Ken Kozlowski Podcast – September 2022
Small Cap Investing with Essex Investment Management

Kenneth Kozlowski, CFP, CLU, ChFC
Chief Investment Officer
Equitable Investment Management

Nancy Prial, CFA
Co-Chief Executive Officer & Senior Portfolio Manager
Essex Investment Management

Transcript

Ken

Hello and welcome to this podcast. I'm Ken Kozlowski, chief investment officer of Equitable Investment Management, the investment advisor for the 1290 funds. It's been a turbulent market this year and investors are concerned, and we want to help. We are pleased to offer you the insights of a range of professional money managers who are looking at markets and companies day in and day out, trying to find opportunities for their clients. So joining me today is Nancy Prial, Co-chief executive officer and senior portfolio manager at Essex Investment Management. Nancy is the portfolio manager for the micro-, small and smid-growth equity strategies. She's been with Essex since 2005 when Essex acquired Burridge Growth Partners, where she was the chief investment officer for their mid and small cap growth strategies. Before that, Nancy spent four years as a senior portfolio manager at American Century Investors and began her career at Frontier Capital Management. Nancy earned a BS in electrical engineering and a BA in mathematics from Bucknell University and an MBA from the Harvard Business School. She's also a chartered financial analyst. So, Nancy, welcome to the podcast.

Nancy

Thank you, Ken, nice to meet with you.

Ken

Great to have you today. And why don't we start, maybe if you could tell us how your team came together and how did you end up focusing on small cap and micro?

Nancy

Sure, I'd be happy to. So the core of my team has been together since 1998 when I joined the Burridge Group, and Saralyn Sacks, who I've been working with since then, was part of the firm there. I kept Saralyn as the first member of my team because she had the characteristics that I look for in terms of a good analyst and also a good team member as we look to build out our portfolios and what we're looking for, and you can see this reflected in my other two team members, Marcy Carlin and Anne Marie McMichael, are analysts who are not only analytical, but are bold-prudently bold I would say, who are thoughtful, but who understand that inflection points are very important. So there's a curiosity, there's a drive, there's a willingness to try new things, and there is an appreciation of the math behind our theory that companies whose earnings and revenue growth rates are accelerating can lead to growth rates that are well above what the street is forecasting, that are all very important criteria for my team.

Ken

You look for under-covered undiscovered companies. What kinds of factors do you look at to find these, and what types of characteristics are you looking for in these companies?

Nancy

So we are looking for companies that are, as you mentioned, undiscovered, under-followed, what we would consider to be under-loved companies. Part of that is a function of the fact that we are investing in the small- and micro-cap space. We think that space is particularly attractive because it is one of the last remaining inefficient spaces in the equity market. The reason the space is inefficient is because of the fact that these companies are not followed nearly as tightly as the larger-cap components of the market. The reason for that is rooted in human nature, it's really behavioral economics. Most companies get to be small- and micro-cap companies because they were larger camp companies, they disappoint their investors, they disappoint Wall Street, they shrink in market cap, and through that process, Wall Street gives up on them, much of the buy side gives up on them, and they live in this pool of under-followed, under-loved. under-appreciated companies. Within that pool however, there are always some companies that are reshaping themselves - either they bring in new management, they get a new product, the markets finally right for their product, and can re-emerge from a period of under-performance into a period of better performance. What we want to do is identify those companies within this large-, small-, and micro-cap space that have those characteristics of a positive catalyst, whether it be management, whether it be product, whether it be market, whether it be marketing,

whether it be corporate structure, balance sheet, that is starting to show in the numbers, where their business fundamentals are getting better, and then do fundamental research to identify which one of those companies, or if any, have the management team, the product depth, and the growth potential to become attractive investments not only for us, but for other investors, and that process of discovery of going from unknown to discovered and owned by many other investors is what has led to the very long-term outperformance of small and micro-cap stocks over pretty much every other part of the equity market.

Ken

You've said your sweet spot for small caps is anywhere from 75 to 450 million. Why is that?

Nancy

So that is because those are the group of companies where we can find companies that share these characteristics of being under followed under owned, under-appreciated, but where there is sufficient liquidity so that we can buy them at prudently for our client portfolios and not risk getting stuck in a name that's too illiquid to get out of should things not work out as we hope. But also, and very importantly, they're big enough that they are institutional caliber names. So we do not want to own pink sheet names or names that really are not ready for primetime because they don't have a product, they don't have the balance sheet, maybe they're fly by night companies. By using 75 million, is that cut off we get rid of most of those. At the upper end, although 450 is very small, compared to the small cap benchmarks, it gives us not only these under-followed under-owned under-appreciated names, but it gives us sufficient runway that we can let those winners appreciate while still staying true to our small and microcap focus. It can go from 450 to 5 billion - that would be a ten-bagger for us and for our shareholders and clients, but it would still be within the small-cap universe.

