A Historic Opportunity in Small Cap Stocks

BY THE OSAM RESEARCH TEAM (APRIL 2020)

No investment principle is more widely understood and frequently ignored than ‘buy low, sell high’. While we would not hesitate to buy at discounted prices in other aspects of life, investing in assets with poor recent returns just feels wrong. However, it is *because* buying stocks at discounted prices feels wrong, that it can often turn out to be right.

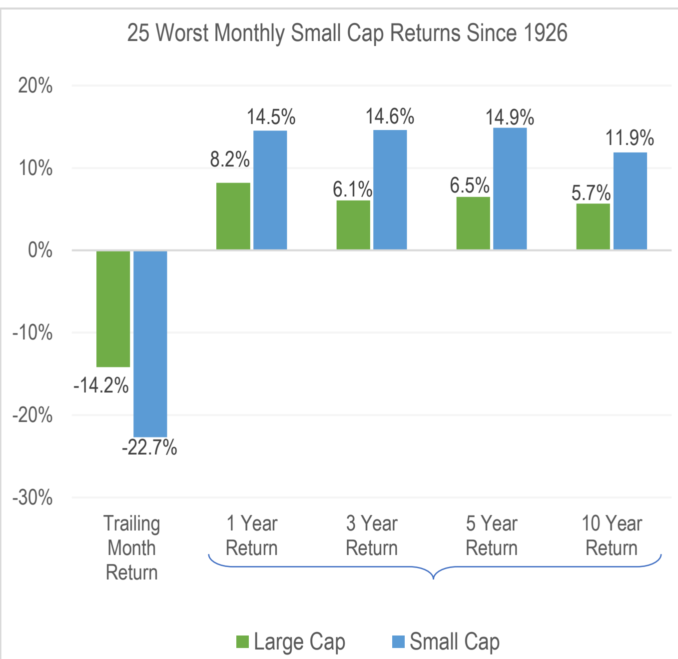
Amid an almost unprecedented market environment in which coronavirus has shut down global economies, there are relatively few investors showing enthusiasm for equities in the near-term. Despite lower valuations implying better future investment outcomes, our human instinct tells us not to buy. This is why OSAM favors a systematic approach that prevents our instincts and emotions from inhibiting good decision-making. While the media provides endless reasons to feel pessimistic, the *evidence* shows attractive opportunities in the market for long-term investors. As the saying goes, be greedy when others are fearful.

It is crucial to remember in a downturn that ‘once in a lifetime’ crises also present historic opportunities.

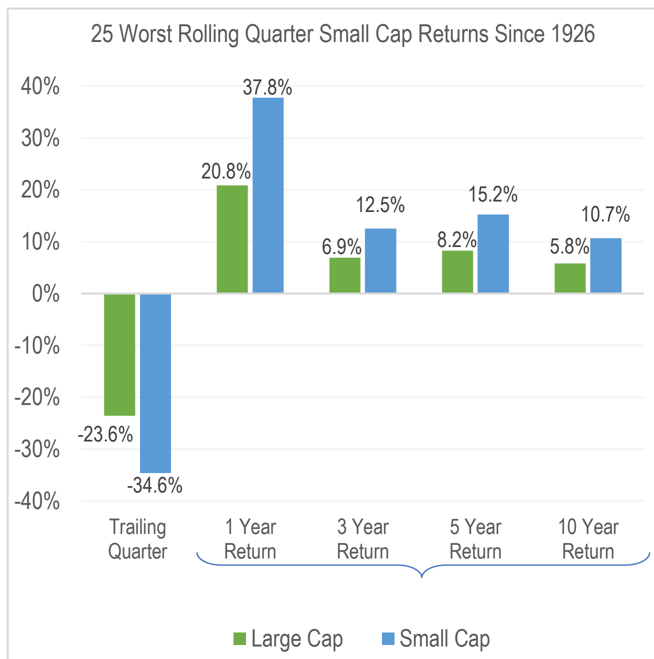
A HISTORIC OPPORTUNITY IN SMALL CAP STOCKS

Every so often there are opportunities that may only appear 2-3 times in an investor’s career, usually around a bear market or recession. In light of the recent bear market, evidence suggests that a historic opportunity may be forming in small cap stocks, among the lowest returning assets in March (Russell 2000 Index, -21.73%) and Q1 (Russell 2000 Index, -30.61%).

