Transcript

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Ken

Hello, everyone. I'm Ken Kozlowski, chief investment officer at Equitable Investment Management. And as always, I'd like to start by thanking our listeners. We hope you find these discussions valuable and are grateful you continue to show interest in our portfolios and investment managers. Today we're going to stray a bit from our normal format, and I'm going to give the stage to Jessica Baehr, president of Equitable Investment Management.

Jessica is a company veteran bringing a wealth of experience and knowledge to our group from prior roles as COO of Equitable Life, at the Employee Benefits business and head of Investor Relations in Equitable's early days as a public company. Jess is here today with two sub-advisor partners, and they will share some insights specifically into the small-cap investment landscape, which has had a very strong movement throughout 2024.

Jess, I'll hand it to you to introduce today's contributors and dive into the discussion.

Jessica

Well, thank you Ken. It truly is a pleasure to be joining you all today. I'm thrilled to share a discussion with two fellow female leaders in the asset management industry.

With me today are Janice Musselwhite, senior vice president at GAMCO Investors, and Nancy Prial, co-CEO and senior portfolio manager at Essex Investment Management. Both women are experts in the small-capitalization company investing[1] space, and bring specialties in sectors from a growth perspective, a value perspective, mergers and acquisitions, and also micro caps. So without further ado, let's jump in.

When we decided to do this podcast, I couldn't help but go back to some of the recent conversations we've had with you both at the end of the third quarter.

At that point in time, you both acknowledged that, yeah, there was strong small-cap performance within the quarter. But despite that, the Russell 2000 Value Index, the Russell 2000 Growth Index [2] still trailed the performance of U.S. large caps. Wow, how times change. Here we are sitting in mid-November and small-cap returns, regardless of investment style, are outperforming the S&P 500.

Talk to me about what you see driving this momentum, and is it more than just a well-timed--and perhaps needed--broadening of the market returns away from the Magnificent Seven [mega-capitalization companies]? So why don't I start with you, Janice. Tell us a little bit of what you're thinking.

Janice Musselwhite

Sure. And thanks so much, Jessica, for the intro and for the opportunity to be here.

Great to chat with you and Nancy today! So, yes, it's been, quite a quite a busy six weeks or so since the end of the quarter in a lot of ways. Seems like a bit of a different world here. So we saw, really, two major dynamics so far, starting off in November and really in the first week of November, which have been driving returns this month so far, and both of which are positive for small-cap companies.

So one was the clarity around the election outcome, which we can talk more about later. And the second is really the continued transition to lower rates with the U.S. Federal Reserve lowering rates for the second consecutive time in back-to-back meetings, and again just days after the election. So really paving the way to a lower rate environment. As we see interest rates continue to decline, we believe smaller and mid-sized companies are positioned to benefit from this trend throughout the rest of the year and into 2025.

Lower interest rates generally act as a positive catalyst for equities by reducing borrowing costs, fostering robust [merger and acquisition activity], increasing consumer spending, renewing investor risk appetite and leading to higher valuation multiples [meaning, stock prices are rising compared to earnings or some other measure]. Importantly, many of these effects are even more pronounced for smaller companies. So, for instance, smaller companies typically face higher borrowing costs than their larger-cap peers.

So reductions in interest rates have a stronger impact on smaller companies. And access to lower-cost funds can help these companies finance additional investments and manage their debt more efficiently—so potentially leading to higher growth rates as well. Lower interest rates also drive consumer spending by making credit and loans more affordable.

And small-cap companies are also typically more sensitive to changes in local consumer behavior since they tend to be more domestically focused, and the impact can be more pronounced. So, yes, I've gotten pretty far here without even mentioning the last part of your question—or the Magnificent Seven [or Mag-7].

So we're really seeing, finally, variables other than those handful of companies that have been driving returns so far.

Jessica

That's great. Just to tack on to that, Nancy, what are you seeing, in terms of sectors and industries. You mentioned, when we last talked, healthcare and IT. They were strong drivers of performance in the small-cap growth space; and on the opposite side, industrials and energy sectors were lagging. Are you still seeing this?

Nancy Prial

We're not really—right now. I do want to put that into some context, though. On a one-quarter snapshot, in the third quarter, it was certainly true that health care [stocks] had a very strong quarter, driven by, a lot of very positive developments [including new drugs] approved by the FDA and [those] new drugs seeing really good uptake, leading to better-than-expected quarterly performance.

