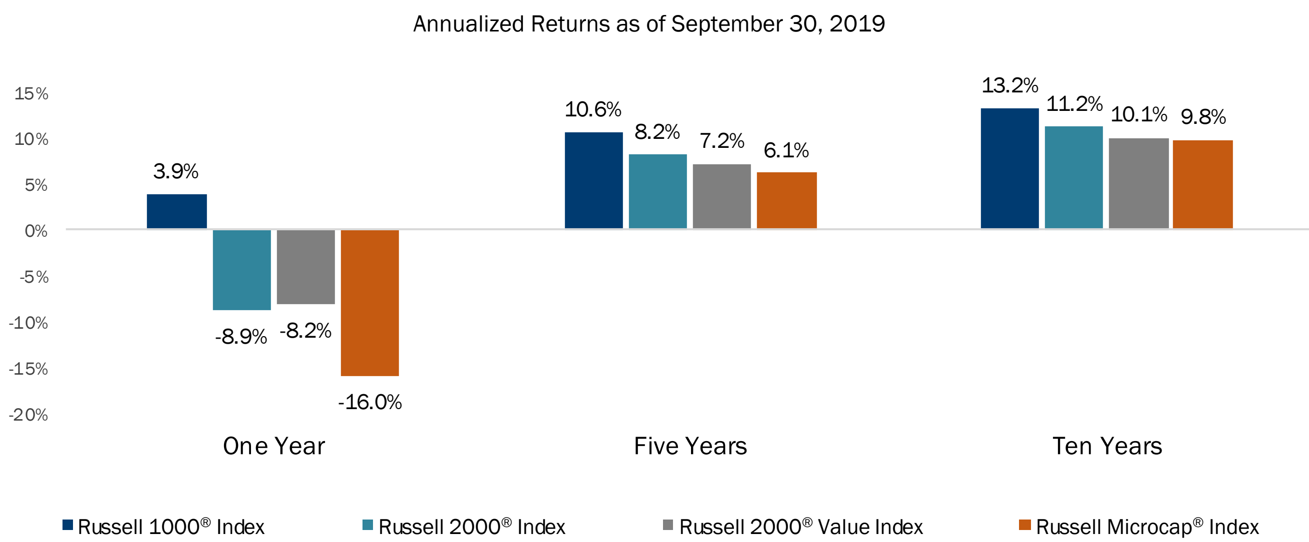
Commentary November, 2019

Are Small Company Value Stocks Dead?

At Pacific Ridge Capital Partners, our investment philosophy is premised on the idea that small company value stocks are the best place to invest in US public equities. This has been a lonely proposition recently.

During the last year, small company value stocks have been in the dumps. In fact, they have underperformed large company stocks over the last ten years annualized, as illustrated in the chart below. The only group of stocks to perform worse than small cap value stocks over these time periods are micro cap stocks.

Figure 1



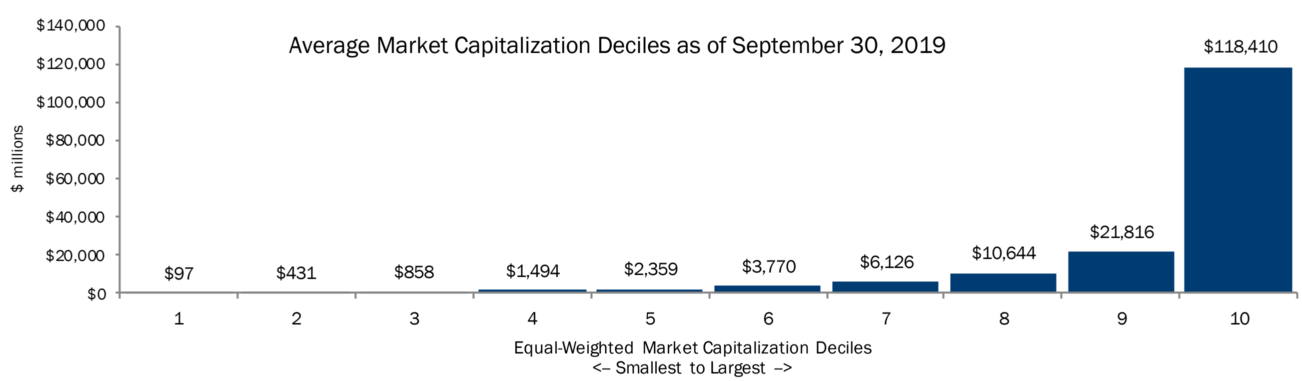
Is our premise faulty? We think not. Based on academic work and our own historical experience, we still believe that small company value stocks are the best place to invest in the US public equities market. Although they have underperformed recently, we believe the pendulum will swing back in our favor. Let's take a look at size and style biases that have been in play over the long term versus the most recent ten-year period, along with causes for these differences and why we believe small company value stocks will again be in favor.

