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SMALL CAP ROUNDTABLE

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July 2008 Roundtable Part 2

Jennifer Schonberger | Jul 24, 2008 09:02am EDT | Comment

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There are many macroeconomic headwinds to contend with in the current environment; however, our panel insists that it's an opportune time to deploy capital — specifically in small-cap growth stocks. Conducting stringent due diligence to take advantage of low valuations on fundamentally sound small caps will warrant considerable upside when the sun finally outshines this financial tempest. And our experts take the temperature of the institutional flow of money as well as risk aversion. (This is part two of a five part Roundtable series.)

How should investors handle their portfolios in this environment? Is it a good time to initiate new positions?



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.

Lisanti: "As this year goes forward people will probably get nervous. I think what we'll see is what we saw in the first quarter, which is the earnings guidance for small caps – not a lot, but many—will be lowered modestly.

"I think you're going to see much bigger drops in large cap earnings as we go forward. So, stocks may pull back, but realistically, we're at the 1,200 range for the S&P. So, we're probably closer to being done. You have to do something you haven't done in a long time: you have to do a lot of work on the companies. Really get to know them. You have to buy them when they don't look pretty on those little charts. It's the opposite of how people have invested for the past 10 years, 15 years, but that's how you have to do it."

Oberweis: "I wouldn't leave cash on the sidelines. I think the predominant sentiment right now continues to be very negative. Most people have very modest expectations for the economy and for the stock market for the coming six months. I found that one of the best times to be buying smaller higher-growth companies is when nobody else wants to, and I think we're still in that environment. Valuations are still substantially below what we typically see for high-growth equities."

Riley: "I think this is a great time. There are the macro dynamics to contend with, but I think a lot of that is reflected in the valuations of small-cap companies, and, again, you have to be in the right ones. I wouldn't be indiscriminate, but there is wonderful opportunity out there."

O'Halloran: "I'm more bullish on growth versus value. The U.S. consumer is leveraged, with a low savings rate, and has just experienced a decline in its biggest asset (the home). So a lengthy period of slower consumer spending than we've had in the last 20 years seems likely. I think that will cause economic growth in the United States to be slow over the next five to ten years. In a slower growth environment as long as we don't have a lengthy recession, growth companies, which are companies that have been developing new markets or have new products or new services, should really shine in an environment where the rest of the economy is growing at a below-trend rate. So I'm very optimistic about growth versus value stocks looking forward."

Evans: "The important statistic which comes from Russell Investments, the purveyors of the Russell indices, is that 12 months from the end of an economic slowdown, call it a recession, small caps are usually up about 24%. In contrast the large caps are up about 15%.



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.

"Small caps typically lead us out of an economic slowdown. Look, a year ago the yield curve was inverted. Today the yield curve is steep, there's definite spread between the Fed funds, the yield on the 2-year treasury and the yield on the 10-year treasury. A year ago, when the yield curve was inverted, most investors were concerned about the economy overheating, not the economy buckling. Today with the yield curve as steep, most investors are focused on the economy being weak and not the fact that the yield curve might be trying to anticipate that the fiscal stimuli, are perhaps going to work with their traditional lag effect to get the economy moving.

"So, there is my basis for optimism. Sentiment is terrible, most people think the economy is awful and there's not really very much in the way of reasons for optimism, except for the yield curve. I think if oil prices stopped going up 40% a quarter and stabilized the economy would be able to do a little better.

"I think it's an opportune time for small cap and small-cap value, because let's be clear, small-cap stocks have been under redemption for the better part of three years. In contrast, international funds have taken in over \$100 billion a year for the last five years. If you look at the international markets in the last year and on a year-to-date basis, the numbers are not pretty. However, U.S. small caps are doing quite well. Canada and Brazil are doing a little better than we are, but China is down almost 50%, Vietnam down 60%, and the European markets are down in the high teen to 20% range.

"Most retail investors don't anticipate the future. They follow and they chase performance. Indeed the U.S. economy is trying to find a bottom and the yield curve is signaling that in 12 months time the economy might be a little better. Again, if the imponderable is that the oil prices just stabilize - you can paint a picture where the people will look at these international results and look at what's happening in the small caps and shift a large amount of assets back into an asset class that has been depressed. So when I'm looking' at valuations right now — price-to-book, price-to-sales — there's a lot of value."

Wyatt: “Investors should make calculated acquisitions. There are many amazing firms out there right now that are trading at ridiculously low pricing multiples. I would, however, wait for evidence of a clear follow through, four successive high volume up days on all major indexes, before even considering a sizeable position. Right now, I’m still looking to sector investing at this point – biotech and pharma seem to be getting quite a bit of money thrown its way. Investors could do quite well getting in front of this swell.”

Do small caps possess certain qualities that will hinder them or benefit them in comparison to their larger brethren in this environment?



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.

Lisanti: “The first is that they are small, which is the biggest difference. The fact that they’re small and focused means you can probably execute better. The ability to execute and have something different will be absolutely critical. Also, the ability to offer what is perceived as good value is critical — whether it’s a service or a product.

