What's Driving Small-Cap Returns?

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U.S. economic activity slowed in the third quarter of 2021 due to both a surge in new COVID-19 cases and persistent bottlenecks in the global supply chain, but we expect a rebound, with the direction of the virus and the pace of global economic reopening dictating timing. Going forward, we see earnings, valuations, and monetary policy as the key factors driving small-cap value performance.

What Are the Concerns?

Consumer confidence has been very weak (near multiyear lows). While we're watching it carefully, we think consumers are in good shape. They were deleveraging before COVID, and their finances and savings levels are still healthy (although the sunsetting of pandemic-related fiscal stimulus payments has reduced the cushion). Unemployment continues to fall, albeit more slowly due to the Delta and Omicron variant surges, and wages are rising.

One risk we do see is rising inflation. What was originally just a bottleneck in semiconductor chips impacting autos has picked up across industries. We are seeing greater supply-chain disruptions, and with these bottlenecks, inflation is picking up. Moreover, while inflation was at first believed to be transitory, it is now beginning to look persistent—and if the Federal Reserve finds itself behind the curve, we believe monetary accommodation may be removed more aggressively than currently forecast. If the policymakers have to play catch up, it won't be good for the economy or the markets.

More immediate in our minds, however, is rising input costs for companies impacting potential sales—i.e., lost sales due to a lack of availability. Rising input costs, along with continuing supply chain disruptions and a lack of available workers, are beginning to crimp margins and output. Much of this already has been discounted by the market, but the extent and duration are unclear.

Lastly, we're watching events in Washington, D.C., which are coming to the forefront. In our view, a deeply divided Congress needs to raise the federal debt ceiling, and the Democratic party is attempting to push through trillions of dollars of new fiscal stimulus. The debt ceiling is almost certain to be raised, and we aren't overly concerned about that, because it's political noise. But the scope and tax implications of the fiscal stimulus remain to be seen. Increases in corporate taxes are significant to small-cap stocks, which were the biggest beneficiaries of the 2017 lowering of the corporate tax rate.

Identifying the Drivers

The last few quarters saw companies beating earnings forecasts by a wide margin. Given the headwinds discussed above, we believe this is likely to come to an end. Nevertheless, our earnings growth expectations for small-cap value overall in 2022 are healthy.

Valuations should also help small-cap stocks in our opinion. The valuation spread between the Russell 2000 Index and the S&P 500 Index is at a historical high, and valuations for small-cap value stocks are even more attractive. Small-cap stocks are actually one of the few sectors of the domestic equity market that are trading below historical levels on forward earnings.

Monetary policy, from our view, should also drive small-cap returns in the months ahead. The Federal Reserve recently signaled that it is ready to begin tapering its massive bond buying program of the last few years. We are optimistic that this is the first step to a more "normal" interest-rate regime, which we welcome, because we think it will help our portfolios given their underweight positioning in utilities and rates (say, via banks).