Size Bias

The academic work is best summarized with decile returns of US publicly traded companies going back nearly 100 years. This data has been collected by the Center for Research in Security Prices, and compiled by Kenneth French[1]. It is particularly useful because it is equal-weighted and does not suffer from survivorship bias.

Figure 2 divides companies into equally-weighted deciles, ranking them from smallest to largest in size. The smallest ten percent of companies represents an average market capitalization of $97 million while the largest ten percent represents $118.4 billion.

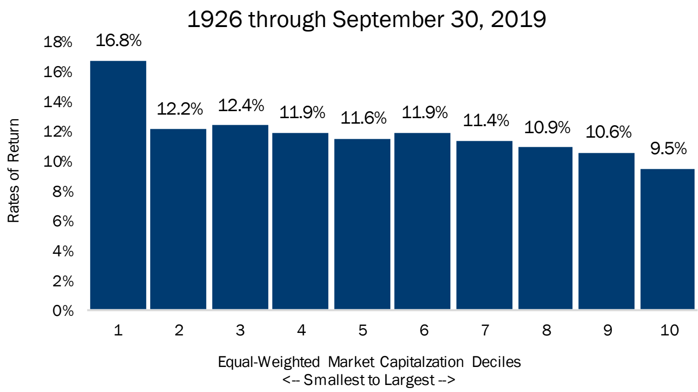
Figure 2



The next two charts compare returns of those deciles over the long term (from 1926 through 9/30/2019) and over the last ten years.

Figure 3 Figure 4

Annualized Returns by Market Capitalization Deciles



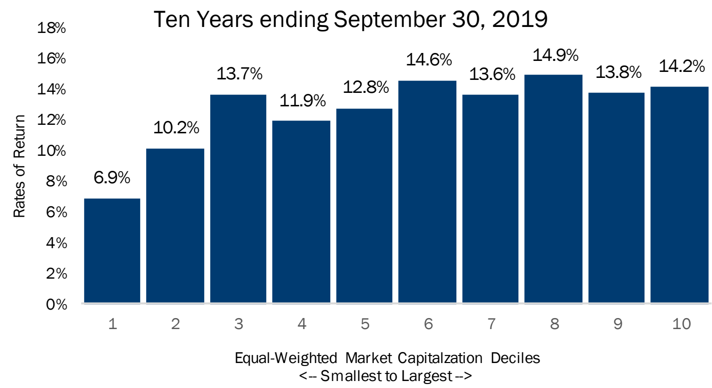


Figure 3 paints the simplest picture of where stock market returns have long been the most generous, within the bottom four size deciles. In today's value, the size of these companies tops out at about $1.5 billion in market capitalization, which has been the sweet spot of our investment strategy.

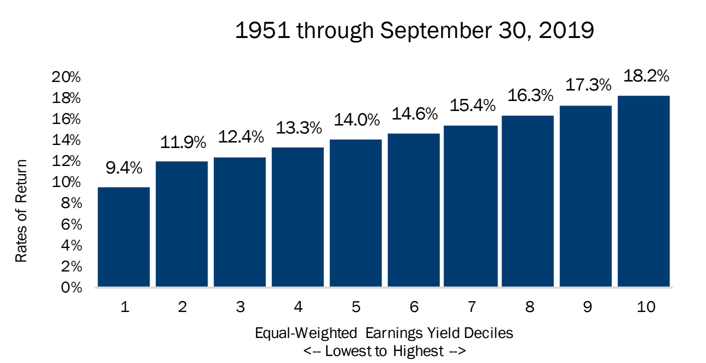
However, if we revisit decile returns for the past ten years as displayed in Figure 4, we notice something different. They are the reverse of the longer-term trend favoring small company stocks. The market has favored the top five decile groupings (mid- and large-company stocks) by a wide margin.