Yet, small cap stocks are one of the better returning assets after bear markets. As the data below shows, small stocks are generally the lowest performers as markets fall, but then significantly outperform when markets recover. These charts exhibit the average *forward* returns in the 25 lowest ranking months and rolling quarters for small cap companies. The relative advantage of small cap stocks following market declines is clear:



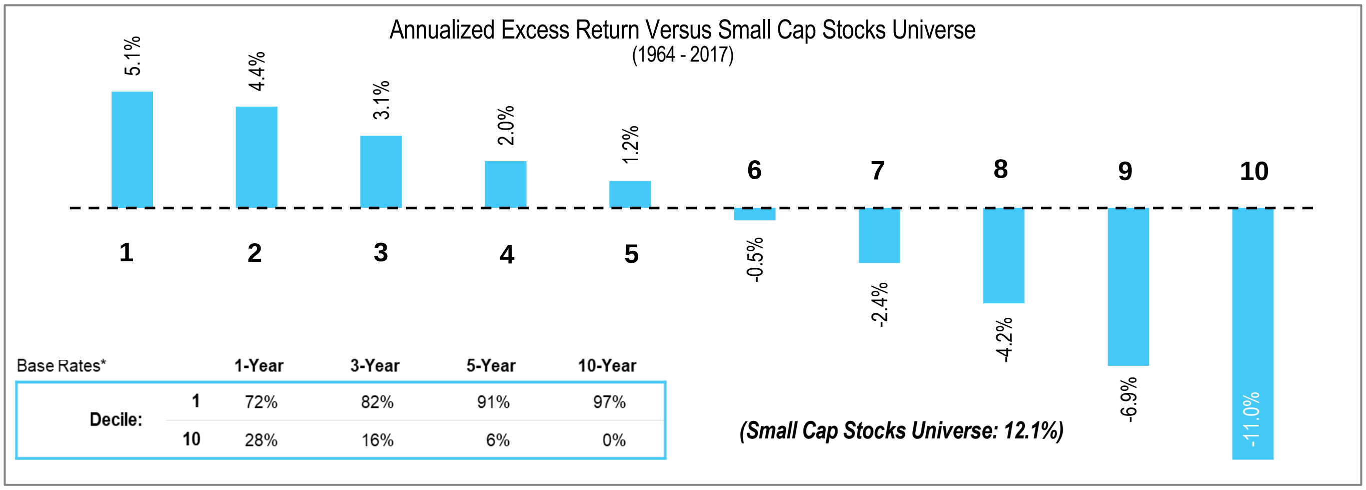
Source: Ibbotson Associates



Source: Ibbotson Associates

THE CASE FOR SMALL CAP VALUE

There is ample data demonstrating the outperformance of smaller cheaper stocks over the long term. The chart below shows the annualized excess return of small cap stocks within each decile of stocks measured by their cheapness. On the far left, the cheapest stocks generated an annualized excess return of 5.1% over the 54-year study, while the most expensive stocks on the far right underperformed by -11.0% annualized.