“Most small companies — small growth companies anyway — have cash. They don’t need money. If they did, they’d come to the market for a specific purpose, so people know what they’re going to do with the money.

“Everybody says that large companies have money, but I think with health care, pensions and the fact that half their money is eviscerated, I’m not so sure that their balance sheets are as strong as they say.

“The most interesting differential is that there’s a wide spread between large-cap profit margins and small-cap profit margins. It rose almost 700 basis points, but what’ll happen as we go forward is that’ll close. It’s normally 300. Large companies have about a 300 basis point operating margin advantage. Large-cap companies probably will see their profit margins decline, and small caps will see their profit margins rise.

“The reason that will happen is because of what’s happened for the past two years. They’ve had Sarbanes Oxley, they have the expense of continuing to do the employee stock ownership program, which many large companies adopt. This enables them, basically, to attract talent without increasing pay. They won’t have to increase out-of-pocket pay because they’re still giving people stock options, so, a lot of the things that kept margins depressed in the past two years have disappeared, or at least stabilized.

“The real small-cap cycle in the late ’70s was about eight years for small-cap growth. I don’t think the current small-cap cycle is done yet. We just moved from value to growth. ...We’ve been doing this for six years. We probably have another four or five years to go on it. We’re still in the middle of all of this.

Oberweis: “Probably the biggest historical difference between small- and large-cap stocks is the international exposure associated with the mega caps. In the area that we focus on, which is primarily in technology and health care, we see particularly within technology, that a lot of small caps have much stronger growth rates than we’ve seen in previous cycles. I don’t know if there’s as much of a difference in the international exposure than I’ve historically seen. That leads us to the second major difference: adaptability.

"When you look back in the second half of the 1970s, we saw an environment that has similarities with the present. These similarities would include an environment that consisted of uncertain economic times with strong inflation, and, quite frankly, a period of difficult market returns that proceeded in the 1974 bear market.



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.

"In the subsequent five-year period, we saw the strongest returns for small-cap stocks that have ever been recorded in history. Then there was a period of lackluster returns for the broader large-cap market, and some of that stems from the ability of smaller-cap stocks to re-engineer the business and adapt to changing market conditions quickly. I don't think we'll likely see that in this environment. Small-cap companies can change, adapt and create products and services where they can innovate their way through difficult overall market or economic conditions. I suspect we'll see that same thing here.

"We talk to CEOs and management teams day in and day out and what we're seeing is that despite overall macro economic slowness, some of the companies in that portfolio have underlying businesses that are continuing to grow at a very favorable rate. In order to do that though, their products are so unique from those of their competitors and they're gathering market share or creating markets where there haven't been any in the past.

"If you can identify companies that are going through that type of growth characteristics where they're bucking macro economic trends and you're able to buy stock in them at prices much lower than what you ordinarily see (in part because people aren't recognizing their ability to continue to grow against some headwinds), then I think there's the opportunity for very strong returns."

O'Halloran: "Small caps had a lengthy period of out-performance between 2000 and 2007. At the beginning of that period, small caps were trading at a significant valuation discount to large caps. That differential has been largely eliminated, so I am neutral between the two size categories today. As long as

the equity market remains hostile, there will likely be a preference for larger companies. If we begin a new cyclical bull market, small caps would likely at least keep pace with large caps. Although I expect the market to be higher at the end of the year, it's not clear to me that it will be the beginning of a new cyclical bull market."

Riley: "They're not diversified, so when your corporate portfolio or your product lines aren't diversified, that's good and bad. When everything's getting worse, it's typically bad.

"Also, the costs to go public are meaningful. When you've got a company that's \$150 million or \$100 million in market cap and they're spending two million minimum to go public, that makes it even more challenging. They're not spreading those costs along, and again I think that's another reason why you're going to see pressure from investors to respond to strategic inquiries."

Evans: "As the world's largest economy, the United States has clearly weakened before everybody else. Our economy has been weak now for some time and that has precipitated the knockdown in interest rates to 2%.

"Across the globe, it's pretty clear that other developed economies, such as Europe and Japan, are slowing and the same can be said for emerging economies. China and others are grappling with massive levels of inflation — far worse than we have here—and a lot of the emerging market economies as well as the developed nations are actually raising interest rates.

"If you look forward six months and the global slowdown continues, I do think that you're going to see the possibility of many emerging economies' central banks reversing course and cutting rates. And it's widely understood that global short rates are more important to driving the U.S. economy than Fed funds.

"In six to 12 months, we could have a synchronized, global, easing cycle and that would be very, very good for small companies because the U.S. economy could receive a massive dose of stimulus from central bankers around the world cutting their overnight rates. You're going to find investors will want to have as much exposure as possible; that's where you come back to small caps."



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.

Wyatt: "In this particular environment it's more a hindrance than a benefit. As conditions improve, that will change. Small caps are inherently more risky, and this is a risk-averse environment if there ever was one. Yet, as the economy and market start to show signs of recovery, investors will again chase risk in search of returns."