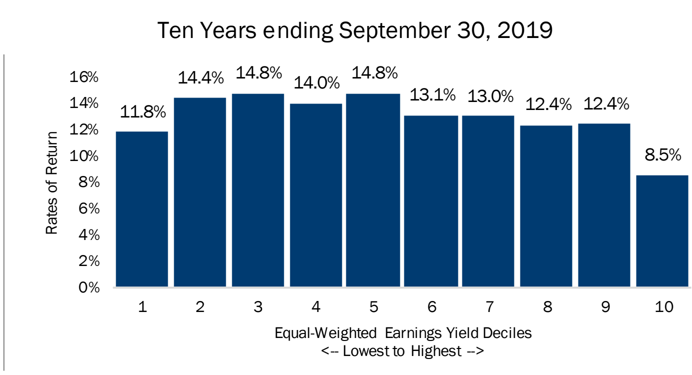
Style Bias

In addition to the pronounced size bias that hampered small company stocks in the last decade, there has also been a change in style bias in the market. Looking again at data generated by Kenneth French[1], value stocks, or those stocks with high earnings yield, have generated far better returns over the long term (Figure 5). However, during the last decade, the market's appetite for higher earnings yield (low multiples) seems to have disappeared. The data in Figure 6 suggests that investors have recently favored expensive stocks, not cheap stocks.

Figure 5 Figure 6

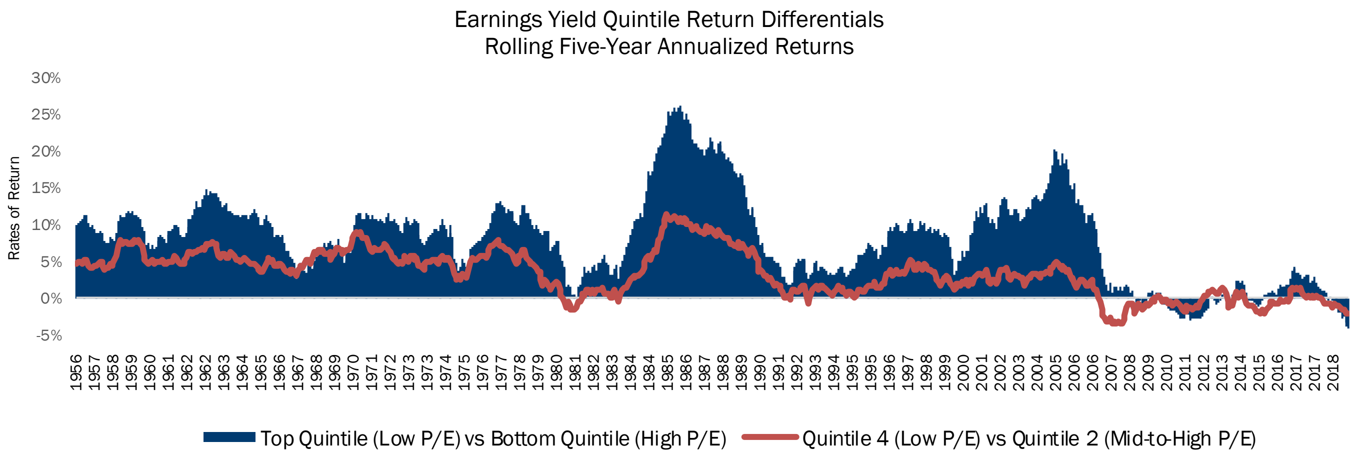
Annualized Returns by Earnings Yield Deciles





A further example of this recent investor preference for growth stocks is demonstrated in Figure 7.

Figure 7



As depicted in Figure 7, value stocks have not been afforded any return premium compared to growth stocks during the past decade. Not only are the recent results unusual, they are at historically low levels.

