RAYMOND JAMES | INVESTMENT MANAGEMENT

Beyond the biggest names

Opportunities in small- and mid-cap stocks

After a rough 2022, small-cap stocks spent the first part of 2023 on a roller-coaster. Small caps started the year strong, outperforming the broader market as investor enthusiasm around a soft landing started to take hold. Then, as hotter than expected inflationary data and hawkish U.S. Federal Reserve commentary stalled the broader markets, the regional banking crisis opened a trapdoor under small caps.

Looking to the rest of 2023, portfolio managers at three independent investment boutiques at Raymond James Investment Management say critical considerations for small- and mid-cap investors include:

- Macroeconomic developments about the path of inflation and the possibility of recession;
- Key secular growth trends; and
- Thematic opportunities that active managers see potentially influencing asset allocation.

Matt McGeary, Tim Miller, and Ryan Harkins recently discussed the outlook for small- and mid-cap investing and with Matt Orton, CFA, Chief Market Strategist at Raymond James Investment Management. A key consideration, one panelist noted, is the importance of maintaining an allocation to small and mid caps.

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"Everyone wants to try to time the market perfectly, but it's very difficult," said Matt McGeary, CFA, Portfolio Co-Manager of the Small and SMID Cap Strategies at Eagle Asset Management. "We believe it is important to maintain some exposure to small caps, perhaps through a high-quality active manager, because if you miss those first few days or weeks of rebound, you really have a hard time catching up as an investor."

THE BIG PICTURE: HIGH BUT FALLING INFLATION VS. THE HAZARDS OF RECESSION

Historically, a high but falling inflationary environment has benefited small caps. That's because it generally implies lower interest rates that drive higher valuations for small caps, which tend to have longer-duration cash flows, said Tim Miller, CFA, Co-Portfolio Manager at Scout Investments' Small Cap Equity Strategy. Since 1950, there have been 20 years when inflation started the year above 3% and then ended lower, according to Furey Research Partners. In those 20 years, the median small-cap return was 21%, Miller noted, and the median outperformance relative to large caps was more than 500 basis points (bps).

"We're pretty confident that inflation will continue to moderate," Miller said. The COVID-19 pandemic disrupted the economy, but companies that Miller's team talks to relate fewer anecdotes about input cost pressures and more about functioning supply chains. Freight pricing is meaningfully lower along with commodity prices, which nonetheless remain volatile, and wage growth appears to have peaked in the summer of 2022.

"The bottom line is we do believe inflation is falling from these higher levels, and that should be good for small caps moving forward," he said.

If, however, the economy tips into a recession, small caps could face continued underperformance relative to large caps, McGeary said. Compared with large caps, small caps tend to be a little more cyclical, with higher beta, more earnings variability, lower cash flow margins, and lower returns on equity.

"Therefore, when investors become concerned about the economy and by extension the capital markets, they sell what they perceive to be at higher risk, so that generally means small caps are sold first relative to their large-cap peers," McGeary said. If you look back at prior recessions going back to 1980, small caps meaningfully underperformed large every time.

Consequently, one key question becomes: Has the small-cap market priced in a recession? In previous recessions, McGeary said, small caps have traded down about 40%, with earnings coming down by about the same amount. Currently, he noted, small-cap earnings revisions or negative earnings estimates are down about 25%, "so I think we're getting there."

As important is what happens after a recession: "When we look at those prior recessions, every time we came out of them, small caps meaningfully outperformed their large-cap peers," McGeary said.

While every recession is different and hard to predict, it's worth remembering that mid-cap stocks have generally offered more defensive characteristics than small caps because they often have stronger competitive positions, more robust balance sheets, and more financial flexibility, said Ryan Harkins, CFA, Senior Portfolio Manager for the Small and Mid Cap Value Strategies at Chartwell Investment Partners. Likewise, with their higher trading volumes, mid caps are less likely to be hit hard by panic selling than small caps. All these factors, Harkins said, mean "mid caps are going to provide a portfolio with a little more defensive positioning in a recessionary environment than small caps would."

Longer recessions with prolonged tight financial conditions can hit small caps particularly hard, McGeary said, because a larger percentage of those companies are non-earners that rely on capital markets for funding. In a higher-for-longer interest rate environment, he said, it's important to recall that higher interest rates mean higher discount rates and lower asset values, all of which make it harder for small caps to generate the kind of free cash flow margins seen in more mature large-caps.

"We've all been living in this environment of seemingly endless liquidity and very low rates, so to the extent that some smaller or newer companies grew up in and rely on that environment to succeed, that could be problematic," McGeary said. "You're likely to see some failures. I think generally balance sheets are in decent shape, but you do have a fair percentage of the market that I believe could be in trouble with rates higher for longer."

