVID-19 crisis has created vast uncertainty and volatility in the markets and economy. The market tumult in recent weeks has highlighted, in our view, the potential value of active management in the small-cap universe.

The volatility in small caps continues to be very high, with daily performance dominated by outsized-factor moves: stocks with low beta, larger capitalization and low leverage are leading the market in drawdowns (peak-to-trough declines) and lag materially on rebounds. While coronavirus news will still command everyone's central attention, investors are now getting a lot more information as companies report first-quarter results.

Material downstream impacts

Recently we've seen the first of what will probably be many small-cap energy company bankruptcies. Many consumer companies, especially in retail and hospitality, are going to be particularly hard-hit as well. Small-cap energy companies weren't capitalized for oil priced in the $20s and consumer-facing businesses weren't structured to withstand "zero" sales. We have seen many retailers say they don't intend to pay rent and some have said they could remain closed until June. The downstream impacts to REITS, labor, and local and state tax revenues are still unknown and present material risk to the economy. Retailers' inventories are also likely to be far out of alignment when they do reopen. While the Fed's response and programs out of Washington have been impressive - and have dramatically lowered the probability of the direst outcomes - we believe too many in the marketplace are still anticipating a V-shaped recovery.

Pricing in negative outcomes

In the current environment, we are looking for companies with strong balance sheets and favorable competitive positions that are pricing in significantly negative outcomes over prolonged periods. We favor companies where we believe severely depressed valuations do not reflect their inherent, longer-term value. We believe these types of companies will be positioned to come out stronger on the other side, whenever that may be. We also are assessing companies' environmental, social and governance (ESG) profiles, particularly in light of the current crisis. How has management treated its workers, clients and communities, what do future preparations look like and is the business or industry at long-term risk?

A shifting opportunity set

The small-cap opportunity set is changing every day, with many stocks down well over 50% and extreme daily price moves. The team maintains an active "Wish List," and we have been adding names previously seen as too expensive to the portfolios. One challenge in the market today is the wide capitalization range within the Russell 2000. The bottom end is $5.6 million while the top end is well over $11 billion, and half of the Russell 2000 currently has a market cap under $430 million. Many managers use $500 million as their lower range, and stocks below that amount can have a significantly lower trading volume, which can create a challenge for initiating or holding issues at that level. The number of stocks in our portfolios has crept up, reflecting the drop in share prices. We want to hold a wide range of stocks opportunistically and remain nimble during these volatile times.

Understanding industry impacts

The scale of the monetary and fiscal response to the economic contraction is a clear positive, especially when we consider that these actions are happening coincident with job loss and demand destruction, rather than being reactive to it. While the stimulus will help certain industries recover in the short term, we are spending some time assessing potential long-term impacts and structural shifts that may take place once the global public health crisis has passed. What will future air travel look like? Will the ongoing shift to e-commerce accelerate? Will office jobs move from cities to less dense areas? Understanding how industries may be impacted in the long run will be critical to identifying the best long-term opportunities.

Bottom line: These challenging times highlight the importance of having a strategic and disciplined investment process. We have a clear definition of quality and nothing about the types of companies we favor today is different from a month ago. We believe an emphasis on downside protection and consistent application of quality, valuation, and time will serve small-cap investors well in turbulent times.

Index definition: *Russell 2000® Index is an unmanaged index of 2,000 U.S. small-cap stocks.*

About risk: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.*


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