The Small Idea: Fear of the Unknown

First Eagle's Small Cap team believes small and microcap stocks represent a particularly volatile and inefficiently priced segment of the US equity market—and that these dynamics can create opportunities for disciplined active investment managers. In *The Small Idea* series, the team offers its perspective on some of the themes and trends impacting this large, diverse pool of domestic companies.

Our many years spent managing small cap portfolios for clients around the world have taught us that experience is a good friend to have, particularly during difficult markets.

We've seen three bear markets in the US during the twenty-first century (the bursting of the dot-com bubble in 2000–02, the global financial crisis in 2007–09 and the Covid-19 outbreak in 2020) as well as countless mini-crises in between. The current stock pullback—"pullback" may turn out to be an understatement, but at this stage we'll withhold judgment on the most appropriate descriptor—is marked by characteristics both similar and unique relative to previous incidents. This time around, the usual suspects of richly priced markets, highly leveraged companies and complacent investors have been joined by multi-decade-high levels of inflation spawned by a global pandemic that snarled supply chains and prompted extreme measures of fiscal and monetary accommodation. As an old colleague of ours would quip, "Same church, different pew."

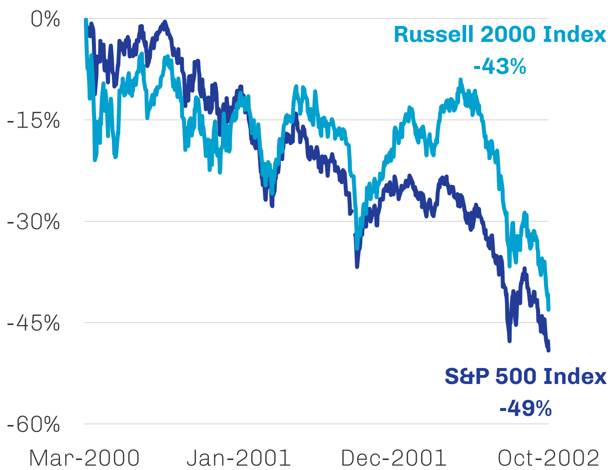
Small and microcap stocks, many of which are undergoing turnarounds or in the process of fixing issues idiosyncratic to their business, often suffer more than their larger counterparts during challenging market environments, and the current episode has been true to form (see charts below). We think this tendency results from the idea that smaller companies are inherently of inferior quality, a common misconception fueled by the limited coverage of these companies by Wall Street analysts. We reject this notion, believing instead that illiquidity and fear are the true drivers of what we view as the chronic overreaction of small cap markets to periods of general distress.

Small Cap Markets Historically Have Tended to Overreact in Challenging Investment Environments

