THE CASE FOR SMALL- AND MIDCAP VALUE STOCKS

Perkins
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UNCOMMON VALUE℠

As the equity market's rally of nearly nine years has taken valuations to very lofty levels, we have cautioned that investors should not ignore the mounting risks. We have been concerned for some time now that the extremely complacent marketplace – as measured by investor sentiment and the Cboe Volatility Index® – created the potential for a violent correction in equity markets. Our concerns were realized at the beginning of 2018 with a sudden and volatile sell-off. Given the changing investment landscape and the numerous risks that accompany this shift, we at Perkins believe that it makes sense now more than ever to consider defensive value strategies, especially within the small- and midcap space.

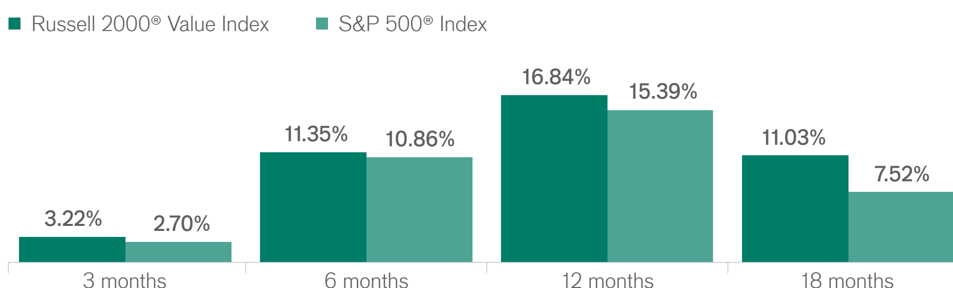
SETTING THE STAGE FOR VALUE

RISING RATES

Since the market bottom in 2009, in a period marked by extremely low and falling interest rates and sub-par economic expansion, growth has outperformed value. But the era of easy monetary policy appears to be coming to an end. The Federal Reserve (Fed) recently raised its target benchmark rate by 25 basis points, citing a continued improvement in the economic outlook and accelerating inflation pressures. This highly anticipated move puts the range for the target benchmark rate between 1.50% and 1.75%, up from the extraordinarily low level of 0%-0.25% that we saw from late 2008 to 2015. What's more, tighter monetary policy is expected to continue, with the Fed forecasting a steeper path of rate hikes in coming years.

Value has historically outperformed during rising rate environments. Indeed, as shown in Exhibit 1, the Russell 2000® Value Index, a measure of U.S. small-cap value equities, outpaced the broader equity market (as represented by the S&P 500® Index) over a variety of time periods during rising rate environments initiated from 1980 to 2004. Rising rate environments tend to favor value stocks because investors no longer have as much incentive to pay up for growth, as investors are able to earn greater returns from assets with lower multiples, rather than from growth stocks alone.

EXHIBIT 1: VALUE TYPICALLY OUTPERFORMED FOLLOWING RATE HIKES



Source: Morningstar, Inc. Data as of 3/22/18
Average returns calculated for the stated time periods following rate hikes on: 8/7/80, 2/1/83, 10/1/86, 2/4/94, 6/30/99 and 6/30/04. Returns greater than one year are annualized

KEY TAKEAWAYS

- In recent years, growth stocks have outperformed value equities. But the relationship may reverse with rising interest rates, as value has historically outperformed in such environments.
- Within value, small- and midcap companies appear particularly well positioned to benefit from today's economic tailwinds, such as U.S. tax reform and deregulation.
- We believe investors should consider companies that have not led the market's multiyear run, as they may present less downside risk.

INFLATION

The return of inflation also bodes well for value stocks. Although it has remained stubbornly low throughout the post-financial crisis recovery, inflation is starting to revert to more normal levels, as shown by strengthening wage growth and price data. Its emergence has the potential to diminish the present value of growth stocks' earnings, which tend to be realized farther out in the future due to the longer time frame to realize these companies' cash flows.

Additionally, many investments that are considered an "inflation hedge" – which tend to hold up better when inflation accelerates – are found in the value category, including commodity-linked investments whose hard assets have intrinsic values less susceptible to inflationary pressures.

AN AGING GROWTH CYCLE

Mean reversion is another powerful trend that could favor value stocks. According to Morningstar Direct data, from the fourth quarter of 1979 through the first quarter of 2018, the average cycle lasted 6 quarters. During this time period, the longest growth cycle topped out at 12 quarters (1989-1992). Conversely, value generally outperformed growth in 2000-2007, a period which included the Fed initiating rate hikes in 2002; in fact, growth only outperformed in three of 27 quarters. Today, however, growth has outperformed in 21 of the last 37 quarters. Certainly, it is normal for the market to shift between cycles in which either value or growth are outperforming, as shown in Exhibit 2. But given how long the current growth-driven market has lasted and the normalization of market volatility, we believe that we may soon return to an environment in which value outperforms growth.

