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Re-Entry Point: Current Volatility Provides Opportunity for SMID Growth

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RE-ENTRY POINT: CURRENT VOLATILITY PROVIDES OPPORTUNITY FOR SMID GROWTH

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WHY SMID WHY NOW?

The beginning of 2022 has seen remarkable changes, and challenges, to the global stage. As inflation continues its climb still higher, the Russian invasion of Ukraine has become the biggest headwind facing the global economy and equity markets, exacerbating these inflationary concerns. While many investors have become fixated on the cyclical events dominating headlines, we turn our attention back to secular growth drivers, focusing on small- and mid-cap (SMID) growth companies that benefit from thematic economic and demographic tailwinds. This environment can cause investors to focus on risk aversion in light of daunting short-term headwinds; however, we think these conditions can offer some of the most attractive entry points to world-class growth companies for investors with a longer-term horizon. We think the opportunity to take advantage of and capitalize on market dislocations is key in seeking to deliver attractive long-term returns.

A Troubled World Stage

Amid a backdrop of spiking inflation, supply-chain bottlenecks, labor shortages and impending rate hikes, the fierce escalation of the Russia-Ukraine conflict has intensified market volatility and uncertainty for the global economy. In particular, trade sanctions against Russia have been expanded to include Russia's biggest export - oil - and financial sanctions have been placed on a number of key Russian institutions, including the nation's central bank.

Oil volatility has been unpredictable with Brent crude recently hovering at over $100 per barrel after previously surging to almost $130 per barrel, the highest level since 2008, when oil hit an all-time high of just over $145.[1] Many market observers expect oil to hit fresh all-time highs in light of restrictive sanctions, a lack of US drilling and supply, inertia on the part of OPEC (Organization of the Petroleum Exporting Countries) to meaningfully increase production and, most importantly, capital-expenditure restraint among large energy producers. This has led to dramatic uncertainty in equity markets, as many investors remain highly doubtful that peace talks offer a realistic exit after several initial rounds of negotiations ended without progress and the gulf between what Russia demands and Ukraine is prepared to accept remains wide.

As of March 8, President Biden announced a US ban on Russian oil and gas imports and the European Union outlined plans to reduce, although not eliminate outright, its dependence on Russian gas. Additionally, the UK joined the fray by introducing a plan to phase out imports. Unfortunately, we appear to be entering a longer, more protracted phase of the war after the initial Russian incursion stalled. China continues to resist condemnation of the invasion, attributing the root cause of the security challenge to NATO's decades-long eastward expansion and criticizing the heavy sanctions that the West has placed on Russia.

Inflation's Fuel to the Fire

Appropriately, the US Federal Reserve (the Fed) and its plans to combat surging interest rates have taken a back seat to the Ukraine conflict. However, inflationary concerns are no less on investors' minds. There is significant speculation that the Fed is in a precarious situation of combating inflation by raising rates while the geopolitical events in Ukraine are set to drive inflation higher through oil, gas and commodities sanctions against Russia by virtually all Western countries.

Moreover, the invasion has increased the prospect of stagflation or even a mild recession, raising the risk of a Fed policy mistake or lower chance of a "soft landing." Soaring commodity prices are tightening financial conditions and intensifying the 'tax' on US consumer spending. It is likely the squeeze on consumer pocketbooks will continue to intensify in the coming months, even if oil prices stop rising. Hawkish Fed policymakers appear undaunted by the conflict and seem to have a high tolerance for financial-market stress in the current inflationary environment.

