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US Small Cap Equities: Finding Opportunity in Volatility

In April 2021, First Eagle Investment Management established a new Small Cap team consisting of Portfolio Manager **BILL HENCH**, Associate Portfolio Managers **SUZANNE FRANKS** and **ROB KOSOWSKY**, and Senior Research Analyst **ADAM MIELNIK**. Though new to First Eagle, the team is well established within the industry, having previously worked together on a small cap equity strategy at another firm. Below, our new Small Cap team discusses their time-tested approach to leveraging opportunities in the small cap market and how they are approaching today's uncertain environment.

Q: Why small cap stocks?

Bill: Small cap stocks represent a particularly volatile and inefficiently priced segment of the US equity market. It is our belief that these dynamics can create opportunities for disciplined active investment managers to identify undervalued small cap names in an effort to generate attractive returns for investors over the long term through diversified portfolios.

There are thousands of publicly traded small cap and microcap companies across the US participating in a wide range of industries, but they do have a number of common features that distinguish them from larger businesses and that promote greater price volatility. Smaller companies tend to offer a relatively narrow line of products or services, with most (but not all) focused on the US market, resulting in a concentrated source of revenue and earnings. While many small companies have high-quality management teams, organizational depth tends to be lacking, making key-person risk

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

a greater concern. They typically have more limited access to the capital markets than larger companies, which can result in vulnerable balance sheets. And their stocks often are thinly traded and have limited coverage by Wall Street analysts. These risks are even more pronounced further out on the small cap spectrum and into the microcap space—areas where we, as true small cap specialists, feel quite at home.

Our strategy seeks to build diversified portfolios of stocks that not only are trading at what we believe to be a discount to their normalized valuation but also have a visible and fundamentally sound catalyst for price improvement.

Small cap stocks, due to their higher risk, historically have outperformed large cap names. Our team's strategy is built on the premise that we can further widen this performance gap by building diversified portfolios of stocks that not only are trading at what we believe to be a discount to their normalized valuation but also have a visible and fundamentally sound catalyst for price improvement.

Q: How does finding opportunities in the small cap universe differ from the market for large cap stocks?

Suzanne: As Bill mentioned, small cap stocks tend to have limited coverage from Wall Street analysts, which we believe is a big reason why the market price of individual companies can at times become widely disconnected from their normalized values. We find there are a number of common reasons for this. The first is a company that is simply being inefficiently valued by the market, typically due to an underestimation of its sum-of-the-parts value. Other companies represent classic turnaround scenarios in which some adverse event like a demand disruption or management failure depresses a stock's price until a solution can be implemented and the improvements are recognized by the market. Finally, we have companies whose qualities—be it accelerating growth potential, the efficiency of their operations or an advantaged industry position—appear to be underappreciated by the market.

Despite their many differences, one 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. Catalysts can include new management, a more favorable business cycle, product innovation and margin improvement, and they are key to avoiding "value traps" in which low-priced stocks are cheap for a reason.

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Rob: We have a saying on the team that "no price is too low;" in the small cap market particularly, prices can plummet independent of fundamentals simply because there is no buyer on the other side of the trade. We have a very disciplined approach to taking advantage of these opportunities. Instead of trying to identify a stock's bottom, which tends to be a fool's errand, 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. This patience has tended to pay off when markets turn and prices normalize. Our sell discipline is the same, but in reverse. We'll slowly exit our positions at a price we find sufficiently rewarding and at a pace that can be absorbed by the market without unduly impacting the price.

Investing in the small cap space is a continual cycle of selling stocks and redeploying the proceeds into new positions. We don't want to hold a basket of value stocks indefinitely. We want the stocks we buy to overcome their issues and become attractive to small cap core or growth investors. Upon driving these better fundamentals, the valuation discount potentially narrows or even closes. Once our investment case on a stock is realized, we move onto the next opportunity.

Q: How does your team stay on top of all the companies in the vast and undercovered small cap universe?

Suzanne: Honestly, it's a lot of work. But the beauty of it is that with each stock we own we're focused on a defined problem and what the company is doing to solve it. We're listening to 1,000-plus earnings calls a year, but we don't need to process every single detail about a company's performance; we're interested primarily in the progress they are making toward overcoming the identified impediment to price appreciation.

Adam: All four members of the US Small Cap team are analysts, and we're all generalists. We all pitch potential investments from a range of sectors and industries, and when a company enters the portfolio we'll rotate primary coverage of that name over time. We meet every morning to go through the portfolio from top to bottom, from largest position to smallest, giving us a forum to discuss news on any of the names in the portfolio. The news could be an announcement about a stock offering, an acquisition, earnings, price volatility—anything really.

In our view, this approach enables each of us to stay current with all the names in the portfolio while creating a broader pool of opinions and less personal attachment to individual stocks.

> With each stock we own, we're focused on a defined problem and what the company is doing to solve it.

