



The Small Idea: Stop Me If You Think You've Heard This One Before

Ah, the magic of streaming music.

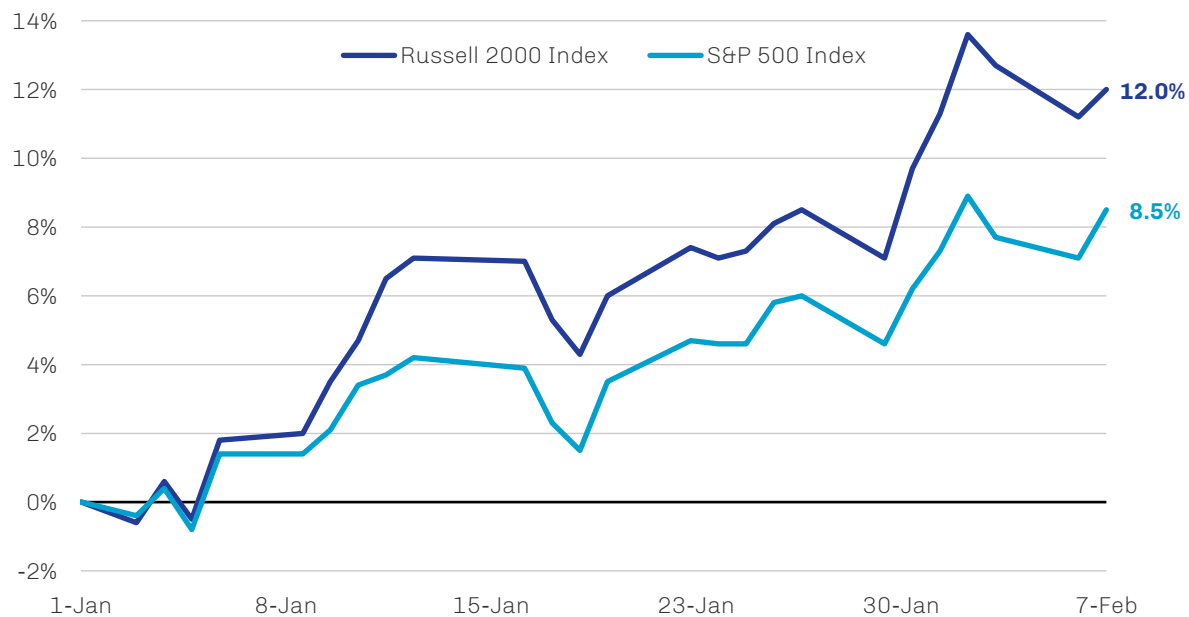
I spent the bulk of a recent drive back to New York City listening to business updates and other news until I had my fill and switched over to some tunes. Before long, the algorithm shuffled up a favorite of mine from the late 1980s: "Stop Me if You Think You've Heard This One Before" by the Smiths. Amid the jangly guitar that was the band's calling card, mononymous frontman Morrissey reminded me repeatedly that "nothing's changed."

I have to hand it to Morrissey: More than 35 years later, he is dead on (on this point at least). Despite the strong rally in risk assets this year, nothing really *has* changed from the perspective of this investor. The macro backdrop that caused so much strife in 2022 continues to be challenging, if slightly improved on the margins. Inflation has pulled back from recent peaks but remains very high, and the Federal Reserve continues to blend policy action with finely tuned rhetoric in an effort to tighten financial conditions without strangling the economy. The war in Ukraine drags on, and US/China tensions recently have been inflamed by a balloon of all things. Domestically, a highly polarized Congress is girding for a battle over the debt ceiling, a high-wire act that could bring about a default by the US government if unresolved by June or so.

While most investment professionals and their clients were happy to see 2022 end, I can't imagine many entered the new year brimming with confidence about the near-term prospects for equity markets given these circumstances. So, to what can the year-to-date rally in risk assets—and the outsized success of small cap stocks, in particular, as demonstrated by the Russell 2000 Index in the figure below—be attributed to? It's been our experience that reversals in small stocks often result from an abatement of selling, not from improved fundamentals, and that appears to be what has transpired year to date. Where we go from here, in our view, largely will be determined by the quarterly results and outlooks that are just now starting to hit the tape.

Good Times, for a Change

Year-to-Date Return through February 8, 2023



Source: FactSet; data as of February 8, 2023.

Of course, bad news isn't the only persistent factor, at least from the perspective of the Small Cap team. With 3,000 or so small stocks in our investment universe, we rarely have a problem finding companies that interest us from a valuation perspective regardless of the economic cycle. In our opinion, success in 2023 likely will not rest on identifying sectors of the economy poised to outperform as a whole, but rather picking the best names in those areas as well as in a host of other spaces that are less overtly attractive.

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Take the aerospace and defense industry, for example. Defense budgets have gotten a near-term tailwind from the war in Ukraine and long-view boost from rising security concerns in our increasingly multipolar world. Total global military spending is forecast to reach nearly \$2.2 trillion in 2023, an 8.6% jump over 2022 in nominal terms and the largest increase in 15 years.¹ In the civilian market, commercial aircraft activity has continued to rebound from the dislocations of Covid-19, and the strong recovery of air travel has prompted increased orders for aircraft.² This surfeit of spending may potentially benefit not only the major original equipment manufacturers but also the smaller suppliers to these companies, only a handful of which we view as having the skillsets necessary to meet normalizing demand for the mission-critical materials, components and systems used in high-cost-of-failure applications.

Similarly, we continue to see strong potential in the small group of highly specialized semiconductor capital equipment companies we believe are likely to benefit from the buildout in semiconductor manufacturing capacity worldwide. These range from designers and builders of manufacturing systems to providers of the equipment and services to test and inspect chips. While the notoriously cyclical semiconductor industry saw weakening demand beginning in mid-2022, its long-term growth trajectory appears intact, buoyed by a structural increase in the demand for the chips and integrated circuits that are omnipresent in our day-to-day lives.

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Oscillate Wildly

It's perhaps worth noting that for all Morrissey's protestations that "nothing's changed," the Smiths had broken up acrimoniously several months before "Stop Me if You Think You've Heard This One Before" was even released. Rather than see the lyric as disingenuous or ironic on Morrissey's part, however, I'll take it as a symbol of the uncertainty that is prevalent in life and the financial markets.

Accepting freeform uncertainty, we make no attempt to forecast the direction of interest rates, GDP growth, inflation or any other metric. We remain ever-optimistic, however, secure in the knowledge that periods of acute uncertainty historically have provided us with opportunities to selectively invest in companies that we believe have the potential to generate above-market returns over the longer term. The significant volatility that accompanied the 2022 downdraft in stocks, for example, allowed us to acquire a range of small and microcap stocks at prices we believed were unmoored from their fundamentals and to construct a portfolio we think is cheap and, more important, positioned well to potentially take advantage of positive currents in the economy.

1. Source: Investors' Chronicle, Janes; data as of February 1, 2023.

2. Source: Deloitte; as of December 2022.

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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.

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.

All investments involve the risk of loss of principal.

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.

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

Russell 2000 Index measures the performance of the small cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

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