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SMALL CAP ROUNDTABLE

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July 2008 Roundtable Part I

Jennifer Schonberger | Jul 23, 2008 09:29am EDT | Comment

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It's halftime for the stock market.

As the financial and housing crises came to a head, the first six months of the year were enveloped in waves of lackluster economic and corporate news, sending small-cap equities into a tailspin. After a volatile first half, the Russell 2000 is limping forward, down 7.4% year-to-date. While winter turned to spring, Wall Street remained entrenched in frozen assets.

For some half-time analysis (edited by Crystal D. Vogt), SmallCapInvestor.com reporter Jennifer Schonberger interviewed six experts who specialize in small caps to gauge their opinions of the market and small caps for the next six months. Our panel of experts include Mary Lisanti, president and chief investing officer of AH Lisanti Capital Growth; Jim Oberweis, president and lead portfolio manager of Oberweis Asset Management; Bryant Riley, founder and managing member of Riley Investment Management and founder and chairman of brokerage firm B. Riley & Co.; Tom O'Halloran, director of Small Cap Growth Investments at Lord Abbett; Brad Evans, portfolio manager of the Heartland Value Plus Fund and the Heartland Value Fund for Heartland Advisors; and Ian Wyatt, Chief Investing Strategist for SmallCapInvestor.com.

Many original thoughts were brought to the forefront. The good news is everyone's bullish and small caps are ripe for the picking if you're selective. Headwinds remain, but our experts appear optimistic, as they think small caps are properly positioned to buck adverse macro trends due to their swift ability to adapt. Some are more bullish on growth versus value. Speaking of value, valuations are cheap as stocks have been knocked down from their highs. Also, the idea pervades that as the global economy slows, global investors will look to deploy capital in U.S. small caps for superior returns. And a look back at history leads some to the possible path the future may bring. (This is part one of a five part series.)

Here's what our experts had to say:

What did you think of the first six months of this year?

Lisanti: "I was a little surprised at how hard the down-draft was — January through the middle of February where everything just went down. I was sort of surprised it happened then.

"First I thought the market had overreacted. But for a while I have felt that we were in this slo-mo environment of basically 0 to 2% GDP growth and that it was going to be 0 to 2% GDP growth for years — I'd say five years, it could be 10, depending on the policy. The reason is because if you go back and look at the '70s and the '90s, it takes years to clear up housing problems. The last housing crisis was in the early '90s.

"It's what happens every 15 years. I don't know why people don't remember this. The one before that was in

the mid-'70s. If you go back and look at '76 through '77, it took almost 10 years to get housing prices back to where they had been.



Mary Lisanti is president and chief investment officer of AH Lisanti Capital Growth. Lisanti has spent 12 years as a small-cap analyst and strategist on Wall Street, holding such positions as CIO of ING Investments, senior portfolio manager for the small-Cap Growth and mid-cap growth strategies at Strong Capital Management and managing director and head of the small/mid-cap team at Bankers Trust Company.

"In the '90s, it took at least four years to get housing back on track and until [that happened], GDP was depressed. It's just going to take a while.

"This is not a corporate profit recession. Those are easy to fix. You clear up your inventories and take it on the chin as a corporation. You can't do that with housing.

"Also the same thing with banks, but this cycle is more extreme. Normally, these downturns don't end until you have a couple banks going out of business, and normally you get consolidations. In 1990, we had the S&L crisis and American Savings and Loan went out of business. We had about 25% of the banks disappear. Even though, most of them were merged, the Federal Reserve acted pretty aggressively. That's normally what you get and we haven't started that process yet. It's going to take a while to work itself out.

"The other corollary to that is despite what the Federal Reserve says, we really do have a lot of flexibility on rates, and what will happen is that rates will stay low for a long time. This is why I'm saying [the current market] has some aspects of the '70s and some aspects of the '90s. However, when you go back and look at the two periods of time, the beautiful thing about them is that they work for small-cap growth no matter what. It worked in the late '70s and in the early '90s because in that environment, relative earnings growth becomes absolutely paramount.

"What is most significant to that argument right now is the dollar. As the dollar stabilizes, a lot of the large multinational earnings growth where half of it has come from the euro will disappear. In the second quarter, people will start to realize that we're just in a slower-growth environment.

"Since we're in this slower-growth environment, earnings growth is going to be 5% to 10%. That may raise fears for small companies, but small companies can avoid tapered earnings growth in the slower environment. Most of the

issues with small companies rely in the financial area, where things are tied to real estate and probably the consumer. Ails that have been troublesome to date are not going to get any better, but I don't think it's going to get any worse.

"If the companies' managements are good, they can probably manage right through this. If they are thinking in a unique and different way and they're small, they will manage."