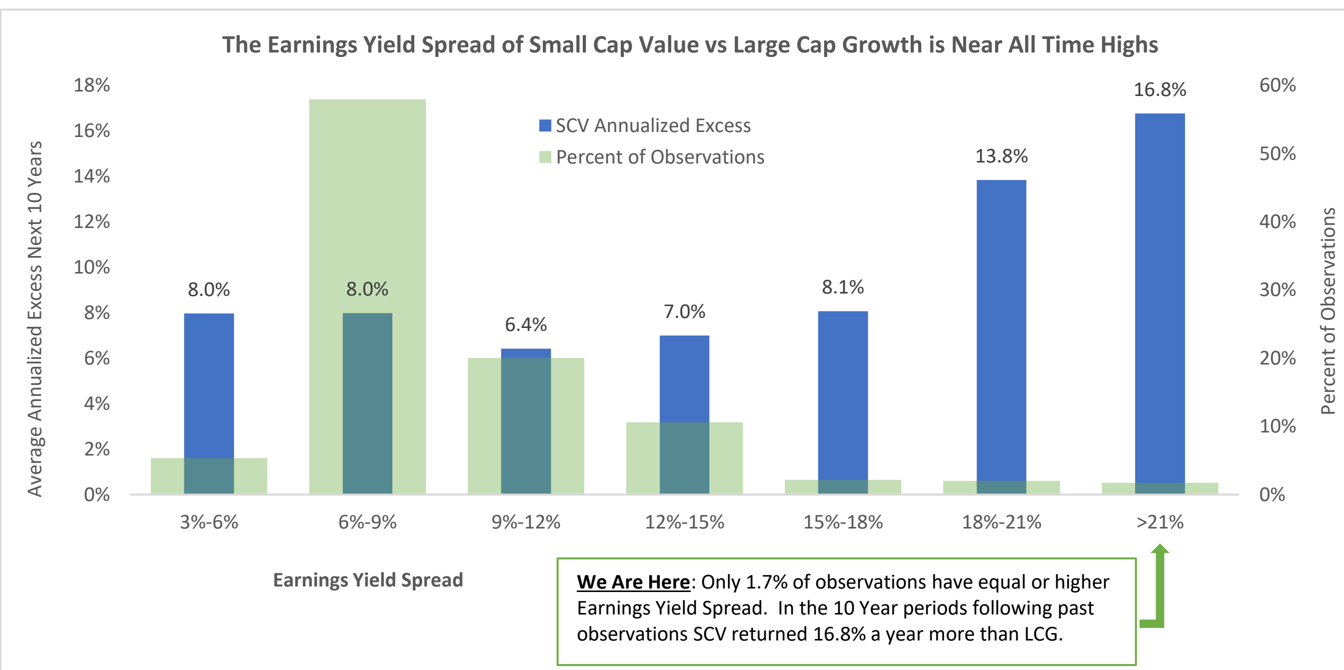


Base Rates*		1-Year	3-Year	5-Year	10-Year
Decile:	1	72%	82%	91%	97%
	10	28%	16%	6%	0%

That said, while there may be a historic opportunity in small cap companies as a whole, small cap *value* stocks are particularly attractive.

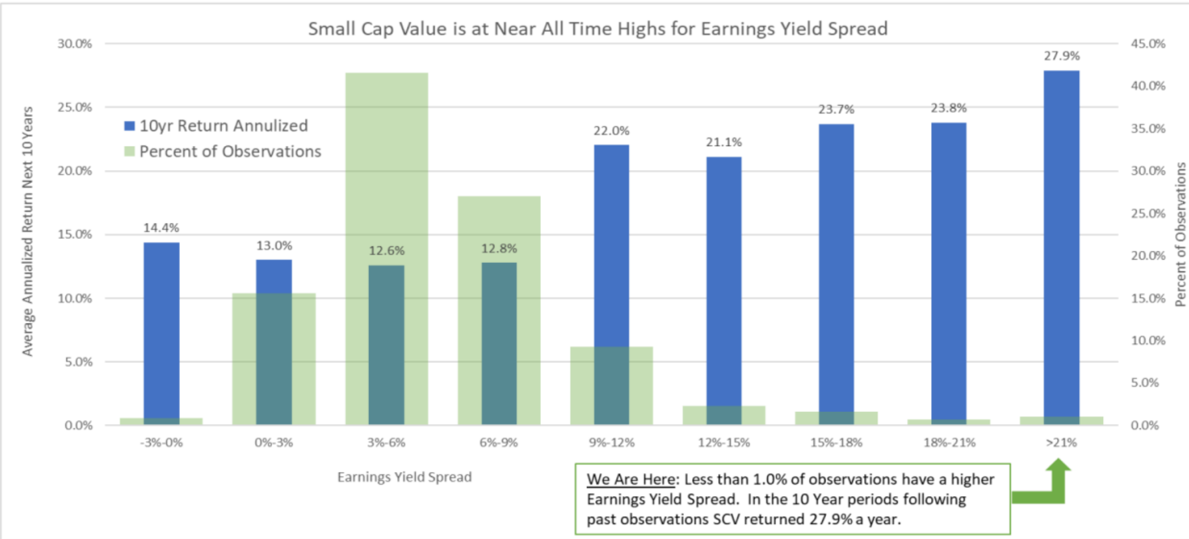
Small Cap Value & Large Cap Growth Spreads Near All Time Highs

Using history as a guide, the current environment in small cap stocks is almost unprecedented. When comparing the earnings yield of the cheapest small stocks (cheapest decile by price-to-earnings) to the most expensive decile of large cap stocks in the US **we see a spread of more than 21%**. Following extreme periods like this historically, **small value outperformed large growth by 16.8% annualized over the following 10 years.**



Earnings Yield Spread on Small Cap Value & 10-Year Treasury Near All Time Highs

A similar dynamic exists in the earnings yield on small cap stocks (cheapest decile) and the 10-year U.S. Treasury yield. This spread is generally between 3-6%, but is greater than 20% today. **Following similar spreads in the past, small value stocks returned an average of 27.9% in the subsequent 10-year period.**