But in the longer arc, and we really think this arc goes back to the mid 2016/2017 period, we've seen strong performance from both the technology and the industrial sectors within small-cap and large-cap stocks. But we'll focus here on small cap, driven really by this fundamental shift in America's manufacturing presence and posture.

We've been seeing a reshoring that was driven originally just by relative cost differences in the U.S. versus the rest of the world, that has been accelerated by many of the policy decisions that have been put in place, and, we believe, will actually continue to be accelerated even more, by some of the policy changes that might get put into place under a second Trump agenda.

And what that means is that all of those forces driving companies to bring their businesses back, to build new manufacturing plants, to then have the power grid and the power infrastructure distribution, transmission as well as generation, roads, bridges, etc., particularly well-suited to small- and mid-cap companies because there are so many of them participating in this part of the market.

We've seen that so far in the fourth quarter, as the industrial sector has really responded very favorably to the election results. And also, as those companies have continued to show, not only are they doing [well and seeing] growth, but they're also seeing [profit] margin expansion. And, again, we think that is likely to continue. Similarly, technology, you know, we can't have a discussion about the market without talking about AI [or "artificial intelligence"}.

In some level, most of the focus on AI early on has been on those very large companies building those big data centers, Nvidia supplying the initial chips, etc. What we're starting to see, starting last quarter and building this quarter, is that that focus expanding and shifting to other parts of that hardware ecosystem, but also, and we think importantly, to companies that will benefit from using that underlying AI technology to come up with some killer apps or perhaps just some smaller applications that drive the productivity that the U.S. and the rest of the world will need in order to keep economic growth at a robust enough level to benefit all of their populations. Health care right now is a little bit trickier. With the change of [the U.S. presidential] administration, we don't know what's going to happen at a government level. But what we do have confidence in, in terms of health care, is that health care is really at an inflection point in terms of the efficacy and the efficiency of many of the new drugs and many of the new devices that are being developed, that are solving problems of health care that have not been solved before.

Again, a lot of focus on GLP-1 [weight-loss drugs] and what the ultimate outcome of that could be. But we don't want to forget about all the gains that have been made in cancer treatments and eye-disease treatments, in respiratory treatments, in robotic surgeries, etc. Again, small- and mid-cap companies are very well-suited to benefit from those because there's so much innovation that goes on in that space.

So we think those three big sectors will continue to be the driving sectors for the foreseeable future. They may flip flop quarter to quarter, but overall, those are great sectors to have strong exposure in.

Jessica

Well, you started to tie in what we're seeing from a sector perspective and some of the policies of recent history. And, also, we do have a change in administration coming.

And so, Janice you also started to hit on this: what's happening in the broader, economy here in the U.S., how small businesses are being impacted, and around interest rates. But I'd love to go a little bit deeper here. How do you see the election results impacting small-cap value companies?

What challenges do you see for small companies given the U.S. geopolitical backdrop that we're seeing?

Janice

Yeah. Great question, and one that I think is on everyone's minds, these days. So, regardless of wherever you stand, politically, I think there's a lot to be said for having, first of all, some clarity on the election outcome, and having that information now on a relatively shorter term time frame—compared to, where we did with the last election cycle—that clarity combined with an administration that has a lower-tax outlook, a lighter regulatory framework, is really helping to fuel a very robust outlook for small-cap companies, as Nancy hit on, as well as expectations for M&A activity, which we can talk about a little bit later, too. As Nancy mentioned, we are seeing those especially strong tailwinds, you know, for industrial companies looking out over the next three to four years. Essentially all those dynamics that are benefiting, smaller companies more broadly as a result of the election, are also boosting the outlook for industrial companies. So, lower taxes, less regulation and emphasis on domestic companies. You know, the reshoring that that Nancy highlighted, as well, and also some of the ongoing spending associated with some of the various infrastructure packages that were passed over the last several years.

Of course, the domestic focus really, right, on both small-cap companies and industrial companies is also a big positive here depending on the implication of taxes if broader tariffs were to materialize, which is something that the incoming administration has been vocal about, as well. In this scenario, this kind of policy would have less of an impact here, on smaller companies as roughly 80% of the Russell 2000 earnings come from domestic sources, compared to about 60% for some of the larger-cap indices like the Russell 1000 Index [of the largest U.S. companies] and the S&P 500 Index [considered representative of the U.S. economy].