Oberweis: "The first quarter at least was probably as about as challenging as I've ever seen it as a manager of a very high-growth small-cap company. During the first quarter of the year, we saw a strong contraction in investor appetite for risk. In theory, when investor appetite for risk contracts, valuations for high-growth companies, which tend to have a high percentage of their valuation derived from future earnings growth,

come down. We saw that in the first quarter. In the first quarter, valuations for many smaller high-growth companies were down as much as 30%, so it was a very significant contraction valuation. I think it's probably a reaction to market conditions that is unjustified by business fundamentals, but without a doubt we're seeing slowness within the market. We are not seeing slowness that would justify a 30% contraction in valuations, and it appears that the markets need to recognize that.



Jim Oberweis is president and lead portfolio manager of Oberweis Asset Management, a growth equity investment management firm that manages approximately \$1.5 billion in micro, small, and small/mid capitalization growth strategies globally, primarily for institutional investors and its own proprietary mutual fund family. Mr. Oberweis is also president of The Oberweis Funds.

"We saw a nice rebound in the second quarter. It's certainly a much better climate than we saw in the first quarter; but I still think we're at the low end of historical valuation ranges."

O'Halloran: "We are in a bear market in the U.S. equity market and this has been driven by a significant slowdown in the economy. It's unclear at this point whether we have entered a recession, but this economic slowdown has been driven by the downturn in home values compounded by excessive lending in housing."

Riley: "From an investment point of view in small caps, it's continued to be brutal since the back half of last year, and it's been very industry specific. There's been some success in energy, but for small caps in all the other industries, it's been difficult."

Evans: "They've been remarkably challenging, no doubt about it. Looking at the various Russell Indices, Russell 2000 value and growth are down about 8% and 3% respectively. The small caps have outperformed the larger caps. The S&P is down almost 13%. The Dow is down about 12. I think this environment has been the ultimate stock picker's market, and if you were inclined to focus more on managing a portfolio based on benchmarks (in terms of your sector weightings), it's been a very, very painful experience. Our benchmark is the Russell 2000 value, which is 32% financials.

"If you've got 32% financials, you're not doing very well right now. Let's be very clear: the sentiment is terrible. The outlook is murky and opaque, and I think there's a lot of fear. You look at the headlines and you've got the sluggish economy, the collapsing housing market, and exploding energy and food prices. The consumer's tapped out. The banking crisis continues to go from bad to worse and seems to be unending. But we're naturally contrarian, from a contrarian perspective, we actually view this environment as one where there's opportunity."

Wyatt: "The first six months of the year continued the overall bearish slide that started in October of 2007 as we ended the first half of 2008 within striking distance of an official bear market, defined as a 20% drop in the S&P 500. At a level of 1,249.6 hit earlier this month, we're there, and with the S&P currently at 1,260 and trending down, we've gotten confirmation of the bearish investing climate that many of us have known has been in place for some time. The story has been and will remain the economy. While many place the blame on oil, in reality nominal oil prices are affected by monetary policy, and as the Federal Reserve's primary

vehicle in buffering against the full blunt force of a sputtering economy, its has weakened the dollar and created an inflationary environment, leading to the pinch we're all feeling — oil included."

What about the next six months we're entering? Are you bullish or bearish?



Tom O'Halloran is director of Small Cap Growth Investments at Lord Abbett. He is responsible for managing the firm's small cap and micro cap growth products, overseeing the investment teams, and directing the investment strategies. O'Halloran has been in the investment business for 20 years.

Lisanti: "I'm really bullish on small-cap growth. There are two parts to secular bear markets—which is what we're in. The first part is the stocks do nothing but go down. The second part is they stay in a trading range. So, what we're going into now is the trading range environment. Trading range environments can take two to three years to go up and down. While the indices were both down, I don't know if they're going to go back and touch their lows, but basically, we hit a high at 1,600 on the S&P and our low was like 1,200. That's it. We're going to do this for the next five years. It's lousy. It's consolidation. We're going to do this for a long time.

"What I'm using as an example is what happened in the '70s. In 1977, we'd entered that trading range. We had a bear market in the '70 through '74 period, then a recovery in '75 to '76 and then '77 was the year we separated out small caps from large caps and that's what I think we're doing now. It's also where relative earnings growth starts to happen.

"That's what's going on this year. That's what we're separating out. So, I'm not positive on the overall market, but I'm very positive on small caps because I think it is increasingly, as everybody's talked about for a while, a stock picker's market. I think what you're going to see going from here is all those things that were thrown out are going to matter, which basically is the quality of management, when you buy it, when you sell it, the timing of stocks—are things improving or are things getting worse before it's evident—and the ability to sort of really do analysis and make judgments. All of those things are going to become very important."

Oberweis: "I'm probably more excited about the prospects of small-growth companies now than I've been in a long time. There are two components that drive stock valuations. The first is the overall economic environment and the second is the price one has to pay for that claim to future earnings. Barring the overall economic environment, we're also seeing extraordinarily low valuations for the types of companies in which we specialize, which is very high-growth small caps.

"Trying to balance those factors out, I would suspect that over the next couple years the economic conditions may improve somewhat and even those that look as though they are dying today are going to look very smart [later] because of the low valuations. Right now small-cap growth stocks are very much out of favor, and historically it's been a very good time to be buying them. They're almost always out of favor during periods of uncertain economic times and yet somehow over a period of two or three years, the market begins to see the light at the end of the tunnel and when it does, we've historically seen some very powerful upward rises.

