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Thinking Big When It Comes to Small Caps

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Anu Rajakumar: The small-cap market, which is often related to relatively younger public companies, offers investors the possibility of attractive returns; particularly in periods of economic expansion and optimism, as we've seen in the first half of 2021. However, with the meme-stock phenomenon early this year, the small-cap market has seen quite a bit of volatility; and with growing inflation concerns, what should investors be thinking about when it comes to small-cap investing? My name is Anu Rajakumar, and joining me today is Judy Vale, senior portfolio manager on the small-cap team here at Neuberger Berman, to share her thoughts on opportunities within this market today. Judy, thank you very much for joining me.

Judy Vale: Thank for inviting me, Anu. It's really a pleasure to be here.

Anu: So Judy, just to get us started, could you share an overview of the characteristics of the small-cap market?

Judy: The first thing that comes to mind is, these are companies that, uh, are in a less-efficient market. There is much less sell-side coverage. Moreover, they have more rapid annual earnings growth than large caps. They have a higher exposure to the domestic economy with 78 percent of sales, with exposure to the U.S., as opposed to large, which is 61. And, perhaps most importantly, you see significantly higher insider ownership with small caps being 17 percent versus eight percent for large caps.

And what that does is, it shows an alignment of management and investor interests. Another couple of overall characteristics of the market is, you see more M&A activity in small-cap, and you also see greater volatility, and that was even before the meme-stock phenomenon. But all in all, it is a very attractive place to shop for businesses.

Anu: OK, great. That's a helpful primer. Now, as a follow-up, could you address what the small-cap opportunity set looks like in today's environment? What are you seeing at the moment?

Judy: Well, I would say there are a couple of things. First off, traditionally, when people want to buy small, they want to buy in the beginning of the economic cycle because the index itself is more cyclical than larger caps. And I would say we're in a very good economic environment; not in the first or second inning, but looking out a year, companies are looking at signs that growth should be quite robust going forward.

Also, analysts' estimates show that the expectations for small-cap growth in the forthcoming year are significantly higher than those for large-caps. Finally, people look at relative valuations. And here, if you look just at the entirety of large-cap versus the entirety of small-cap, both groups are trading at the highest that you've ever seen. So what that says is, in aggregate, nothing is cheap. However, if you're just looking at companies with earnings, and you make that comparison, then small is selling at a significant discount, both on an earnings basis and a cash flow basis. So I would say, from the valuation point of view, it, it looks to be quite an attractive time.

Anu: Now, earlier you mentioned that one of the characteristics of small caps was a greater exposure to the U.S. economy, and just growth in general. Could you relate that back to the pandemic? How did small caps fare sort of at the, you know, end of the first quarter of 2020? And how did they perform as a vaccine was developed, and there was more optimism about the U.S. economy?

Judy: Well, with the announcement that vaccines were in our very near future, back in the fall of [2020], small took off like a rocket ship; and that enthusiasm continued through last year. And I think that what we've seen has been a shift within small to, at one point or another, you'll see growth stocks take the lead. More recently you've seen value take the lead. And then this year, we've also seen an unusually strong burst in speculation. Small has always been a volatile asset class; but we've seen some really off-the-charts volatility, particularly in the beginning of this year with meme stocks.

Anu: Perfect. On that note, as a portfolio manager in the small-cap space, what are your thoughts about those speculative stocks? Have there been any instances where those stocks have really met the hype?

Judy: I think it's conceivable that one or two might. However, if you look at them as a group, I would say, investor beware. Now, usually, people think about stocks that their price action is based on the hype from social media. And they're being hyped not necessarily because they're good businesses. In fact, some of the most prominent meme-stock names that you've all read about have been companies that have been in trouble and, in fact, had very high short interest. So I would say that these are wildly speculative businesses, on the whole. There could be one or two, at some point in time, which really is the next Amazon.

But on balance, I would say they are a highly speculative asset class, or sub-asset class. And I think that, for the average investor, you would be well served to stay clear of them; because as much as they've had a meteoric rise, most of the meteoric rises have been followed by an equally dramatic crash. So I would say, for your average investor, run for the hills. Don't go there.

Anu: Think that's a fair point. You know, it actually leads me to my next question, which is really about the concept of active management versus passive management. You know, I think one thing about small-cap indices is that they sometimes have less-quality names, sometimes be a little bit junkier. Talk about the importance of active management within the small-cap space.

Judy: In my opinion, it is really paramount. Because, if you're looking at the components of the index, you will find that a very significant portion – more than 30 percent of companies – don't have earnings, which are either very low-quality businesses or wildly speculative. You don't get this kind of difference between high quality and low quality when you're looking at the corresponding large-cap indices.

So I would say, in small, you can capture a good amount of the upside and eliminate some of the really death-defying downdrafts if you stick to higher quality businesses, which I think is sort of intuitively clear. And the way you do this is through active management. This also ties into what we talked about right off the bat, which is the fact that small-cap markets are less efficient. There's less Wall Street coverage. Earnings estimates are all over the place. We actually know companies where there is no written analytical coverage, which I think is wonderful.