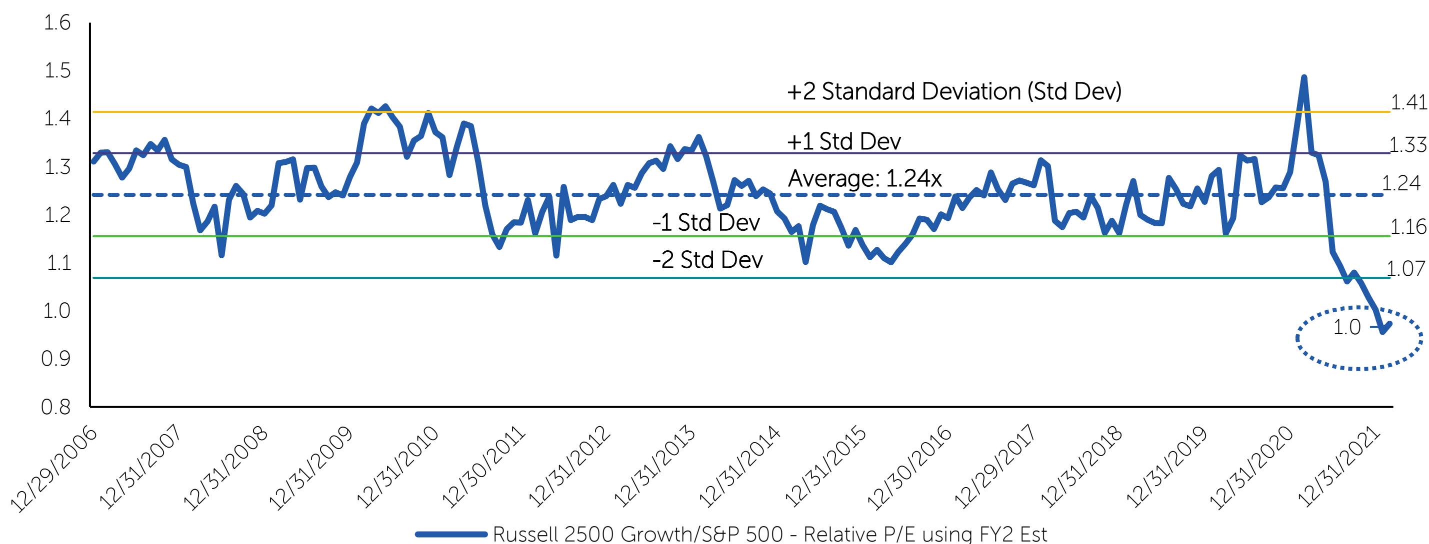
Historically, growth and value small-cap stocks were top performers during the protracted stagflation environment from 1974-1982. During this time, inflation ballooned to nearly 9% per year while GDP grew a miniscule 2% per year.[2]

Why SMID now?

Despite these economic headwinds, we believe the SMID asset class currently offers distinct advantages to investors, including attractive relative earnings growth and valuation and the low exposure of small-cap stocks to foreign revenues.

Over the last decade, small-cap stocks have seen their relative valuations to large-cap names fall dramatically, especially post pandemic. As the global economy reopened and the supply-demand dynamic became more distorted (amplified by still-stressed supply chains and massive, unprecedented stimulus), large-cap stocks saw their valuations meaningfully outpace their smaller-cap brethren.

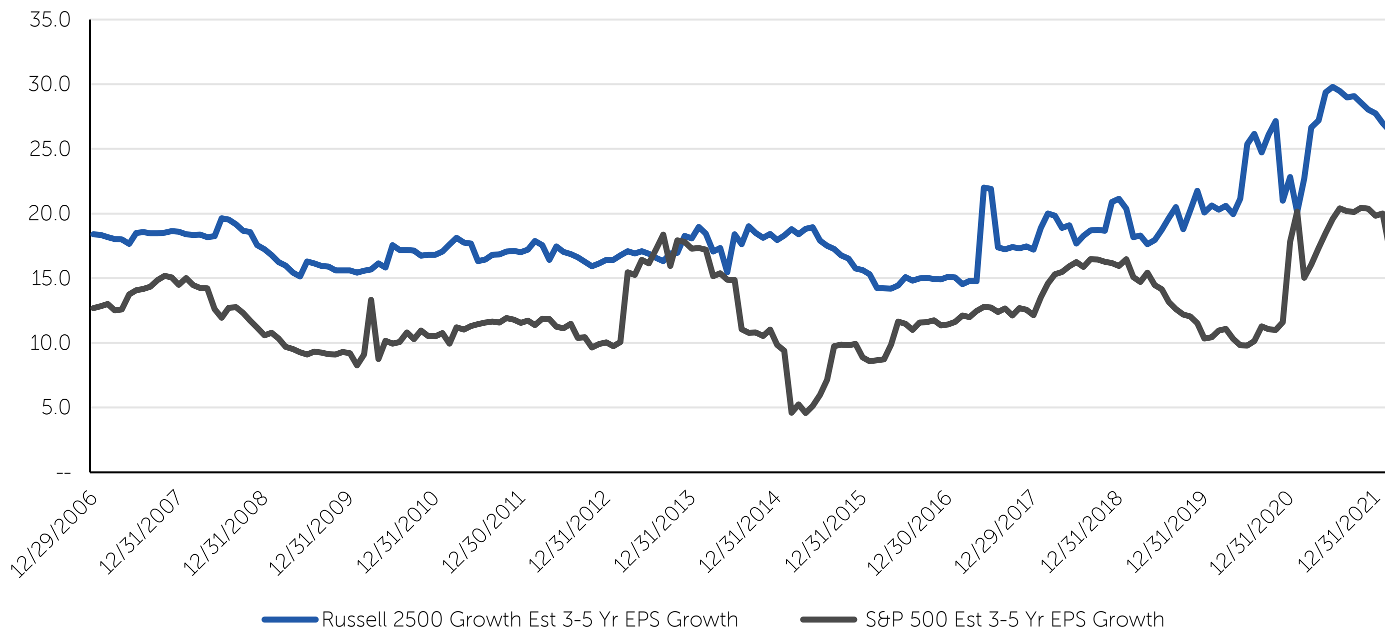
Russell 2500 Growth versus S&P 500 Valuation: Price/Earnings (P/E) FY2 Estimates