"I don't know if it'll be in the next six months, but I suspect sometime in the next couple years you're going to see one of those very strong upward movements for small-cap growth stocks."

O'Halloran: "I'm bullish for the next six months. I believe that the condition of the U.S. economy is not as bad as many fear. The labor market is healthy. Unemployment of 5.5% is actually better than what was thought to be for employment in the mid-90's. It used to be that 6% was thought to be full employment. We went to 4% in the latter part of the decade and early part of this decade. So 5.5% is still a healthy job market. Although Europe is slowing, Asia and the emerging nations of the world are not slowing that much. The rest of the world economy is healthier than the United States.

"The U.S. corporate sector is profitable and flush with cash. That should enable the maintenance of a decent job market. The correction in housing I believe is in a bottoming process, and the Fed has been very aggressive in cutting rates. During the next year, this aggressive monetary policy should have a positive impact on the economy. All of these factors should enable the U.S. economy to just transition to a slower rate of growth. Maybe there will be a recession, but I don't think it's going to be that deep or that long.

"The equity markets are attempting to put in a bottom. Stock prices have reached very attractive valuation levels. I believe the market in the second half of 2008 is going to anticipate a better economic picture in 2009, and move up ahead of that. So I'm bullish."



Bryant Riley is founder and managing member of Riley Investment Management, an investment advisor which provides investment management services. He also is founder and chairman of brokerage firm B. Riley & Co.

Riley: "I am bullish on the areas that we follow for a variety of reasons—and when I'm talking I'm referring to companies with a lot of cash, and strong balance sheets mostly in the technology space. I have a view that you're going to see consolidation that will come from foreign buyers, industry and larger capitalized companies."

Evans: "For the next six to 12 months I'm relatively optimistic, but I have to say that I'm not necessarily optimistic on the benchmarks. I'm optimistic in the respect that this will be an environment where stock pickers should be able, if properly allocated, to do fairly well. I think the leadership groups of energy and materials and industrials are likely to continue to do much better than the areas of financials and consumer discretionary.

"So, I kind of buy into, right now, that the oil prices are an imponderable and at \$140 a barrel that is going to create a significant headwind on the economy. From what we can tell, the economy will probably remain very sluggish; whether we're actually in a recession, I don't know, but it's going to feel like we are: very slow, sluggish, stagflationary type of environment. To invest in an inflationary environment, I think you're going to want to be in groups that have pricing power—those are materials, energy and industrials."

Wyatt: "Ultimately, the economy will recover, as will the dollar. The next six months, however, will likely be much of the same environment for investors — the S&P dropping 20% doesn't mean things will magically turn around and move up; fundamental factors cause the market to do that. Unfortunately, the fundamentals don't look appealing on the equities side. I would be a cautious investor over the next six months, with the fourth quarter as a possible point to keep an eye on — not for a full-blown turnaround, but at least some signs of life."



Brad Evans is a portfolio manager of the Heartland Value Plus Fund and the Heartland Value Fund for Heartland Advisors. Evans is a Chartered Financial Analyst and has more than 11 years of investment industry experience.

Some would say we're in a stock picker's market. Do you think that that is still the sort of market that we're in now or would you define the market differently?

Oberweis: "It's a stock picker's market. I think that the types of companies in which we specialize, smaller high-growth companies, have a greater propensity to be able to do that than larger companies when you think about it. It's very hard for General Electric or Microsoft to overcome broader economic trends because they are, frankly, just so large.

"The companies in our portfolio are smaller companies with one or two products. The aim again isn't macro economic growth, but it's to gather market share and create a pie or get a larger slice of an existing pie. Smaller high-growth companies tend to be much more tied to the success or failure of their underlying products than they are to a couple-hundred-point shift in GDP."

Riley: "I think we're in a market where you'd better be conservative as it relates to balance sheets. When some say conservative, they think of Disney. When I say conservative, you need to assume that the spigot for capital is turned off. So we need to focus on companies relative to their size that are well capitalized.

Trying to raise money right now would be brutal. You could have a small-cap company that's gone from four to two in this environment just because of supply and demand and other issues. But if they don't have to recapitalize themselves like all of these banks, you're different in valuations, but you're no different in the amount of shares outstanding. So if ultimately you were right on your valuation, it'll come back. It's the way you have to go and recap your company that comes into play. It makes it very problematic to come back."

Wyatt: "It's almost always a stock picker's market in the short run and an indexer's in the long run. Most of our selections this year centered on oil and agriculture related picks allowing us to stay ahead of the overall market. This current market remains a stock picker's market, particularly in light of the fact that certain sectors show prolonged strength against the broad market. One thing that stock pickers should be aware of though is that indexers tend to outperform as a market recovers. The returns of a confirmed broad based rally may be best captured with a change in strategy that is inclusive of all sectors – so exposure to a market cap weighted index ETF should definitely be considered by prudent investors when a rally can be validated."



About the Author

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