Suzanne: In terms of generating new investment ideas, we run very few screens, which comes as a surprise to some people. Instead, we're always reading—not just general market or macro content but also industry-specific publications like *Women's Wear Daily* or *Automotive News* or *Semiconductor Review*—in hopes of sourcing an idea for further research. We're also listening a lot; we probably have 1,400 engagements with company managements a year, through conferences, one-on-one meetings, earnings calls, etc.

Bill: Pre-Covid, we would regularly attend industry conferences where we'd see presentations from 10 or 12 small cap companies over the course of a day; most of these businesses were not necessarily in our wheelhouse from a pricing perspective, but we took note of them all the same. For years, I went to an annual consumer conference in Florida and would hear from all these great small cap restaurant companies that didn't meet our investment criteria. With the onset of Covid-19 and its disruptions to markets and the economy, particularly in the restaurant space, these names suddenly became viable options for our strategy.

Rob: We've all been working in the small cap space for a while in various capacities, and we all have a lot of history with these companies. A fair number of our investment ideas involve companies we had invested in or researched previously. Again, these are small companies with limited resources relative to larger cap names. Sometimes a problem gets fixed and then reemerges in the future or a different problem crops up to impair market valuation. Or it could be a cyclical business whose price ebbs and flows with conditions in their industry. We believe ourselves to be long-term shareholders, and in practice many of our portfolio companies past and present tend to stop by to see us once a year to bring us up to speed on their operations.

> While we've always felt that the consideration of ESG factors was in many ways implicit in our process, in 2020 we formalized how these concerns are integrated into our research.

Q: Do you incorporate environmental, social and governance (ESG) considerations into your analysis?

Rob: We've always felt that the consideration of ESG factors was in many ways implicit in our research and the types of investment opportunities we target. Business turnarounds, for example, often come about because of improvements in corporate governance. Companies with accelerating growth may be tapping into opportunities in renewable energy to drive that growth. The ability to manage social factors can have a significant impact on any company's operations.

In 2020, however, while working at another firm, we began to formalize how ESG considerations are integrated into our research, and ESG analysis now is an explicit part of our process. We investigate and document the relevant ESG factors for each new stock we consider—looking at their third-party ratings, going through company filings and sustainability reports—to determine the risks and opportunities these factors represent for the company. We're not exclusionary, but we feel like we go into each new investment with a good understanding of where a company sits from an ESG standpoint and how that may impact its ability to improve its market valuation.

Bill: It's worth noting that up until about six months ago it was very difficult to get explicit, detailed ESG disclosure from small cap companies; it just wasn't something they felt compelled to provide. The tide has turned quickly though, and ESG seems to come up on almost every earnings call we listen to. Even small companies are recognizing the impact these issues can have on performance and on investor sentiment.

Q: Your strategy typically holds 150 to 300 stocks. What are the advantages of such broad diversification?

Rob: Diversification, alongside valuation, is a key element of our portfolio risk management. Part of this is a function of the small cap market itself. Remember, these are small—in some cases very small—companies. A concentrated small cap portfolio may find itself owning more of an individual company than it wants to simply by putting its assets to work. Further, the daily liquidity of these names tends to be limited, so even as we are building our relatively small positions, we do so slowly so as not to unduly impact the stock price. As I mentioned earlier, this helps us get a better average price on the stocks we buy.

Our broad diversification also helps us manage client cash flows. If we have a large subscription or redemption, it's a lot more effective for us to buy or sell 5,000 shares of 200 different positions than it would be to buy or sell 500,000 shares of one name given the general illiquidity of the small cap market noted earlier. But it's also connected to the heightened risk factors that smaller companies face; a broad selloff may punish stocks independent of their fundamental value, and we'd be reluctant to meaningfully reduce a position we continued to believe in just to raise cash.

> Diversification is a key element of our portfolio risk management. Everything matters more for a small company, and even a somewhat minor adverse event could potentially be fatal.

Suzanne: Everything matters more for a small company. An adverse event that's an annoyance for an S&P 500 name could potentially be fatal for one of our companies given the small company characteristics we talked about earlier. While we expect every stock we buy to be a winner, we know that ultimately some of our investment theses will fail to play out. From a risk management perspective, we believe it makes sense not to have all our eggs in a limited number of baskets. A concentrated portfolio is feasible, but it comes with a much different risk-reward profile.

Q: Where are you seeing opportunity in today's small cap market?

Bill: We're bottom-up stock pickers, but there are occasions when we're able to identify several companies within the same industry that we believe are both underpriced and have the potential to benefit from the same catalysts. One current example of this is in semiconductor capital equipment. In our view, a buildout in semiconductor manufacturing capacity in Asia, North America and even Europe is likely to drive significant demand for the products manufactured by a small handful of companies with highly specialized technical expertise. There are a number of stocks we expect the benefit from this demand, including companies that design and build semiconductor manufacturing systems to those that provide the equipment and services to test and inspect chips.