Anu: Now I know one of the other areas that you're able to add value is through your engagement with those companies. Could you describe your approach and maybe share an example of a recent engagement?

Judy: OK, with pleasure. First off, we have always actively engaged with our companies. And even before we heard the words, "ESG," we would engage with them to better understand their businesses, the trends in their businesses. But we also interacted and gave them a lot of feedback, particularly on issues of governance. And interestingly, the companies that we talk to generally welcome our input. So what we're talking about is how they allocate their capital. What are the constituents of the board? How do they have bonus pay for management? So we have always been extremely interactive with managements on these fronts. However, with the rise of ESG investing, we have become broader in our interactions, and we have sought to specifically engage on both environmental and social matters, as well as the governance, which we've done for the last 20, 30, 100 years. And I'll give you a couple of examples.

There's a consumer-staples company that we're involved with, and we were engaging on the subject of environmental issues. And, in an overall way, we were pushing the company to become more ESG friendly. But specifically, we asked a lot of questions that had to do with the treatment of the wastewater-discharge systems.

And as an outcome, they implemented ongoing testing, monitoring, treatment of the discharge systems; and they established best practices for all stormwater runoff from their properties. They also replaced inefficient equipment in facilities and looked for opportunities to reduce energy demand. Some examples would be, they included the installation of light sensors in warehouse and storage areas and the conversion of fluorescent lighting to more efficient lighting alternatives. And the company attributed a lot of this to our engagement and encouragement. So that's an example of an environmental interaction.

You know, we've had so many interactions on the subject of governance, where, as I mentioned, a lot of it has had to do with capital allocation; and that's been very ongoing. But we've also taken a very active hand in helping companies to tinker with their incentive-compensation plans, to make certain that they are more firmly aligned with investors. And a number of our companies have mentioned to us that our engagement with them was definitely a force here.

And on the social front, we've encouraged our companies to increase their diversity, and have gotten very good feedback on specific programs that have been implemented within the companies to better facilitate this. So on average, I think this is another benefit of active investing. Because we tend to invest in companies for a long time, we really know our companies and our managements. And companies trust us to give them advice that will be good for them as well as for investors.

Anu: Perfect. Thank you very much. Now, in terms of risks on the horizon, you know, a huge driver of disruption these days is inflation risk. So Judy, tell us a little bit more about the impact that rising inflation might have on small caps, and any other risks you think that investors ought to be aware of.

Judy: Sure. And I'm going to say, first off, that inflation risks do not specifically impact small caps. They impact small and large companies pretty much the same way. But they do impact different industries quite differently. So I would say that virtually all of our companies are seeing upticks in their input costs, not only in materials, but also in labor rates. And this is simply endemic these days. But it's a period where I think it's very, very important to invest in companies that have the ability to pass through their cost increases. That, again, plays to the importance of active management and quality investing.

Anu: All right, Judy. As we start to wrap up here, if you had to sum up a few takeaways from this conversation, what would they be?

Judy: Well, I would say the first thing is, **stay away from meme stocks**.

Anu: [Laughs]

Judy: Stay away from the shiny object, the attraction of making a fast buck; because you can lose it as quickly as you can make it. Usually, by the time you hear about it, the run is almost over. So of course I'm talking to my bias here, which is, I am a conservative investor. But I really think that investors have to be very careful with the speculative corners of the small-cap marketplace. And the second thing I would warn is that you are getting a lot of indirect exposure to these speculative areas of the market, if you decide to go passive. So, if you go passive and buy an index, you will get exposure to the U.S. economy, but you're also going to get exposure to the tune of more than a third of the companies that you're indirectly buying through the index that are not making money. And in a market downdraft, they will be very, very vulnerable.

Anu: Terrific. Thank you, Judy. Now, as a bonus question, I would love to get some thoughts from you. You know, it's a rarity and a delight to have a senior portfolio manager who's a woman be a part of this show. You are a disruptive force in your own right, Judy. Please share some of your words of wisdom that you'd like to impart on people who are beginning their career in this industry, based on some of your experiences.

Judy: Well, I think the most important thing is, if you know the job you want, go after it. If you know an investor that you really, really respect, and want to work for them, approach them. But I would say, take a very, very active hand in how you're approaching this. Do not be passive yourself. And if you're passionate about getting a job, express it. I would also say that times have changed, and managers are looking to hire more women. So I also think that, shall we say, the worm has turned, and the environment is very favorable for women to get into the business.

Anu: Terrific. Thank you very much, Judy. Some great words to live by, following your passion and to be active, not just in your security-selection decisions, but also in your career decisions, as well. That'll do it for this episode. Thank you so much for sharing your story with us, and for your thoughts on the small-cap market. Very intrigued to see what lies ahead for small caps. Judy, thank you for joining me again.

Judy: It was a pleasure. Thanks, Anu.

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