Let's maybe talk for a minute about, how some of these dynamics are also shaping the M&A landscape. So, a lot of companies, and their boards, were likely delaying making some of these larger strategic decisions, including M&A decisions, just due to general uncertainty around the election outcome and some of that longer-term planning was kind of put on hold.

So, now we have a decision which includes a lot of, information about what the next four years will look like. And M&A is expected to benefit from some of those trends, as well. So far this year, if we look at just the first nine months of the year, there were about $2.3 trillion in deals announced. This is up slightly from the same period the prior year, up about 15%. Importantly, for this part of the investment world, on the smaller-cap side, private equity's share of M&A has grown to about 40% year over year, and now comprises about a quarter of deal activity. This should really stand to benefit smaller companies that get a share of private-equity deal proceeds in terms of their acquisition focus.

And then, of course, a continued decline in rates should also, help M&A activity going forward, making deals easier to finance as well.

So, switching gears for a minute, I know you had asked about potential challenges, Jessica. So, one possible challenge for small caps we'll just have to see is whether some of the incoming administration's policies may be more inflationary, things like tariffs, immigration policies and, potentially, tax cuts.

In the scenario that some of these items do result in more inflation, and the U.S. Federal Reserve moves to increase rates, small caps are more sensitive to rate increases. So this could dampen, some of the other dynamics that we just spoke about.

Jessica

Nancy, anything additional from your perspective on, on challenges or additional opportunities that you're seeing that, that perhaps where we're not talking about, as it pertains to the current environment and outlook?

Nancy

Right. Well, I mean, certainly, as Janice said, one of the big risks that we face, not just for small-cap stocks, but really for the market overall is: will the policies of the incoming administration change the success that the Fed has shown with bringing down the rate of inflation?

And if in fact it does, and we end up in an environment that is much higher inflation than is currently expected, leading to, again, higher interest rates—that will have a deleterious effect on growth overall in the economy. And with small-cap stocks just being smaller companies overall, and less able to thrive in a more challenging economic environment, that would certainly pose some risks to the sector.

We don't see any evidence of that happening yet. And in fact, we think there is chances are that the economy will actually surprise positively over the next period of time, driven really by the productivity increases that we were finally starting to see in the U.S workforce. But it's something we want to keep our eye on. Another major risk that, again, is not just for small-cap stocks, but is a risk overall for the market: the geopolitical risks that we face in this world.

We have had the benefit for 30-odd years of an increasingly peaceful global economy, and that peace dividend seems to have ended over the last three to five years. And we are now in a world with many more regional conflicts that can change the calculation on both multiples overall in the market, as well as the risks to both specific companies as well as specific sectors, as the world re-acclimatize itself to an increasingly dangerous environment.

There are some ways, as investors, of course, to benefit from some of this move to an increasingly contentious world by investing in smart defense and companies that will benefit from that. But it is an external risk that we need to keep in mind. What we know about markets is [that] markets do best when they can climb [a wall] of worry.

So we are always happier as investors when there are a lot of things to worry about, because that's when the market is not yet fully discounting all of those future growth prospects. And, conversely, we tend to get very worried when it seems and feels like it is just clear sailing ahead, and we can't think of anything to worry about!

So I guess the good news today is there are lots of things that investors can worry about and that the markets can worry about, but we think that provides the opportunity for growth to drive stock price appreciation going forward. And it's incumbent on us as portfolio managers and important for investors to invest in such a way so that they're not overpaying for growth, but [small companies] have an opportunity to benefit both from that growth, and also from multiple expansion as that growth gets recognized.

Jessica

Well, what I what I'm hearing is, so a lot of this uncertainty does in fact create opportunity as it relates to investing. So: lots of opportunity, not just challenges! And we've got some nice, I think, tailwinds to look ahead to.

This has been a really rich discussion!

I very much appreciate both of your time and your insights. Just to close out. I'd love to hear from you both about what are you seeing, around small-cap valuations. How does this compare with what you're seeing in terms of mid-cap and large-cap securities today?