> We're bottom-up stock pickers, but there are occasions when multiple companies in the same industry appear to have the potential to benefit from the same catalysts.

Adam: We've also added positions in companies along the aerospace supply chain, another segment of the economy served by small cap businesses in which expertise is paramount and barriers to entry are significant. As commercial aircraft activity rebounds from Covid-19, there are only a handful of companies we see as having the skillsets necessary to meet normalizing demand for the mission-critical materials, components and systems used in high-cost-of-failure aerospace applications.

Another area we like a lot is homebuilders. We understand that this statement may be a bit controversial, as the sharp rise in housing prices over the past year-plus could suggest that demand may have been pulled forward due to the implications of Covid. That said, we continue to see plenty of reasons to remain bullish on housing demand. When we look at normalized supply and demand data for housing in the US, the country is still undersupplied by hundreds of thousands of units. Meanwhile, interest rates remain low, employment is improving, and wages have increased. And despite higher home prices, the housing affordability index is well off year-ago levels.[1] In our view, all of this should add up to a longer-than-expected cycle.

Q: What do you expect in the small cap space moving forward?

Bill: There's always something going on in the small cap space, but these days it seems we have to get through an unprecedented amount of noise to find meaningful signals. A lot of this is related to the impact supply chain disruptions and Covid-driven demand have had on a variety of industries. Take bicycles, for example. Bikes have been difficult to come by for over a year now due to increased demand and a variety of supply-chain complications. But does the recent spike in bike sales represent a durable shift higher in demand that will buoy revenues and earnings across the industry for an extended period? While we tend to think not, that doesn't mean attractively priced investment opportunities cannot emerge in this space.

These days it seems we have to get through an unprecedented amount of noise in the markets to find meaningful signals. But our investment process is built for this kind of environment.

And while we're stock pickers at heart, we're not blind to the state of the world. Whether it's Delta variants, geopolitical issues, commodity prices or any number of other concerns, we need to consider the potential impact of systemic risks on companies in the small cap space. But our investment process is built for this kind of environment. These near-term risks, even if severe, may create opportunities for us to selectively invest in companies that we believe have the potential to generate above-market returns over the longer term, and we will aggressively pursue these opportunities as they emerge.

At the end of the day, it's a labor-intensive process. You really have to love putting in the work.

1. Source: National Association of Realtors; data as of August 12, 2021. The Housing Affordability Index measures whether or not a typical family earns enough income to qualify for a mortgage loan on a typical home at the national and regional levels based on the most recent price and income data.

Bill Hench

Bill Hench is head of the Small Cap team and portfolio manager of the Small Cap strategy. Prior to joining First Eagle in April 2021, Bill was portfolio manager of the Small Cap Opportunistic Value strategy at Royce Investment Partners, where he worked for 18 years. Before that, he spent 10 years in the institutional equity business in Boston and New York, most recently with JP Morgan. He began his professional career as a CPA with Coopers and Lybrand. Bill earned a bachelor's degree from Adelphi University.

Suzanne Franks

Suzanne Franks is associate portfolio manager of the Small Cap strategy. Prior to joining First Eagle in April 2021, Suzanne was assistant portfolio manager of the Small Cap Opportunistic Value strategy at Royce Investment Partners. Before that she founded Vivid Research Inc., an independent research boutique focused on companies facing opportunistic or event-driven catalysts. Previously, she was a principal and portfolio manager at Opportunity Research Group. Suzanne earned a BBA in finance, magna cum laude, from Texas A&M University and an MBA from The University of Chicago Booth School of Business.

Rob Kosowsky, CFA

Rob Kosowsky is associate portfolio manager of the Small Cap strategy. Prior to joining First Eagle in April 2021, Rob was assistant portfolio manager of the Small Cap Opportunistic Value strategy at Royce Investment Partners. Before that he held various analyst roles at Sidoti & Company, OFI Institutional Asset Management, Ballentine Partners and Thomson Financial. Rob earned a bachelor's degree in finance from Boston College and an MBA from Vanderbilt University, and he holds the Chartered Financial Analyst designation.

Adam Mielnik, CFA

Adam Mielnik is a senior research analyst on the Small Cap team. Prior to joining First Eagle in April 2021, Adam was a senior analyst for the Small Cap Opportunistic Value strategy at Royce Investment Partners, where he worked for seven years. Before that he was an intern at Global Arena Capital and HFP Capital Markets. Adam earned a bachelor's degree in economics from Fordham University, and he holds the Chartered Financial Analyst designation.

Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up.

Environmental, social and governance (ESG) issues may be factors, among many, that are considered as part of our fundamental research process. We do not seek to invest in companies based on ESG criteria.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Investment in gold and gold-related investments present certain risks, and returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets.

All investments involve the risk of the loss of principal. The principal risk of investing in value stocks is that the price of the security may not approach our estimate of its intrinsic value or may decline in value.

The risk management process includes an effort to monitor and manage risk, but does not imply low risk.

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. 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. One cannot invest directly in an index.

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