Also important for more cyclical small-cap companies is the shape of the yield curve, McGeary said. Cyclicals tend to thrive more when the curve is steeper. If the curve stays flat, he said that could be an additional headwind for small caps.

SECULAR GROWTH TRENDS: ‘INNOVATION ISN’T GOING TO STOP’

Beyond inflation, interest rates, and trends in financial conditions, the panelists said several secular growth trends bear watching as potential drivers of returns for small caps.

During the era of zero interest rates, high-octane growth companies flourished in industries like biopharmaceuticals and software. The low implied discount rate on their future earnings pumped up their valuations, Miller said, and the stock market essentially served as a public venture capital market.

“I don’t really see that changing,” he said. “For the most part, the market has embraced money losers in the initial public offering (IPO) market and will continue to do so, as that gives traditional equity investors the opportunity to participate in early-stage and a lot of hyper-growth companies.”

While higher interest rates may make raising capital more expensive for younger companies and tighter lending practices likewise might make debt financing more difficult, Miller said, “innovation isn’t going to stop. There’s always going to be a willingness to feed that appetite for capital. There’s just way too much upside for investors to ignore.”

So, along with healthcare and software, the panelists said promising frontiers of innovation in small and mid caps include:

- **Artificial intelligence.** Mass adoption of artificial intelligence (AI) will require significant computing and network capacity, Harkins said. Many small- and mid-cap companies are involved in building that infrastructure, and they include both growth and value companies. Moreover, in addition to those manufacturers of chips, network equipment, and data centers, there are all the companies that can use AI to improve their businesses.
- **Electric vehicles.** “We’re very bullish on the future of electric vehicles,” Miller said. The International Energy Agency’s global outlook for electric vehicles (EVs) reported that consumers bought 10 million EVs globally in 2022, or 14% of all new cars sold, and China accounted for about 60% of those EV sales. In the first quarter of 2023, more EVs were sold than in the same quarter last year. The agency forecasts that 35% of cars sold worldwide in 2030 will be electric. EV tax credits and other incentives in the U.S. Inflation Reduction Act, plus zero emission vehicle mandates adopted by a growing number of large states, make EV adoption a long and sustainable trend. While a small-cap investor wouldn’t be looking at an EV automaker with a massive market cap, Miller said he believes smaller-cap EV opportunities include companies focused on integrated chips for vehicle components, charging and power management, or in-cabin technology, as well as firms specializing in advanced materials, battery technology, and charging networks. “The bottom line is that you don’t just have to invest in large-cap automakers to get exposure to some massive growth going on in that EV space,” he said.
- **Supply chains.** Here the innovation worth watching revolves less around technology and more around mindset, McGeary said. The COVID-19 economy blew up the “just-in-time” inventory management paradigm and revealed how fragile supply chains can be, he said. Among the companies that his team invests in, one trait most often drove success during supply-chain disruptions, he said. That attribute was having a management team that maintained a long-term perspective and showed a willingness to invest in their business, their people, and their processes through troubled times.

“When things get tough, sometimes one of the worst mistakes you can make as a management team is to cut back as aggressively as you can, cutting all your good people, and assuming they’re going to be there when things normalize and you want them back,” he said. “It doesn’t always work out that way. Companies that kept investing and kept their good people around, had better lead times and were able to take share when the economy started to normalize and supply chains started to loosen.”

HEADWINDS AND TAILWINDS

Given the recent performance of small caps, what will it take for the asset class to bounce back?

In the short term, McGeary said, market breadth needs to improve from an exceptionally concentrated level that has been fueled by an investor focus on central banks and policy makers.

“I’m a traditional bottom-up fundamental investor,” he said, “and I believe we’ve got to get back to the point where all the attention is not on ‘What is the Fed’s next move?’ and more is on ‘What are good investment opportunities in our economy?’ ” For his team, that means not chasing data or market sentiment

that changes by the minute, but instead leaning into a process that focuses on earnings quality, cash flow, and balance sheets, plus companies that have pricing power and quality management teams.

"At the end of the day, we try to maintain a long-term focus," he said. "In this kind of market, you can get opportunities, because the market is ignoring so much and concentrating on so little."

And amid the noise, each portfolio manager sees key themes to watch for the long term.

Miller: "We still really like biotech." He noted that the global biotech market is estimated to be $900 billion this year and is expected to continue growing at a high single-digit pace for the next several years. While biotech companies typically lack profitability – a challenge for the Scout Small Cap team, which works to invest in profitable companies – Miller said there are other ways to participate in the industry's growth. Those include steering clear of most biotech drug makers that face binary outcomes while looking at companies that supply tools, conduct clinical trials, or focus on drug-delivery or key enabling technologies. "We don't necessarily have exposure to the success or failure of a specific drug," he said, "but rather to that overall growth in drug sales and research and development spending."