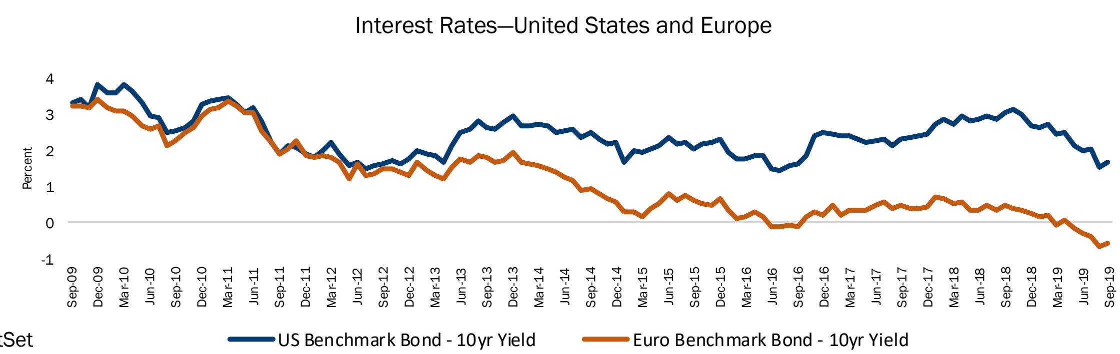
We appear to be either in the midst of a long-term structural change of where investment returns are derived, or in the midst of an anomaly. We believe it is the latter and is rooted in the sustainability of the longer-term trend. This leads us to be optimistic that at some time in the near future, market return distributions will return to the longer-term trend favoring both small size and value style.

Causes of Recent Size and Style Biases

What has driven the current focus away from small and value stocks? We believe there are five key reasons triggering this phenomenon: 1) interest rate structure, 2) technological changes to distribution, 3) index construction, 4) passive investing and 5) asset growth in investment management.

Interest Rate Structure – During the last decade, US and worldwide interest rate structures have collapsed.

Figure 8



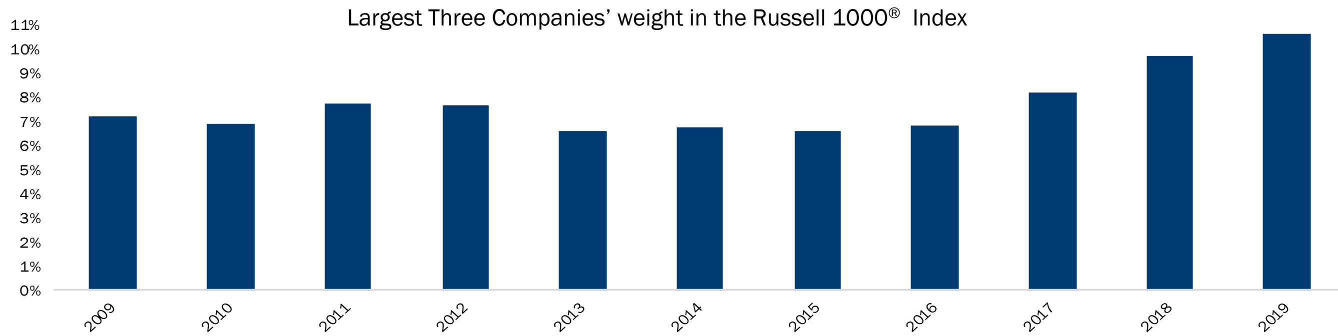
Source: FactSet

Lower yields on traditional “safe” assets have forced investors to hunt for returns in riskier assets – or growth assets. Growth company prospects are heavily influenced by this, as they typically need more outside capital to grow. Because there is a paucity of returns in the bond market, investors are more willing to shift their equity bias to growth stocks and more speculative investments. This helps explain why the number of unprofitable companies completing IPO’s is hitting historic levels not seen since the tech bubble of the 1990’s. It also explains the clamor for private equity and alternative investments during the last decade.

Technological Changes to Distribution – Advancements in marketing and distribution have compressed margins in numerous industries and business models over the past decade, most notably driven by the growth of Amazon. This compression has been strong in industries that have historically been populated with value stocks. In particular, Consumer Discretionary, Consumer Durables, Health Care distribution, and Business Services, have gone through tremendous transformation and culling, in what would otherwise have been periods of cyclical recovery. This lack of cyclical rotation during the last ten years has been a noticeable headwind for small company value stocks.