Source: Factset, February 2022.

In addition, while valuations have dropped one standard deviation below their historical average, consensus outward growth estimates remain higher for smaller-cap names, a fact that appears lost on some investors. While earnings growth is expected to slow broadly across the economy, we are observing slower deceleration among smaller-cap stocks. This earnings durability is very attractive in a slowing growth environment. We believe that the multi-year low in valuations, coupled with a higher forward growth rate, may create a compelling smaller-cap environment heading into the remainder of 2022 and into 2023.

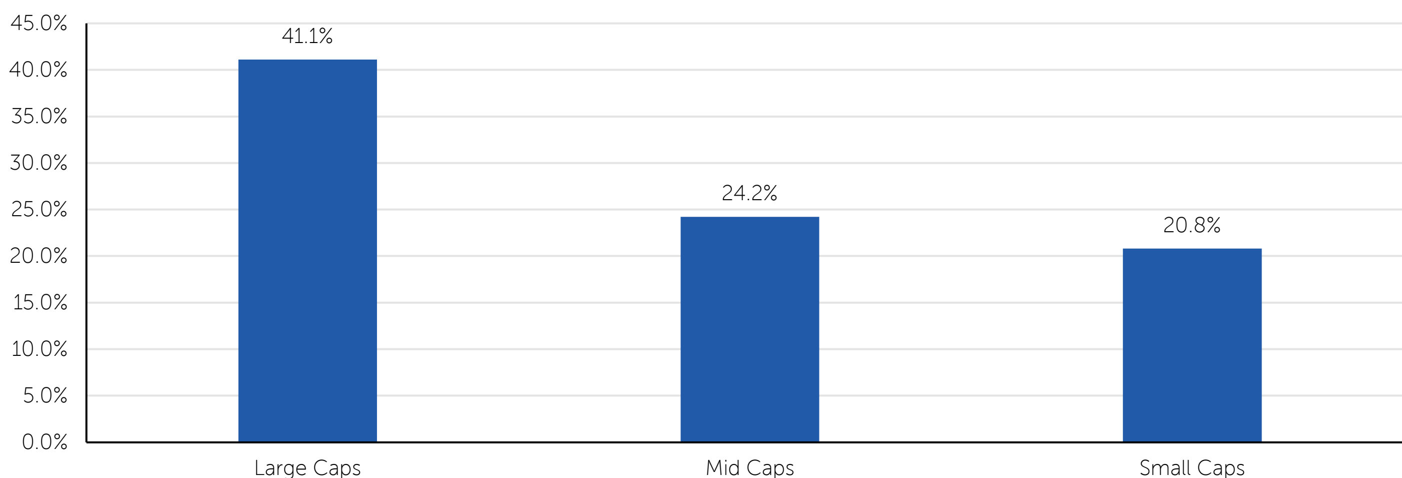
Russell 2500 Growth versus S&P 500 Earnings per Share (EPS) Growth Estimates over 3-5 years



Source: Factset, February 2022.

As global growth is expected to decelerate, smaller-cap US companies may be less exposed to the global economic slowdown and better able to weather the current geopolitical storm owing to their lower exposure of revenues to international markets. However, despite being better protected from overseas revenue, investors must remain vigilant of higher commodity prices and labor costs, which typically affect companies negatively across the entire capitalization spectrum.

