

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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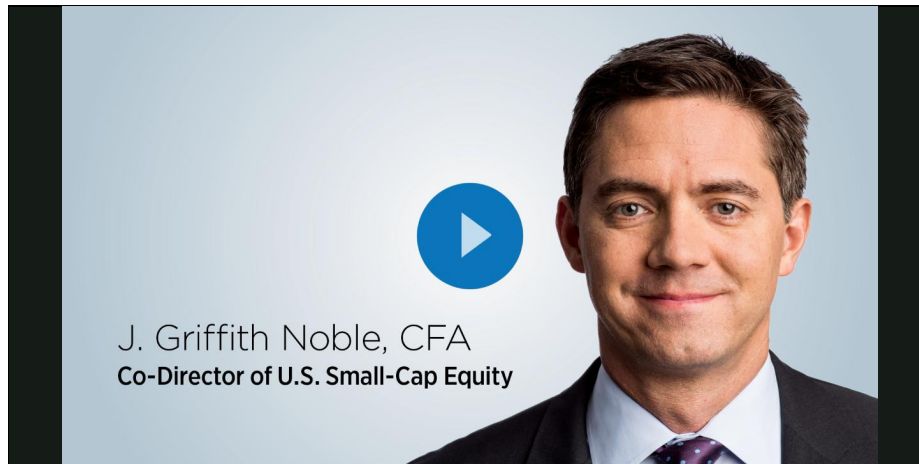
Equities

2020 Mid-Year Outlook: US Small Caps

Boston - Significant opportunity remains in the "quality" small-cap space.



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"Businesses create value for shareholders by generating strong returns on capital, and the market should return to rewarding those companies, in our opinion, that create this value."

It's been a remarkable year in the equity markets thus far, and in small cap in particular, with the largest and fastest sell-off in history followed by what's been a record rebound. Volatility hasn't been equitable to all areas of small cap, and relative opportunities have emerged.

To start, year to date, small growth has outperformed significantly, marking the fifth year it's bested value. Valuations for small growth are close to levels seen at the peak of the tech bubble, depending on the measures you use. Micro cap, as defined by the lowest quintile of market cap in the Russell 2000, and low quality as measured by the lowest quintile of ROE (return on equity) have both outperformed from below by over 20 percentage points, and high leverage has also outperformed dramatically.

To put this all together, quality to starting to look very attractive. Over the past 25 years, the top two quintiles of return on capital significantly outperformed the Russell 2000. They've also had the added benefit of lower volatility and downside protection.

Businesses create value for shareholders by generating strong returns on capital, and the market should return to rewarding those companies, in our opinion, that create this value. Opportunity in quality comes with the optionality of better downside protection if the recent rally improves premature.

We believe the recent run up in the market warrants some caution, and five things we're monitoring closely are: first, massive fiscal and monetary programs that have propped up the economy, and it remains to be seen if they can hand the baton off to self-sustaining growth.

Second, leverage continues to be very high. Before the downturn, corporate debt was at an all time high, and with large scale debt issuances and underfunded

pensions, the problem's only gotten worse.

Third, the election. Fourth, valuation. Now the recent performance of growth, tech and healthcare are all key areas of risk.

Lastly, the virus. The increases we're seeing in infection rates are likely to continue, and what will the consumer and governmental response be to that?

With all the volatility and extremes in performance, we continue to use quality as our compass. We believe it's important to acknowledge there's still a wide range of potential economic outcomes, and we continue to take advantage of opportunities and also adjust to risks as they emerge.

Russell 2000 Index is an unmanaged index of 2,000 US small-cap stocks.

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