Index Construction – The Russell and S&P indexes (the dominant source of benchmark data) are capitalization-weighted indexes. This results in a smaller proportion of large companies representing a larger portion of the returns. For instance, the three largest companies in the Russell 1000® Index have grown over the past few years to represent over 10% of the weight of the entire Index.

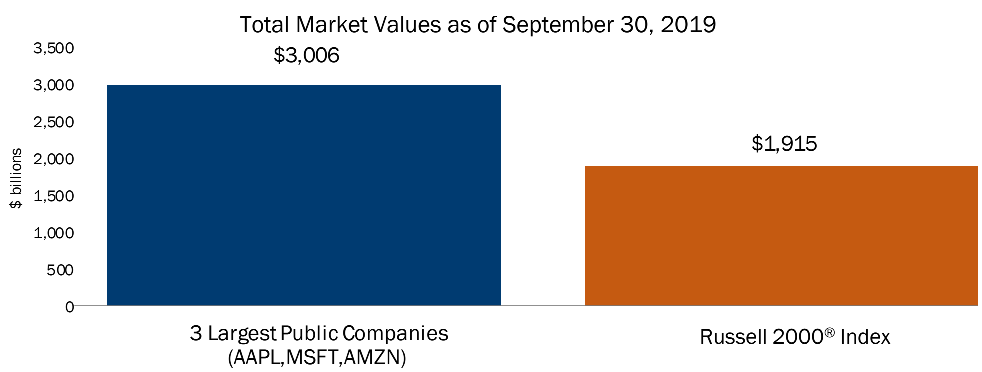
Figure 9



Source: FactSet

Not only do these three companies make up more than 10% of the total value of the largest 1,000 companies, but they also eclipse the value of the entire Russell 2000® Index, as shown below.

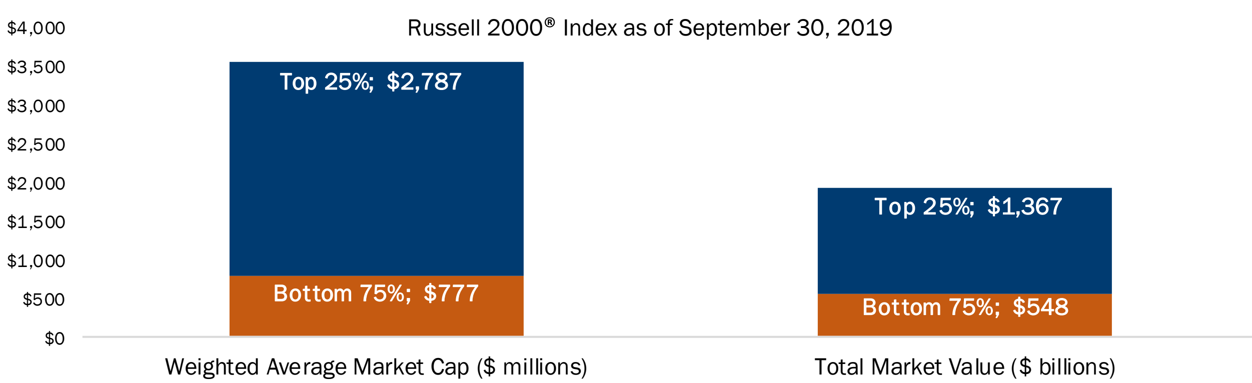
Figure 10



Source: FactSet

This constituent concentration is not limited to the Russell 1000® Index. Figure 11 demonstrates that the 1,500 smallest companies in the Russell 2000® Index make up only 29% of the total valuation of the index total, and have a weighted average market capitalization that is only one-third as much as the 500 largest companies in that same index. This concentration has been growing over the last decade.