Ken

Are there particular sectors that you focus on and if so, is that strategic or in response to current market conditions? And if you could talk about some of the themes that are most interesting to you right now.

Nancy

So let me answer that question in two ways. Let me start upfront with how we think about sectors. So we are growth investors and we want to invest in industries, companies, areas, that have a secular growth tailwind behind them. As a result, that does mean that traditionally we will have healthy exposure in the growth segments of the market, consumer, technology, healthcare and, certain aspects of the industrial markets. However, there are very few sectors that we would say never to, because there are sectors that cyclically can come in and out of favor or that perhaps have a shorter-term positive catalyst that will turn them into growth industries for the

intermediate term, even though they may not be growth industries today. Right now, we are investing in a combination of what we would consider secular growth areas as well as some more cyclical growth areas. As a few examples, we are very bullish on healthcare broadly and particularly in tools and diagnostic systems that can help to identify diseases early, can help to develop drugs faster and better with higher efficacy, and that can provide surgical treatments for areas that perhaps have not had good treatments before. Some of those areas are in the areas of cancers - using artificial intelligence and big data to identify cancers earlier as well as to treat cancers earlier, some of those are in genomic analysis for personalized medicine so that your treatment can be tailored to your particular genomic background. On a somewhat more prosaic level, some of those areas are things like treatments for the eye, particularly retina macular degeneration, etc., treatment for aging bones, spinal surgery and other orthopedic techniques, and also cosmetic surgery treatments because we all want to look younger, we all want to look better, and we do see a big trend of increasing focus, both men and women, in using cosmetic treatments and cosmetic surgery to improve our appearance. Some of the other areas were particularly excited about right now, of course, our technology With the move to 3G-4G next generation Internet, internet of everything, the digitization of our entire world, some themes that you'll see in a lot of growth portfolios, but we think that we are entering a point with the internet and with technology and with digitization where we are going to have solutions for problems That nobody really ever dreamed of - smart cities as an example smart cars. Aligned with that, our sustainability solutions which is also a big secular growth theme. On the more cyclical area we're looking for areas that are benefiting from increased spending, particularly some increased government spending. So we're very bullish today on infrastructure and the reshoring of manufacturing in the United States that encompasses both some of the energy patch as well as semiconductors. That's just a flavor of some of the areas that we're looking at and excited about today.

Ken

Thank you. Maybe you could tell us about your approach to portfolio construction and talk a bit about your risk controls for various stages of growth?

Nancy

Of course. So we look at risk controls and portfolio construction in a couple of different ways. As a start, we do build our portfolios from the bottoms up - stock by stock - because we are fundamentally stock pickers and when we look at our sector allocation and our thematic allocation, it's driven by those individual stock names that go into the portfolio. However, it's very important as portfolio managers to understand not just the individual stock characteristics, but how they form together to impact the portfolio as a whole, whether they be obvious correlations or perhaps hidden correlations. In order to take that into account, we look at diversification, as I mentioned in a couple of ways. The first, of course is the traditional sector

allocation and we want our portfolio to reflect our best ideas. We want our sectors to reflect our best growth areas and so you will see in general that our top three sectors will tend to be about 70 to 75% of the portfolio, generally concentrated in the traditional growth areas I've talked about. Another layer that we look at though, is what we think of as phases of growth, and let me explain what I mean by that. We think of it as a three-legged stool with the phases of growth being companies that are secular sustainable superior growth companies, companies that are re-emerging growth stories that have perhaps been very neglected perhaps look like value stocks, and then companies that are visible emerging growers. The portfolio is roughly balanced, 1/3-1/3-1/3 through those three areas, although we can tilt that slightly depending upon where the growth is coming from in any given economic environment. As an example, in a slower growth environment, we will have more companies in the superior sustainable growth, in an environment that's coming out of a soft patch or a recession, we're going to have a lot more companies in that re-emerging growth story category. And the reason this works not only on a diversification basis, but also for risk management is that these types of companies have very different expectations built into them, they sell at very different valuations, and they will act as a little bit of a counterbalance to them. The re-emerging growth stocks tend to do better in a somewhat more value-oriented environment even though they are growth companies, the superior growth companies, the sustainable growth companies, have higher multiples, they're more well known, they'll do incredibly well in a growth market. The third level that we use for diversification is the catalysts that are the underlying cause for the improving economic growth of improving fundamental growth that our companies are seeing and that can range from companies that are restructuring to improve their returns and their financials, to companies that are growing because their industry is improving, companies that are growing because they're gaining market share, and companies that are growing with innovative new products. Similarly to the growth phases, those different buckets have different betas, they have different valuations and different level of expectations. So we not only get a well-diversified portfolio, but we get some risk management as well.