Source: OSAM Research

INCORPORATING QUALITY IN SMALL CAP VALUE

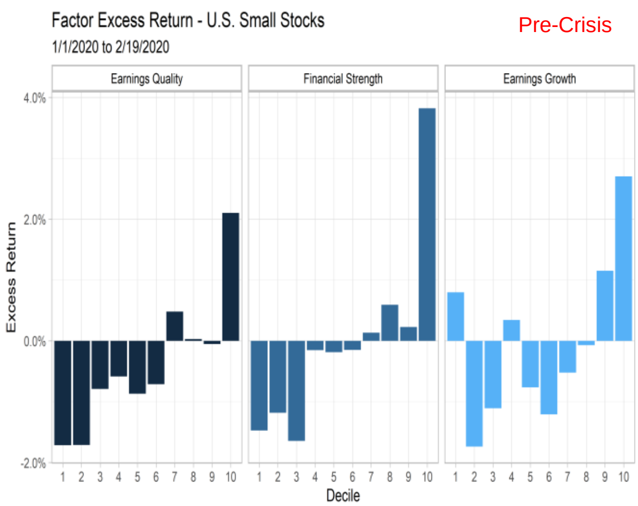
While small cap value has a long record of generating meaningful outperformance, we must emphasize that investors should not simply buy the cheapest decile of small stocks. Due to their size, small cap companies are generally more susceptible to economic shocks like the one we currently face. By merely buying the cheapest group of small cap stocks, there is no safeguard protecting investors from unstable companies ill-prepared for an economic downturn.

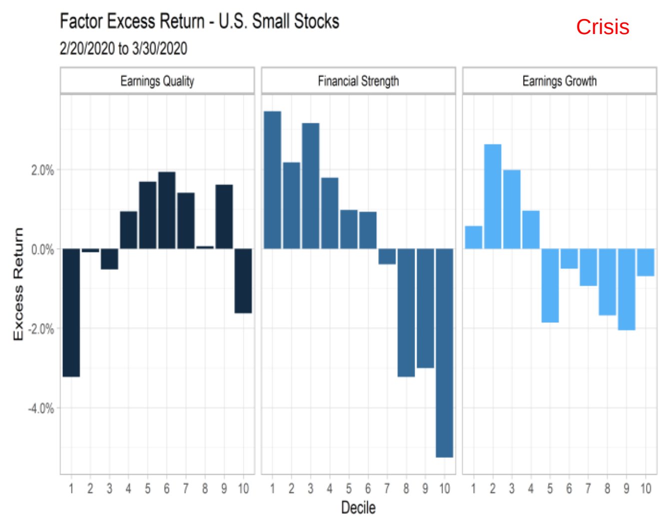
For this reason, it is *crucial* to incorporate quality factors in the investment process for avoiding these unprepared and ill-equipped companies. At OSAM, we screen out companies from our investable universe that score poorly on *Financial Strength* (highly levered companies reliant on external funding), *Earnings Quality* (companies with non-cash earnings and aggressive accounting), and *Earnings Growth* (declining free cash flow and profitability). These quality factors have an even greater impact in the small cap universe:

Reducing Risk in Market Downturns Through Quality Factors

There is a popular model in financial history called the Kindleberger-Minsky model, which states that the ‘fraud cycle’ lags the market cycle. Said differently, frauds and bad businesses usually don’t get exposed until markets fall, and investors became more skeptical and conservative. The infamous Worldcom fiasco after the Dot Com crash, and Bernie Madoff’s ponzi scheme blowing up amid the Great Financial Crisis are prime examples.

This is relevant for investors because it means market downturns simultaneously create historic opportunities to buy stocks at lower prices, but also pose increased risks as companies with questionable accounting and business models are exposed. The first quarter of 2020 offered a glimpse of this phenomenon. Before the downturn began on February 19th, when markets were up and sentiment was high, companies in the lowest decile of our quality measures outperformed the market. When markets dropped, however, these low quality companies significantly underperformed as investors sought refuge in companies with good financial strength and earnings growth.