Foreign Source Revenues by Market Capitalization

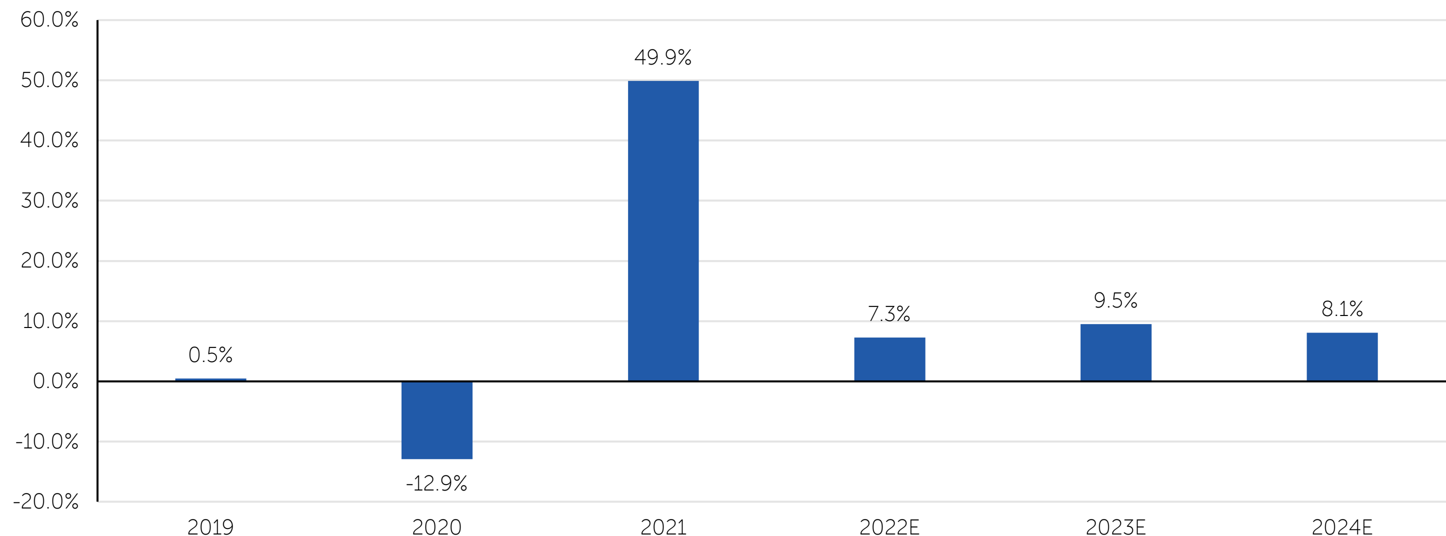


Source: Strategas, March 8, 2022.

A Thematic Approach

Investors have clearly been focused on the cyclical economic recovery and the sectors and companies that benefit from this environment. As the economy and company earnings begin their return to normalized rates of growth and become somewhat challenged, we believe long-term investors need to be well positioned for secular growth drivers, focusing on thematic economic and demographic trends.

S&P 500 Annual Earnings Growth Rate



Source: Zacks Investment Research, March 2022

These themes can be drawn from broader fundamental research. For example, we have focused on a group of stocks that many are simplistically calling 'Covid winners,' which we believe are broadly, and mistakenly, being written off by the market. In our view, the Covid crisis actually validated these business models, proving that their markets were much larger than many investors realized. Overall we think the market has taken an overly basic view, bucketing stocks as either Covid 'winners' or 'losers' and has not thoughtfully considered which companies experienced larger, long-term structural changes for the better as the result of the pandemic. Through this lens, we have been able to identify various themes at use in our strategies, including digital transformation and health-care innovation.

We have long used a thematic focus to help identify where we can find meaningful innovation and market disruption. We believe our thematic approach helps identify high-potential companies earlier than most and gives us confidence to own these stocks through the volatile times that are part and parcel of the asset class. The beauty of working within a thematic framework is that, if truly disruptive themes are identified, they can persist for years. As a case in point, we first took note of the cloud computing theme in 2010, and, 12 years later, it still remains a powerful driver with new and exciting investment opportunities that have spawned from the evolution of this theme. Looking forward, we see an abundance of exciting themes on the horizon, including those surrounding digital transformation, advanced manufacturing, consumer discovery and health-care innovation, to name a few.