Ken

And over time, those different phases, has one or two been particularly fertile in terms of those names that have contributed to performance or is it really just a function of what's going on in the market at that particular time?

Nancy

So we add value in all of those phases, but I will say the way we consistently get our best value-add is when we buy a company that is in that bottom re-emerging growth story bucket. I like to think of those as my farm team actually, because they all have tremendous promise, but we may have to wait for them to be discovered. These companies tend to be at the smallest end of the market cap. They're the least well known, they may be what we call ugly acceleration and what I

mean by that is they are companies where the revenue is still declining, the earnings may be still declining, but it's declining at a lesser rate. So they're coming out of a downturn, but it growth has not yet turned positive. And these companies are, as I mentioned, extremely, extremely under-followed and under-appreciated. What we find many times with the ones that graduate out of the farm team and to use a bad baseball analogy, make it into the majors, is that they can graduate from being re-emerging growth, move up into visible emerging growth where that growth is starting to get noticed by the market, they're starting to gain other growth investors and then the handful of them actually can move up into the sustainable growth category where they get recognized as the superior growth companies that they are. And that to us that is what's fun about investing in microcap - it's fun for us, and we hope it's fun for our shareholders and client where you discover something very early on, I like to think of it perhaps as a sheep in wolf clothing. It's under-loved at the beginning and at the end of the day everybody says wow, what a great company.

Ken

Now I love that analogy from farm team to 300-hitter within your portfolio. So thanks for that. Final question - do what's your outlook for the next year, two years? What does that look like?

Nancy

So obviously we are going through a challenging point in the market right now. I think having been through the first half that we've been through and with valuations where they are, it's very hard not to be bullish today. We had the first half decline that we haven't seen in about 40 years. That doesn't happen very much, and there have been, I think, eight or ten of those over the time that we've been able to measure the market. In addition, particularly in the small cap space, valuations are very attractive. We see that the Russell 2000 Growth is selling at forward earnings - so this is 2023 earnings - at less than 14 times, unless we worry that that earnings number is too high, I would note that it's actually selling it only a little over 14 times for the rest of calendar year 2022, a year that's over half over at this point, and we have seen very strong positive earnings surprise data from the small-cap universe. We think that this current environment is one that could be particularly well suited to small cap stocks. Not only do we have attractive valuations and attractive growth rates, we do have somewhat higher inflation than we've had in the past and small cap stocks over their history have been one of the few asset classes to outperform in an inflationary environment, in addition, many of the small cap companies are particularly well geared to the economic environment we are in today with a lot of exposure in industrials, a lot of beneficiaries of higher oil prices, a lot of beneficiaries of infrastructure and reshoring spending and much less exposure to overseas, so the strong dollar does not hurt them. One more point I'd like to make is small caps are under-owned, they remain under-owned, they remain under-loved. I've been in the business since 1984, which was a period when

small caps were equally under-loved and, although the past cannot predict the future, I think there are some analogies to the period of the early 80s and the period today.

Ken

Nancy, that was very insightful. Thank you so much for your time. Thanks for being with us today and best of luck for the rest of the year.

Nancy

Thank you very much.

This discussion is provided for informational purposes only and should not be construed as investment advice. The views and opinions expressed are provided by the speakers as of the date of their contributions, and do not necessarily represent the views of Equitable Investment Management Group, LLC or its affiliates. Any such views and opinions are subject to change at any time based on market or other conditions and are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Securities and sectors referenced should not be construed as a solicitation or recommendation or be used as the sole basis for any investment decision.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person.

1290 Funds® is part of the family of mutual funds advised by Equitable Investment Management Group, LLC, a wholly owned subsidiary of Equitable Financial Life Insurance Company (Equitable Financial).

Equitable Financial is an indirect wholly owned subsidiary of Equitable Holdings, Inc. Equitable Distributors, LLC is the wholesale distributor of 1290 Funds®. Equitable Advisors, LLC (member FINRA, SIPC) (Equitable Financial Advisors in MI & TN) offers the 1290 Funds® to investors.

1290 Funds® is a registered service mark of Equitable Financial Life Insurance Company, New York, NY 10104.

1290 Funds® is distributed by ALPS Distributors, Inc., 1290 Broadway, Suite 1000, Denver, CO 80203, which is not affiliated with Equitable Investment Management Group, LLC; Equitable Financial Life Insurance Company; Equitable Distributors, LLC; Equitable Advisors, LLC.; (member FINRA, SIPC) (Equitable Financial Advisors in MI & TN);; Essex Investment Management Company LLC.

© 2022 Equitable Holdings, Inc. All rights reserved. EQH000393 (9/22) (Exp. 9/24)