Harkins: "As a value investor, industry themes and that sort of thing really aren't as important to how we invest. We're typically investing in companies in more established industries that have stumbled for one reason or another, and as a result, they're cheaper than they have been historically. Our challenge is to determine whether those companies are undervalued or whether something structural has changed and as a result they deserve a lower valuation than they've received historically."

The stimulus-fueled wave of speculation in low-quality stocks, meme stocks, special purpose acquisition companies (SPACs), cryptocurrencies, and non-fungible tokens (NFTs) seems to have broken. "I don't think we're going to see any more movie theater chains selling for 40 times revenue like we saw back in 2021, or B-list celebrities and sports stars hawking SPACs," Harkins said. "I welcome that we are heading toward an environment where fundamentals and valuation matter, because that's the way to general returns over the long haul and help clients meet their investment objectives."

McGeary: "Manufacturing productivity in our economy has been pretty bad for the past 10 or 12 years, and if you think about what we learned from COVID about how our economy changed, we're still having a hard time finding enough employees and the right employees to reshore manufacturing to address some of these supply chain issues we talked about. We need to do a better job as an economy investing in our manufacturing infrastructure."

As a result, he said, themes of productivity and AI-driven automation have "a lot of tentacles and a lot of opportunities throughout many, many sectors that I think will be exciting to think about for the next decade or so."

For more insights from our boutique investment managers click here.

About Raymond James Investment Management

Raymond James Investment Management is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our boutique investment managers – Chartwell Investment Partners, ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. We believe providing a lineup of seasoned, committed portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

About Eagle Asset Management

Eagle Asset Management provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

About Scout Investments

Scout Investments' independent equity investment teams take a selective approach, using rigorous research and analysis to seek out high-quality companies and patiently pursue long-term capital appreciation for clients. Our thoughtful approach to asset management extends to cultivating lasting partnerships with our clients.

About Chartwell Investment Partners

Chartwell Investment Partners LLC, is an investment management firm dedicated solely to the investment advisory business. Chartwell's philosophy is to rely on proprietary, bottom-up research to find high quality investments across its various product offerings.

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Growth companies are expected to increase their earnings at a certain rate. When these expectations are not met, investors may punish the stocks excessively, even if earnings showed an absolute increase. Growth company stocks also typically lack the dividend yield that can cushion stock prices in market downturns.

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Definitions

Growth investing is a stock-buying strategy that focuses on companies expected to grow at an above-average rate compared to their industry or the market.

Value investing is an investment strategy that involves picking stocks that appear to be trading for less than their intrinsic or book value.

Hawkish, dovish, and centrist are terms used to describe the monetary policy preferences of central bankers and others. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

Secular stocks are characterized by having consistent earnings over the long term constant regardless of other trends in the market. Secular companies often have a primary business related to consumer staples most households consistently use whether the larger economy is good or bad.

Equity duration is the cash-flow weighted average time at which investors can expect to receive the cash flows from their investment in a company's stock. Long-duration stocks include fast-growing technology companies, including those that may not pay any dividends in their early years, while short-duration stocks tend to be more mature companies with higher ratios to dividend to price.

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Cyclical stocks have prices influenced by macroeconomic changes in the economy and are known for following the economy as it cycles through expansion, peak, recession, and recovery.

Beta is a measure of the volatility or systemic risk of a security or portfolio compared with the market as a whole.

Non-earners refers to companies that have not yet reported or do not consistently report earnings, which is positive, after-tax net income for specific periods of time.

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.

Defensive stocks provide consistent dividends and stable earnings regardless whether the overall stock market is rising or falling. Companies with shares considered to be defensive tend to have a constant demand for their products or services and thus their operations are more stable during different phases of the business cycle.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

The discount rate is the interest rate the U.S. Federal Reserve charges commercial banks and other financial institutions for short-term loans. A forward interest rate acts as a discount rate for a single payment from one date in the future, and discounts it to a date that's closer in the future. An implied discount rate equals the difference between the existing discount rate and the forward or futures rate.

Future earnings, also known as forward earnings, are an estimate of a company's earnings for an upcoming specific period, such as a quarter or fiscal year.

An initial public offering (IPO) is the offer of shares in a private corporation to the public in a new stock issuance for the first time.

The Inflation Reduction Act (IRA) is federal legislation passed in August 2022. It aims to help curb inflation by directing spending toward reducing carbon emissions and lowering health care costs, while also aiming to improve taxpayer compliance through increased funding for the Internal Revenue Service.

Just-in-time inventory systems seek to coordinate orders of raw materials and product components with manufacturing production schedules. The goal is to increase efficiency and reduce waste by receiving goods when they are needed for production, thereby reducing inventory costs.

Pricing power, also known as market power, refers to a company's ability to manipulate the price of a product or service in the marketplace by controlling the level of supply, demand, or both.

Reshoring describes the process of returning manufacturing operations to a company's home country. It is the opposite of offshoring.

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