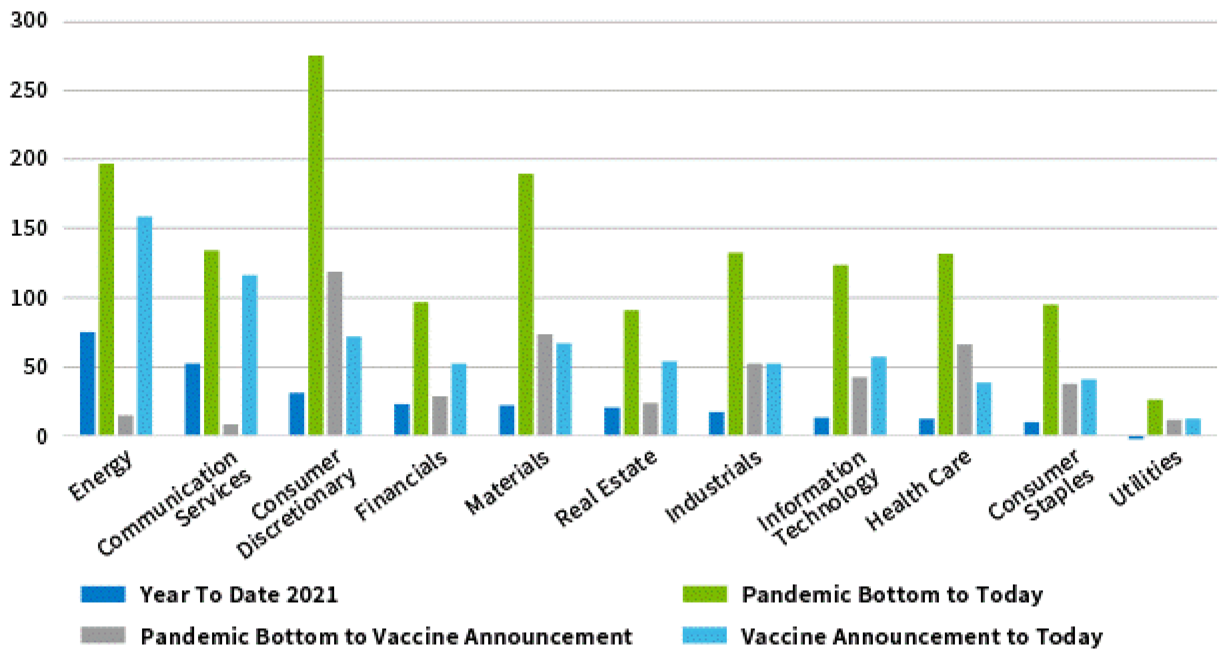
Looking for Opportunities

From the day after the vaccines were revealed effective in November 2020, it has been a challenging environment from an allocation perspective.

We'll explain why, but first take a look at the chart below, which shows the Russell 2000 Value Index sector performance during some key time periods around the pandemic.

There are a few interesting things about this sector chart that show us what's driving performance in small-cap value and how that's affecting active managers.

Russell 2000 Value Index Sector Returns Over COVID-19 (Basis Points)



Source: FactSet and William Blair, as of September 2021. Based on Global Industry Classification Sectors (GCIS). Past returns are no guarantee of future performance. A direct investment in an unmanaged index is not possible.

One area of challenge for active value investors has been the communications services sector of the Russell 2000 Value Index. It skyrocketed in 2021 because it held AMC Entertainment, which was up 1,695% year to date as of September 2021. If you're wondering why AMC was even in the benchmark, it had not yet surged when Russell set constituents in late May.

A similar situation existed in the consumer discretionary sector, where GameStop—what we call "a meme stock"—performed so well it left the benchmark in June.

Materials is also worth mentioning for a similar reason. Steel stocks began surging in the fourth quarter of 2020, driving up performance of the benchmark's materials sector. But not all value managers are focused on the commodities space. We, for example, don't have any exposure to metals and mining companies or more commodity-oriented chemical companies; we tend to invest in things that add value to turn raw materials.

The point is, there are stocks that perform well that would never pass our filters, and the fact that they are (or were, in the case of GameStop) in the benchmark creates a headwind for value managers who don't hold them. In hindsight, had we owned the worst balance sheets we could find in the third quarter, we probably would have performed better, because in some cases those stocks performed well.

But, we won't do that. It has been one of those periods where deep value has outperformed, but we are not deep value investors. Year-to-date, indices have contributed on price-to-book value (P/BV), but we look at more than that: price to earnings (P/E), price to sales (P/S), and enterprise value to earnings before interest, taxes, depreciation, and amortization ratio (EC/EBITDA). We seek to continue to do that, with healthcare and financials being two places of particular interest.

We believe healthcare is an interesting place for active managers. With the June 2021 Russell 2000 Index rebalancing, biotech stocks are close to 6.5% of the index. There are 178 of them, and only a few have earnings and positive cash flows. In fact, non-earners are at a record high in the Russell 2000 Value Index more broadly—40%. That, again, speaks to the role of active management. We really have to keep an eye on that situation.

We also think the outlook is rosy for small-cap value investors in financials When the Fed started talking about removing accommodation at the end of September, bank stocks surged. In our opinion, they could continue to do well, because rates may rise. Plus, historically speaking, banks are not expensive.

In this environment—as in all environments—our process is very much bottom-up. Earnings growth is not a key component; we're just trying to pay discounted valuations for the earnings and growth we do see in the near to intermediate term. From a top-down basis, however, we do believe projected earnings growth is still higher for value stocks than it is for growth stocks, so the cyclical trade still has legs.

The narrative in the third quarter was peak everything, but the more interesting ideas we have relate to the market overly discounting the decline in earnings as we see it. And that's where value earnings are opening up right now—and where we think it's a good idea to be a bit contrarian.

This will likely be a short economic cycle; I don't think we will see a long, slow economic expansion as we did from 2009 to 2019. But we don't think the value trade is over.

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