Figure 11

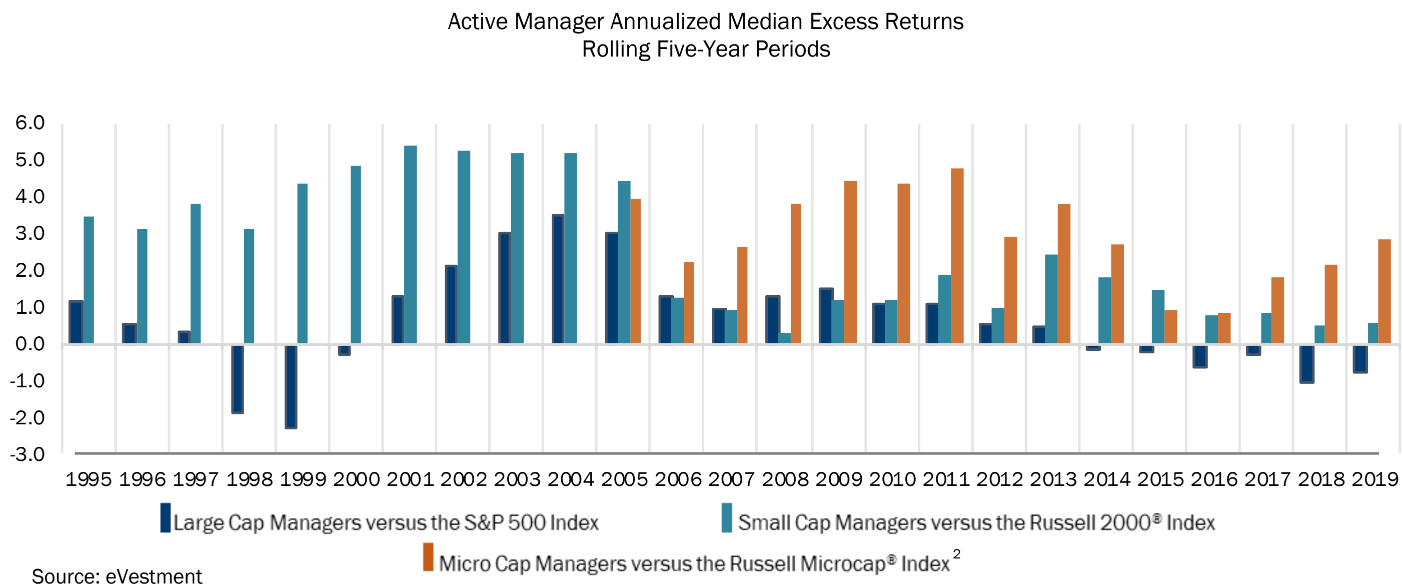


Source: FactSet

This is a phenomenon we have seen before. In the late 1990's, the NASDAQ-100 Index dwarfed the size of the remaining 4,000+ companies in the NASDAQ Composite, and masked the underlying sell-off in the market that began in late 1996 and resulted in the market crash of early 2000. In fact, it took nearly 15 years for the NASDAQ Composite to recover. As well, in the late 1960's and into the early 1970's, a group of stocks known as the "Nifty Fifty" took a very concentrated share of investment returns, only to end up resulting in massive sell-offs and index declines.

<u>Passive Investing</u> – The rise of passive investing is well documented. Mutual fund and ETF data suggest that many investors believe that they are unable to select active managers that will outperform their respective index. It is true that outperformance each and every year is a very high hurdle to expect from a long-only manager. However, there are areas where managers can add value.