EXHIBIT 2: GROWTH HAS OUTPERFORMED VALUE SINCE 2008

Source: The Leuthold Group. Data as of 2/28/18
The data is drawn from Leuthold's Royal Blue universe which includes the 99 largest institutional equity holdings as determined by Leuthold research. The 33 highest price-to-earnings ratio (P/Es) companies are categorized as Growth and the 33 lowest P/Es are categorized as Value. The relative strength ratio measures the cumulative monthly performance of the Growth vs. Value baskets (total return including dividends, equally weighted.) The ratio is set to 100 at inception (12/74).

FINDING OPPORTUNITIES IN SMALLER MARKET CAPS

CAPITALIZING ON ECONOMIC TAILWINDS

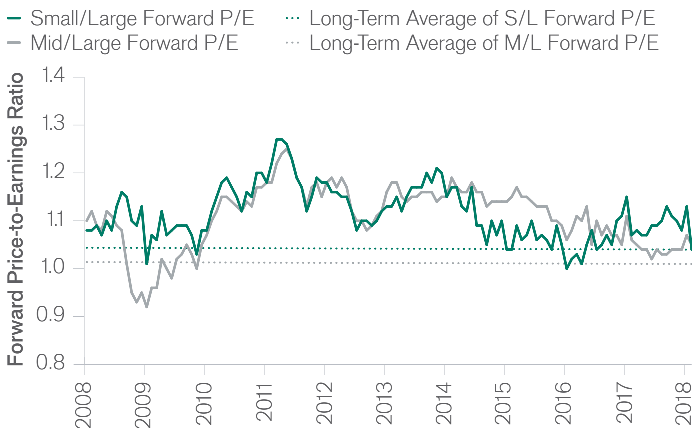
Within value, we believe investors should focus on small- and midcap stocks. In our view, small- to midsized companies are particularly well positioned to benefit from a number of macroeconomic trends, including tax reform, regulatory relief and rising rates due to an improving U.S. economy. Smaller-cap firms, for example, typically earn a majority of their revenues in the U.S. and, therefore, pay a higher effective tax rate than their multinational peers. As a result, small and midsized companies stand to realize greater benefits from tax reform, as a significant reduction in their corporate tax rate will likely boost earnings. The ability to expense rather than depreciate capital spending may also provide a boost, as capital spending has been lackluster for many years. As another example, regulatory relief could ease pressure for many industries, particularly financials. Proposed regulatory changes for banks would narrow the focus of oversight and exempt smaller institutions from some of the more onerous capital requirements.

U.S. gross domestic product improvement should also disproportionately benefit smaller companies: since they tend to be more domestically oriented, strengthening economic growth is likely to find its way into increased earnings estimates for these firms, benefiting the segment. A strengthening economic environment also supports further rate hikes, which should further bolster financials. Rising rates aid banks, as they can then earn more from the spread between the interest rate they pay their customers and what they can earn on their lending activities.

ATTRACTIVE RELATIVE VALUATIONS

While valuations across the broad U.S. equity market are elevated, we note that U.S. small- and midcap stocks are not expensive relative to their large-cap counterparts. In February 2018, the ratio of forward price-to-earnings (P/E) ratios of small-cap and large-cap equities was 1.04, in line with the long-term average of 1.05. Similarly, the ratio of forward P/Es between mid-cap and large-cap equities was 1.05, compared with an average of 1.01. As shown in Exhibit 3, the ratio has been generally trending toward 1 in recent years.

EXHIBIT 3: SMALL- AND MIDCAPS ARE NOT EXPENSIVE RELATIVE TO LARGE CAPS



Source: Jefferies Group LLC. Data as of 3/15/18
The forward price-to-earnings (P/E) ratio measures share price compared to forecasted earnings for the next 12 months per share for the stocks in an index. The Small/Large Forward P/E represents the ratio of the forward P/Es of the Russell 2000® Index and Russell 1000® Index. The Mid/Large Forward P/E represents the ratio of the forward P/Es of the Russell Midcap® Index and the Russell 1000® Index. When the ratio is 1, the two indices are equally valued. When the ratio is greater than one, the small- or midcap index is trading at a premium to the large-cap index. When the ratio is less than one, the small- or midcap index is trading at a discount to the large-cap index. The long-term averages of the small/large and mid/large forward P/E ratios represent the period from January 1987 to February 2018.

