The Small Idea: Deja Moo

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.

This edition was written by Bill Hench, head of the Small Cap team and portfolio manager.

On the right side of my desk is a copy of a proverb. It says, "Worry is like a rocking chair. It will give you something to do, but it won't get you anywhere." If I turn my head to the left, I see another: "Deja Moo—The feeling you've heard this bull before." Both of these pearls of wisdom have resonated with me of late.

Recently, the team was asked about our current worries in the small cap space. As fundamental, bottom-up investors, the Small Cap team focuses primarily on idiosyncratic risks that, while not unique to our investment universe, are more pronounced among smaller companies. Common business risks—revenue and earnings stability, management skill and balance sheet strength, to name just a few—tend to exist on a size-based continuum. A large cap company may have a broadly diversified product line, a deep bench of talent and easy access to the capital markets, factors that all help promote operational stability and a certain degree of resilience. In contrast, a smaller company may have a narrow line of products, limited organizational depth and a high cost of capital, giving it a narrower margin for error.

The path from big to small is accompanied by a corresponding scaling of market liquidity and volatility, which historically has left smaller markets prone to dramatic price swings during periods of heightened volatility, as has been evident thus far in 2022. It also has created opportunities for us to selectively invest in smaller companies that we believe have the potential to generate above-market returns over the longer term.

Though we are fundamental, bottom-up investors, we are not blind to the state of the world.

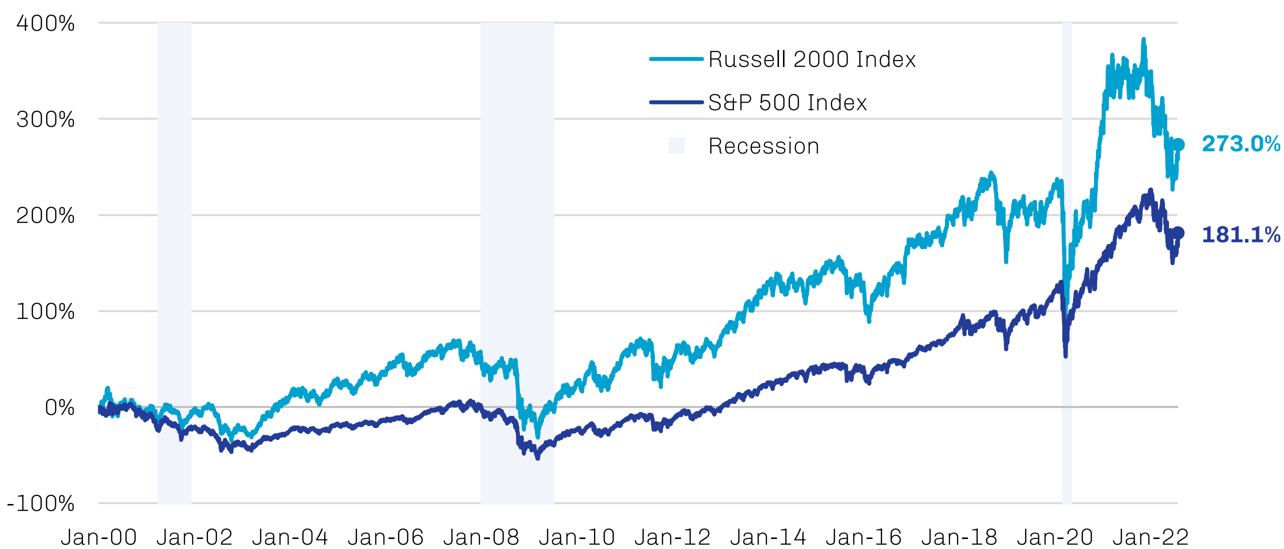
That said, we're not blind to the state of the world. We need to consider the potential impact of systemic risks on the companies in our investment set, and the aforementioned question about our greatest source of worry gave us a lot to consider. Multidecade-high inflation, receding fiscal and monetary support, a war in Europe, geopolitical unrest and a pandemic with an uncertain trajectory are all huge concerns that seem highly unlikely to be resolved in the very near future. However, we face another broad issue that I find just as worrying—the state of our union.

Survive and Advance

In the last two decades or so, the US has not only survived but thrived despite a number of highly disruptive events. The economic and market impacts of the dot-com bust, the global financial and eurozone debt crises, multiple armed conflicts and the Covid-19 pandemic were all ultimately overcome by a combination of hard work, cooperation and more than likely a little bit of luck. While markets' resilience in the face of the current tightening cycle remains to be seen, I believe history is on our side.

US Equity Markets Have Overcome Numerous Disruptions in the Twenty-First Century

Percent Change in Price Level, January 2000 through July 2022



Source: yCharts; data as of July 31, 2022.

Past performance is no guarantee of future returns.

Many small companies, both public and private, have helped fuel these rebounds. Perhaps this shouldn't come as a surprise; small businesses, as defined by the US Small Business Administration, comprise 99.9% of all firms in the United States, contribute 43.5% of our gross domestic product and have accounted for 62% of net new job creation since 1995.[1]

In our portfolios, meanwhile, we can provide examples of small cap businesses that helped grow the market for multifamily housing (commercial real estate lender Walker & Dunlop), lower the cost of medical care (medical facility operator Surgery Partners) and provide financial services to smaller companies that lack access to large banks (financial services company B. Riley Financial). In addition, a number of the companies we hold have helped improve our world with advances in environmental science, energy efficiency, food production and mental health services.

Back to the current state of our union. My primary worry involves the apparent polarization of the populace and leadership; not the specific politics of the left/right schism but rather its potential fallout. I believe a robust economy that offers opportunity to all who seek it is critical to our success as a country and, by extension, the success of the businesses that comprise it. In an era of widespread skepticism and mistrust, how do we preserve the foundational principles that have supported ambition, entrepreneurialism and ingenuity for generations in the US? How do we ensure people in the US—both those born here or otherwise—continue to have a fair shot at achievement? How do we make certain the global competition for resources, financing and customers remains an even playing field for US companies, big and small?

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The country has faced numerous—and sometimes similar—worries in the past and to this point has been able to conquer them. But if we do not constructively and collectively address current potential headwinds to economic vitality like tax policy, fiscal indebtedness, capital availability and wealth inequality, concerns about the ever-shifting investment implications of inflation, monetary policy, etc., in my view, may soon seem trivial.

1. Source: US Small Business Administration, Office of Advocacy; data as of December 2021.

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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.

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A bottom-up approach to investing primarily considers factors affecting individual companies and secondarily focuses on industries and economic trends.

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