Figure 12

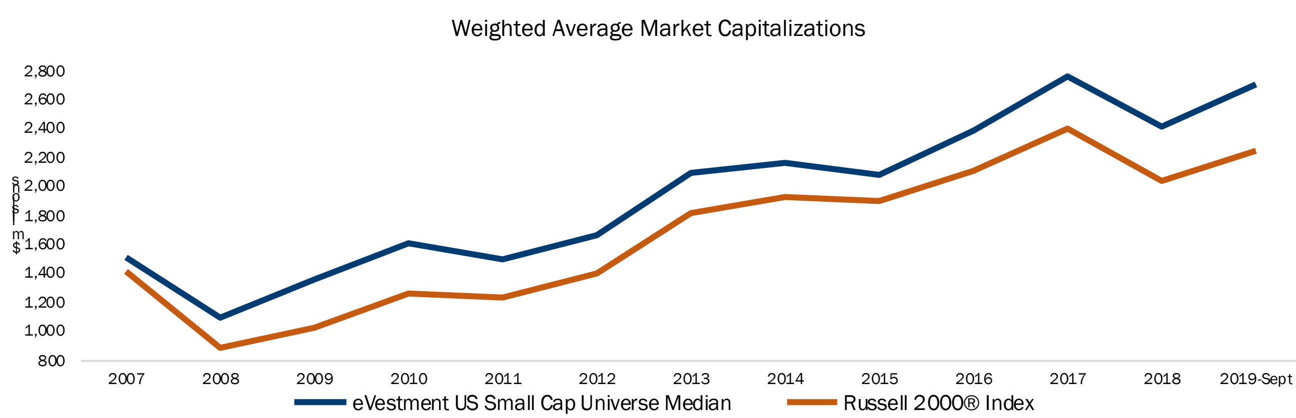


Source: eVestment

Derived from eVestment, Figure 12 considers active managers in three equity asset classes – Large, Small and Micro. Clearly, the smaller the companies, the better the chance for active management gains. Passive investing feeds the momentum trade, just as it did in the 1990's, until those trades unwound under the scrutiny of valuation.

<u>Asset Growth of Investment Managers</u> - When investment managers demonstrate an ability to generate excess returns, the market delivers assets. As this happens, a point is reached at which the manager must invest in larger companies to deploy larger allocations of capital. In our small cap peer group, this results in "market cap creep," as seen in Figure 13.

Figure 13



Source: FactSet

This “market cap creep” fuels a momentum trade into the largest companies at the expense of the smaller, cheaper assets. This strategy works as long as market momentum continues to be a tailwind.

Will the Pendulum Swing the Other Direction?

Given these trends of the last ten years, why should anyone care about small company value stocks? We believe that small company value stocks will come in favor again for two reasons; 1) valuations are attractive and 2) strategic buyers or private investors will ultimately seek out the undervalued companies.

Valuations are Attractive – Over the years, our clients have heard us stress the importance of paying the right price for an asset. Small company value stocks today have some of the most appealing valuations we have seen in a long time.

The two charts below demonstrate value as a function of sales and earnings. Both measures are at levels not seen in years. Each index is represented by a proxy, which is defined as the recreation of the Russell indices at the beginning of every calendar year.

Not only are absolute valuations low, but relative valuations suggest that small company value stocks are long overdue for an extended run. If the historical context explained above is to revert to the long-term trend, that increase will be led by the smaller companies in the market, and the smaller companies within the index.

Figure 14

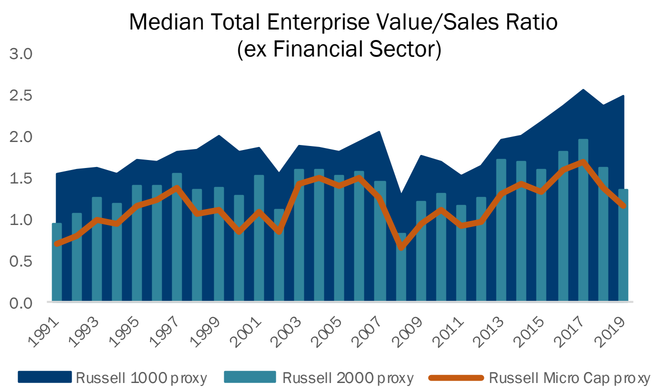
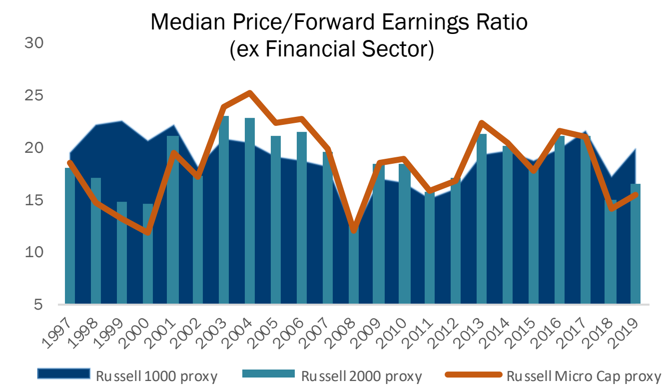


Figure 15



Source: FactSet

Why is this? As smaller companies grow, their characteristics evolve over time.