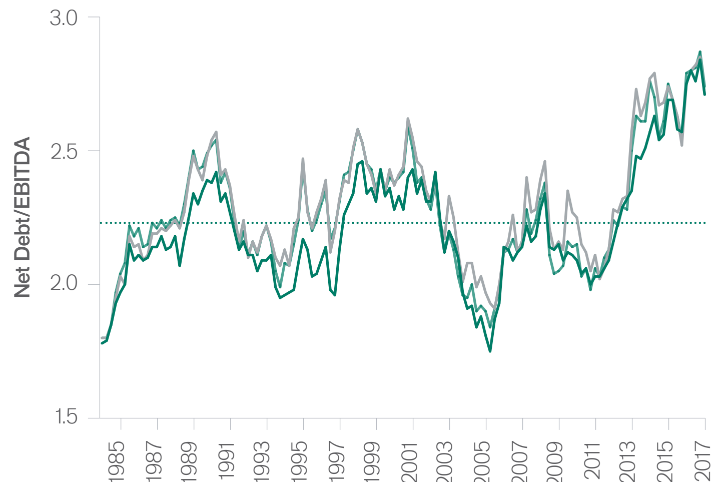
FOCUSING ON QUALITY

While we believe that value stocks, especially those on the smaller end of the market capitalization spectrum, are poised for strong performance, investors should not be complacent in their positioning. Certainly there are opportunities, but risks have increased in the market and smaller-capitalization stocks can be more susceptible to adverse developments than larger capitalization securities.

HEALTHY BALANCE SHEETS WANTED

One such risk is leverage, which remains high across the market (see Exhibit 4). In recent years, we have been concerned as many companies have used easy monetary policy to irresponsibly increase leverage on their balance sheets. Companies have been able to easily access low-cost debt to engage in shareholder-friendly activities, such as stock buybacks and mergers and acquisitions. We are concerned that some of these companies may have taken on more debt than they can comfortably service. And at this point in the business cycle – already extended by historical standards – it is especially concerning that many of these firms have not been diligent in subsequently deleveraging their balance sheets.

EXHIBIT 4: LEVERAGE REMAINS HIGH IN THE RUSSELL 2000 INDEX



Source: Jefferies Group LLC. Data as of 3/15/18
Data shown represents net debt to earnings before interest, tax, depreciation and amortization (EBITDA) for the Russell 2000® Index for the period 12/31/84-12/29/17. Sectors are based on the Global Industry Classification Standard (GICS).

This creates a potentially dangerous dynamic. Until recently, the slow pace of economic recovery has been challenging for earnings growth, particularly in cases where a firm has significant cyclical and commodity exposure. An overly levered balanced sheet may compound an earnings miss and make it much harder for a company to recover. Moreover, if profit margins decline from here, high debt levels could squeeze companies' free cash flow. Given these trends and where we are in the business cycle, we believe it is especially important to look for companies with solid balance sheets.

FOCUS ON THE DOWNSIDE

As a cornerstone of our process, our primary focus has always been on potential downside risks, and we are concerned by the continued bullish complacency we are witnessing in the market today. In our view, investors may be overlooking the downside risk that comes with lofty valuations, particularly when interest rates are rising. Therefore, we think it is increasingly important to focus on companies with durable competitive moats, reasonable stock valuations and healthy balance sheets.

Additionally, we believe that less mainstream holdings, which we think of as "off the beaten path," may be less exposed to this general bullishness and, crucially, less exposed to a reversal in the level of bullishness. Our research efforts increasingly direct us to stocks with minimal Wall Street or sell-side analyst coverage, management teams that are not overly promotional

and are good stewards of shareholder capital, and niche businesses with secular business drivers. In navigating today's great bull market, we believe that the further a stock is from front-page headlines, the better.

We also favor an eclectic mix of holdings. A healthy mix of different drivers of alpha (i.e., risk-adjusted performance) has the potential to strengthen portfolios. Ultimately, as the market and many of its individual stock components become increasingly unattractive from a reward-to-risk standpoint, we want the portfolios that we manage to look less like the market. We believe that having a diversified portfolio may help to navigate volatile markets, including changes in the geopolitical landscape and potential disruptions to free trade.

LOOKING BEYOND THE HEADLINES

Value stocks have been out of favor during the current bull market. But now, as rates are starting to rise and inflation is picking up, we believe value offers better risk-adjusted opportunities. Within value, we particularly like companies on the smaller end of the capitalization spectrum as we believe they are reasonably valued on a relative basis and stand to benefit from macroeconomic tailwinds, such as a strengthening economy, deregulation and tax reform.

Moreover, amid the general bullishness we observe, we are focused on mitigating downside risk. Securities that are off the beaten path appear particularly attractive as we seek to limit our exposure in the event of a market correction. We also favor diversified portfolios, as we believe having different drivers of alpha may help to strengthen a portfolio's ability to withstand a variety of news headlines and potential economic outcomes.

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Growth and Value investing each have their own unique risks and potential for rewards. A growth investing strategy typically carries a higher risk of loss and a higher potential for reward than a value investing strategy. A value investing strategy invests in "value" stocks, which can continue to be inexpensive for long periods of time and may never realize their full value.

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