How does the institutional flow of money into small caps now compare with that of the beginning of the year?

Lisanti: "I would say, in general, that there is still some resistance to small caps, but more people are thinking that they need to move from value to growth. I'm going to do it in large caps first, and then I know I need to do it in small caps."

"Usually you need a year — money tends to follow performance a little bit. I would say that flows are better than they were in the year before. As we go forward this should pick up."

Oberweis: "I think virtually every risky asset class, be it emerging markets or small caps (essentially any area with high volatility), is seen as having a strong tapering off of inflows. That's normal during this type of environment and it can come right back in as soon as confidence returns to the marketplace."

O'Halloran: "It's gotten worse, but there weren't very significant flows into small caps at the beginning of the year anyway, so it hasn't been good all year. But if the market does better in the second half of the year, as I think it will, then the money should be coming back into small caps and other likely sectors."

Riley: "Terrible. There are institutions out there which are flowing down to the small caps. If you were to ask me from a trading perspective where we are, that's typically not the worst thing in the world. It can last a while, perhaps a year and a half, but at some point value will win — and there's a lot of value out there. When you have people selling for reasons that have nothing to do with the fundamentals or the valuation of a company that usually provides opportunity, there are a lot of inefficiencies down the lower you go."

Evans: "We've been under redemption through the end of May. Investing in small companies today is a contrarian investment and that's why it's so intriguing to me. Nobody wants to own them. I wouldn't say it's a hated asset class but it's a neglected asset class. As the U.S. economy pulls out of this slow down, investors around the world will be looking for U.S. investment exposure. The S&P 500 has been a safe haven because it's perceived to have greater international exposure. You could see a flood of money coming into small caps in the United States to try to gain exposure to a rising tide of economic activity here."

Wyatt: "Right now big money looks to be focused on the oil spike and the agricultural boom, regardless of capitalization. There was a point in April when money was flowing into tech across all capitalizations. That fizzled fairly quickly, though, and there doesn't seem to be anything to that effect in place now."

Risk aversion seemed to deflate somewhat after the Bear Stearns collapse, but has since then notched higher. How risk averse are investors right now?



Ian Wyatt is Chief Investment Strategist for SmallCapInvestor.com. As a well regarded small cap stock expert, Ian also serves as the Editor-in-Chief of two independent investment newsletters, Growth Report and Rising Star Stocks.

Lisanti: "That depends on how you define it. I think what's going on with people is this huge war between fear and greed. The logical mind will tell you that if you're going to try and get a better percent return from a bonded portfolio, you're going to be taking enormous risk."

"I think what people are going to come back to is that it's not so much about the risk that we take, but what kind of risk are we taking for what kind of potential return. I think people will see that small-cap growth is probably less risky an asset class. It is certainly less risky than it was 10 years ago; with regulation of Sarbanes Oxley, it's much less risky. Earnings growth also plays a role."

"Usually in the year you get these kinds of shocks, people don't come to that conclusion because they're still shocked. After overcoming shock, they ask, 'Where can I get a return on equity in the double digits, in the 15%, 16%, or 20% range?' If you want to stay domestic, you're going to have to go to small caps."

"As we go forward, the dollar will stabilize, the price of oil will come down, and the rest of the world will slow. As the rest of the world slows, money will come back to the United States, and as foreign money flows back to the U.S., I think people will say, 'Okay, well, I don't want a 5% return, I want a 10%, 12%, or 15% return' and that's going to push them into small-cap growth."

O'Halloran: "The volatility index (the VIX) is trading in the mid-20s; it spiked to the mid-30s earlier in the year. Investors are not as risk adverse as they were when Bear Stearns was collapsing earlier this year. However, the VIX is certainly up from the low of 15. Cash levels seem to be quite high. The put-call ratio is very high right now. Media headlines are extremely bearish, flush with doomsday forecasts. Generally speaking, people are more risk adverse and more bearish than is normal, and that is one of the reasons to be bullish about the second half of the year."

Riley: "I think they're risk averse. Risk is an interesting thing. I think there is a view that the smaller you are, the riskier you are, but if you're in companies that generate a decent amount of cash relative to size, that's not very risky. It's very conservative, but it's small. There are a lot of those situations out there where sometimes risk and small don't go hand-in-hand. There are smaller companies that have really good balance sheets and have some decent customers that have recurring revenue that aren't risky, but people will move away from them in this kind of environment."

Evans: "Absolutely, there's blood running in the streets. There is so much negativity. It hasn't reached the extreme levels that we saw in March, but it's getting close."

Wyatt: "I'd say they're about as risk averse as could be expected. What brought about this whole situation was the misallocation of risk by those viewed as the best at understanding, partitioning and profiting from risk, the major IBs of the world. If they were unable to properly assess risk, it's understandable that the lay investor is a little tepid when it comes to assuming risk."



About the Author

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