Figure 16 displays profitability for three equity indexes, the Russell 1000®, the Russell 2000® and the Russell Microcap® Index. It shows increasing profitability of larger firms to smaller firms. As smaller companies grow, they gain efficiencies and scale that translate into higher profits. With those higher profits, over time, the market starts to pay more for their revenues. Said another way, their multiples expand.

Figure 17 shows the total enterprise value to sales multiple for that same group of companies. It is easy to see that through the progression of size, the excess returns on capital from small companies increase and the market is willing to pay for it.

Figure 16

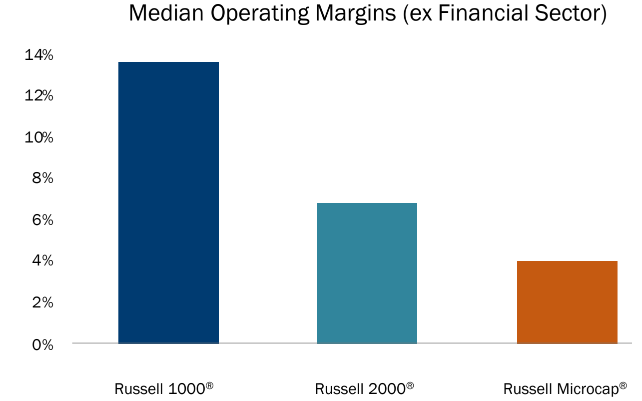
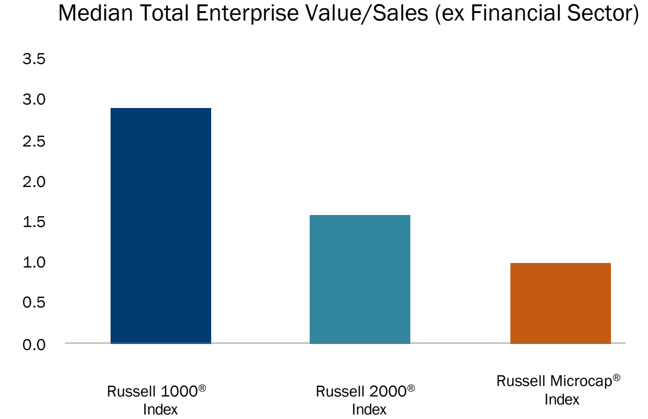


Figure 17



Source: FactSet

Strategic Buyers or Private Investors — The situation presented in Figure 16 and Figure 17 create the classic opportunity for an accretive acquisition by strategic buyers. A larger public company, trading at a higher valuation multiple due to higher profitability, can often create value by purchasing a smaller peer. By eliminating overlapping costs, and the synergies and scale that comes from integrating the smaller company, the strategic acquirer can often achieve higher profitability on the acquired revenue quickly and keep its higher multiple of revenue on the combined entity.

If public investors do not pay for these potential excess returns, the private markets will. Evidence for that is shown in the table below. The vast majority of M&A transactions occur with companies that are below $1 billion in valuation. Current premiums paid for middle-market deals average about 500 bps higher than for larger companies.

Figure 18

Twelve Months ending September 30, 2019

Disclosed Deals	Number	$ (Billions)
$1 Billion and above	281	$1,250
$50 Million to $999 Million	1,300	$341

Source: FactSet Research

In Closing

Because of the recent trends in investment returns, we are optimistic about the future. Small company value stocks have been a solid leading investment over the long run, and we believe that trend will continue. Based on our analysis, we find compelling reasons why deploying capital to small company value stocks will be a successful long-term strategy and is a prudent choice now.

Ultimately, investment preference will be determined by returns earned on capital deployed. We do not believe that this basic principle has changed. There will always be periods of time, some longer than others, that test investors patience, or lead investors to believe in fashionable investment trends that are not based on a solid valuation framework.

At Pacific Ridge Capital, we will continue to adhere to our proven small company value-oriented investment philosophy.

[1] Kenneth French Data Source: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
[2] The Russell Microcap Index inception date was 1/1/2000, therefore, the eVestment Micro Cap Universe excess returns are shown beginning with 2005 data.

PACIFIC RIDGE
CAPITAL PARTNERS, LLC

4900 Meadows Road
Suite 320
Lake Oswego, OR 97035
(503) 886-8970