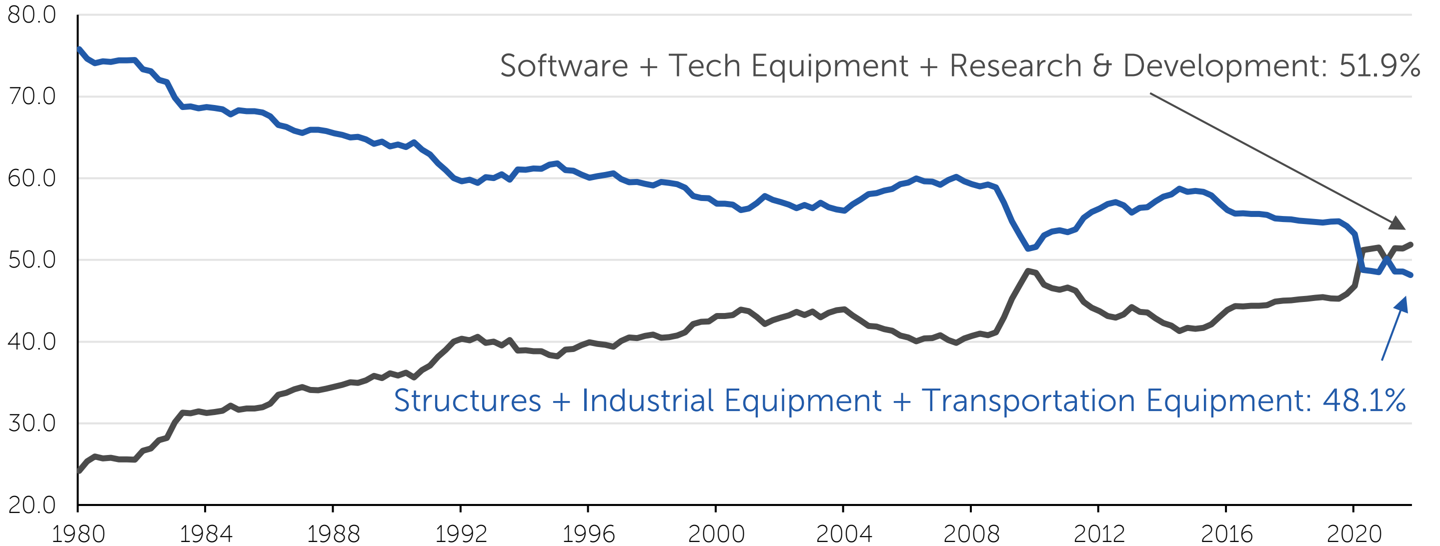
Businesses are becoming more data-dependent and data-driven than ever. The global Covid pandemic has only accelerated this trend, and we believe the broad digital transformation of the global economy has only just begun. The move to digital transformation, the frictionless economy and cloud computing, among others, remains in relatively early stages with what we believe is over a decade of runway for growth. We are inspired by companies that have assembled impressive innovation and go-to-market engines, achieving important scale in their core CPaaS (communication platform as a service). CPaaS is still in the early stages of penetrating new use cases and market niches, which we expect will help these companies achieve their growth targets.

Health-care innovation is another theme that we think is especially exciting. There are many elements of health care that we believe are going to see multiple decades of progress condensed into just the next few years, including telehealth and better primary care offerings. Additionally, we believe that holding the health-care system accountable for outcomes and costs is going to be another major step forward.

Conclusion

As inflation surges, interest rates prepare to rise, supply chains continue to be disrupted and oil prices remain volatile, the war in Ukraine only exacerbates global economic and market volatility, leading investors to naturally become increasingly skeptical of equity markets and areas of the growth. This environment can lead investors to become overly short-term focused, creating additional portfolio volatility instead of taking advantage of these fairly short-term dislocations to position for eventual longer-term outcomes. However, secular growth drivers remain in place and their economic influence over the next few years appears quite robust. Our economy is fast becoming a 'digital economy,' making it all the more important for portfolio investments to reflect this dynamic.

Capital Expenditure Components - Percent of Total Capital Expenditure 2021:4Q



Source: Piper Sandler, April 2022

Overall, we are optimistic about the transformational economic shifts and continued momentum across the economy, benefiting many small- and mid-cap growth companies which are less exposed to deglobalization and geopolitical risk. Additionally, growth stock valuations and current risk/reward prospects appear very attractive as the asset class is trading at multi-year lows relative to the S&P 500. Finally, we believe small- and mid-cap companies are going to grow at a higher rate than what we thought was possible just a couple of years ago, allowing investors to take advantage of the current more moderate securities pricing. Importantly, we believe a thematic approach is key and allows investors to discover companies with better growth prospects that have the endurance to meet these volatile times.

Endnotes

[1]U.S. Energy Information Administration, "Europe Brent Spot Price FOB." 30 April 2022.
[2]Karande, Aditya S., Furey Research Partners, "Insights." Volume 2772, 9 March 2022.

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