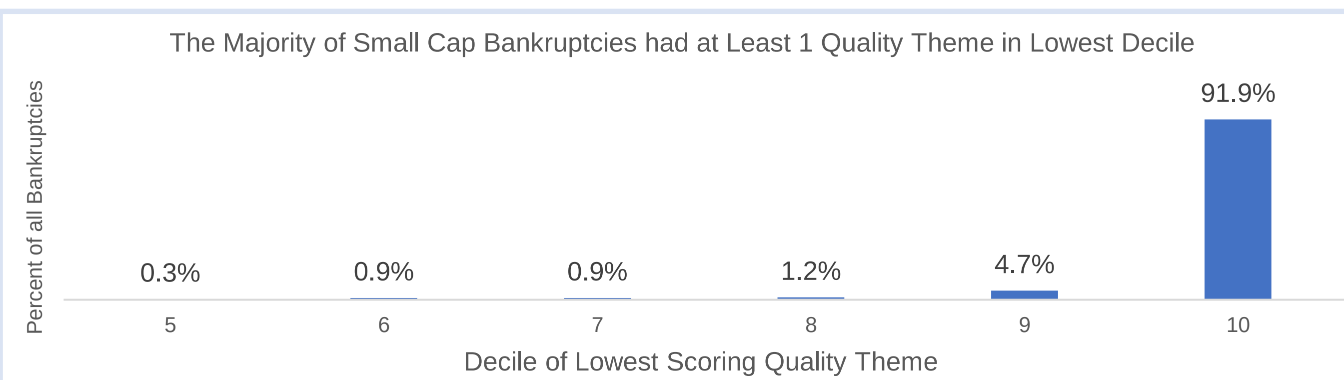




OSAM SMALL CAP VALUE STRATEGY

There is clearly risk in indiscriminately buying small cap stocks during market downturns. In OSAM’s Small Cap Value strategy our Earnings Quality, Financial Strength and Earnings Growth overlays ensure that while investing in one of the better returning assets exiting downturns, the strategy is only buying companies with good financials and strong fundamentals, **while avoiding the lowest scoring**.

To demonstrate the efficacy of this approach, our systematic use of Quality as an exclusionary factor has been critical in avoiding worst-case scenarios like bankruptcy. The chart below shows that 92% of bankruptcies in the small cap space were identified ex-ante by falling into one of the lowest deciles of our quality themes—stocks that we specifically exclude in our process.



What is the result? A portfolio with substantial advantages over the benchmark in terms of valuation, returning cash to shareholders, and quality. As of March 31st, the Small Cap Value portfolio was 25% cheaper than the Russell 2000 Value index (measured by Price/Earnings), had a 1,020% higher Shareholder Yield ratio, and 1-year historical EPS growth rate over 7,000% higher than the benchmark. In terms of quality, the portfolio was significantly less reliant on external financing (527% lower), had a 100% higher Cash Flow-to-Debt ratio, and higher use of accruals (27% lower).

			Portfolio	R2000V	Rel Adv
VALUE		Price-to-Earnings Ratio	7.8	10.4	25% Cheaper
		Price-to-Sales Ratio	0.5	0.6	17% Cheaper
		EBITDA/Enterprise Value (%)	20.9	10.2	105% Higher
		Free Cash Flow/Enterprise Value (%)	9.2	0.8	1050% Higher
		Shareholder Yield (%)	5.6	0.5	1020% Higher
QUALITY	EARNINGS GROWTH	1-Year Historical EPS Growth (%)	22.3	0.3	7300% Higher
		Return on Invested Capital (%)	19.6	13.0	51% Higher
	EARNINGS QUALITY	Total Accruals/Total Assets (%)	-5.2	-4.1	27% Lower
		Depreciation/CapEx (%)	2.2	2.2	-
	FINANCIAL STRENGTH	External Financing (%)	-4.7	1.1	527% Lower
		Cash Flow-to-Debt Ratio	0.4	0.2	100% Higher
MOMENTUM		Trailing 9-Month Total Return (%)	-28.2	-20.6	37% Lower

In these times of market stress, we believe the Small Cap Value strategy is poised for strong performance moving forward by investing in one of the better returning categories out of bear markets, holding companies with significantly better characteristics than the benchmark, and investing at near record-high earnings yield spreads with other assets, implying higher future returns.

Since March 2004 through March 31st, 2020 the Small Cap Value SMA outperformed the Russell 2000 Value benchmark in 92% of rolling 5-year periods (3.3% Avg. Excess Return), and 95% of rolling 10-year periods (3.3% Avg. Excess Return).

If you're interested in learning more about our research, or our Small Cap Value strategy is available in both SMA and mutual fund investment vehicles, please reach out to our team. We'd love to speak with you further.

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OSAM CONTACT INFORMATION:

O'Shaughnessy Asset Management, LLC ■ Six Suburban Avenue ■ Stamford, CT 06901 ■ 203.975.3333 Tel ■ 203.975.3310 Fax

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