Percent Change in Price Level

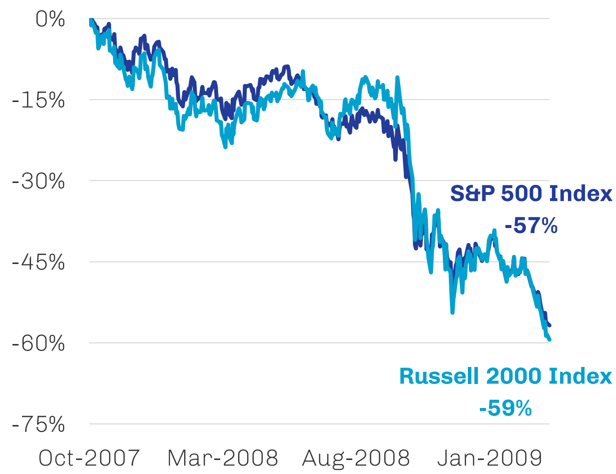
Dot-Com Bubble

March 24, 2000, through October 9, 2002



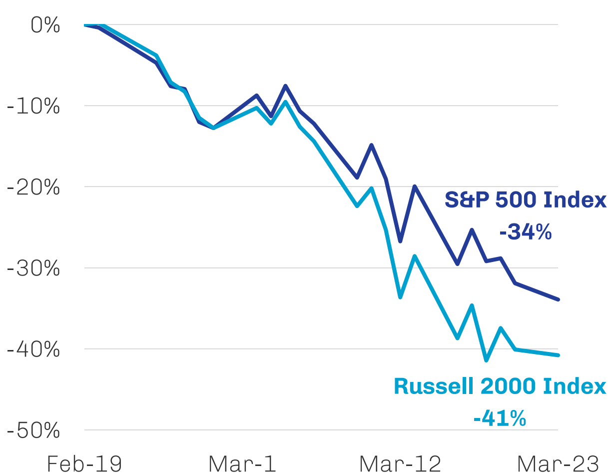
Global Financial Crisis

October 9, 2007, through March 9, 2009



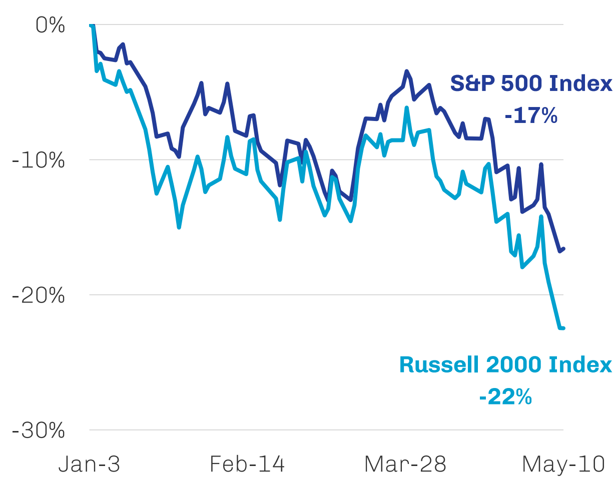
Covid-19

February 19, 2020, through March 23, 2020



Current Market

January 3, 2022, to date



Source: Bloomberg; data as of May 10, 2022.

Past performance is no guarantee of future results.

A mentor of ours opined that the prices of smaller stocks in stressed environments do not appear to be rooted in traditional valuation metrics so much as they reflect arbitrary numbers at which investors have decided they are willing to buy or sell. He also warned that there is no price too low for small stocks in a rough market—there may not be a buyer on the other side of a trade regardless of the discount offered. While such inefficiencies can make for a bumpy ride, they also create opportunities for disciplined, research-driven investors.

> While the inefficiencies prevalent in smaller stocks can make for a bumpy ride, they also create opportunities for disciplined, research-driven investors.

Accepting that we cannot identify a particular stock's bottom or the turning point of the market as a whole, what can we do to leverage turbulence for the benefit of our clients? We maintain the same investment discipline we apply in more placid periods, relying on our fundamental research, frame of reference and familiarity with the companies in our universe to help us maximize upside potential in our portfolio.

One key commonality between large and small cap companies is that businesses with competitive advantages, regardless of size, tend to trade at a premium to their lower-quality competitors. Understanding this, we look for companies priced at a discount to either their history or to their industry and then seek to understand why this discount exists and, importantly, if it is fixable. If we believe the current discount is due to some transitory issue, we look for a specific catalyst on the horizon that may serve to normalize the stock's market valuation. When we identify a stock that meets our criteria, we establish a position at a level we find attractive and slowly add to it in order to get the best average price we can, and this patience historically has tended to pay off when markets turn and prices normalize. Diversification, meanwhile, is an important element of our risk-management process, and we hold a broad array of relatively small positions in an effort to mitigate the impact of idiosyncratic outcomes.

Lemons and Lemonade

We have no idea how current circumstances will play out: how low the market will go, when it will bottom or what issues may emerge to support or further damage the confidence of investors. However, our experience investing during similar periods in the past gives us confidence that maintaining a diversified portfolio of what we believe to be attractively priced stocks gives us the potential to take advantage of today's uncertain circumstances.

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Past performance is not indicative of future results.

Risk Disclosures

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and micro-size companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

All investments involve the risk of loss of principal.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities it is also considered a proxy for the total market.

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