Great. Sure. Maybe I'll maybe I'll start off, if that works for you all. Just kind of taking a step back and considering this massive valuation trend and kind of this massive discount that small caps, right, have had, compared to large caps, over the recent period, if we think about, recent performance, again, just going back through the third quarter period, and we think broadly about an index that's more focused on small- and mid-cap companies like the Russell 2500 Value Index, those companies potentially are benefiting from some of these same trends as well, and we've seen little bit of a, of a reversal there, as well. So the Russell 2500 Value Index [of small- and mid-cap stocks] significantly outperformed the S&P 500 during the third quarter [of this year].

So if we look back at pretty much any other longer-term kind of standard period, right, like the one-, three-, five- and ten-year periods, in October—and even refreshed through mid-November--essentially, overwhelmingly over the last decade, large caps are really besting smaller-cap and SMID (small-mid-cap returns on an overall market-wide basis, as represented by proxy indexes.

This is quite different from what the long-term trend has been, if we were to look back many decades and consistently see that small caps have delivered excess returns over large-cap companies on a market-wide basis.

Janice

So, if we just kind of take a snapshot, and a quick look at the current valuations we're seeing [the small/mid-cap price to earnings valuation] remains compelling at the end of October, with prices around 16 times estimated earnings for the upcoming 12 months for the [Russell 2500 Value Index], versus kind of low 20s, 22 or so for the S&P 500. That gives us about a 20%, you know, discount rate just from a pure valuation perspective there. If we take a look into the smaller-cap value space, we would see an even steeper discount there, somewhere in the mid-30s, kind of [around] 35% discount to large- cap stocks. So this is being referred to by some as really a generational, valuation discount for this reason. And again, by almost any metric that we look at, you know, too in terms of price to cash flow, price to sales, forward P/E you're seeing a really significant valuation discount for small caps, and smaller and mid-cap companies.

So the attractive valuation differential underscores the importance of valuations as a strong determinant of long-term performance and some kind of a reversion to the mean. So we're hopeful that what we're seeing here in this outlook we have going forward, over the coming years, will help us to get back there.

Again, as we talked about before, this outlook is its further amplified by the effect of lower interest rates, that we talked about earlier too. And a lower, discount rate leads to higher valuation multiples for stocks, as well. So, this is another impact that's even more pronounced for smaller-cap stocks.

And since these stocks are more reliant on earnings growth, the increase in valuation multiples is, even more, important. And a significant portion of their value is based on future growth expectations, as Nancy mentioned.

And again, I think we would probably be remiss to have this conversation without at least touching on, for a quick second on this massive concentration we've been seeing in the broader market within a handful of names, or seven or so names.

But, in spite of this (or maybe because of this), huge concentration where roughly a third of the broader market is, is concentrated in in seven names, it does leave a big opportunity, within smaller-cap companies where we see a lot more, diversification. And it makes doing the work and the research even more important and more valuable and more potential alpha discovery for, for managers that are willing to do the work—to generate potential alpha for their clients.

Nancy

I'm going to jump in as well. And, you know, everything that Janice said about the small-cap value space is also very true in the small-cap growth space. And we find the same thing as you go down in market cap, into the smallest size of the market, that valuation discount becomes even greater.

So to put that in a little bit of context, because there has been a fair bit of conversation about how this first move up, particularly this move over the last six weeks, has been valuation multiple expansion. And that's true. We have seen the multiples expand in this move up. Interestingly, we have not seen that relative multiple change. So even with the multiple expansion in the small-cap growth and value space, it's still maintaining the discount because multiples have expanded just as much and, over the longer term, even more than in the large-cap space.

But it's also important to understand that in market history, this is actually how market cycles always start. The first move is generally multiple expansion, because what we know is that low multiples are a necessary, but not a sufficient condition for a sector or an asset class to outperform. We've had this necessary condition for a couple of years—really, actually for about ten years—

but we were waiting for those earnings growth numbers to improve. What we saw in the third quarter was acceleration of both revenue and earnings growth in that small-cap space. And we're seeing a meeting of those growth rates now being driven both by improving growth fundamentals in small-cap, as well as the math of still-excellent growth, but declining growth rates in those largest-cap stocks as they compare against the absolute extraordinary growth rates we have going forward.

And so that, then, provides that catalyst to take this from a multiple expansion cycle to an overall earnings-growth-driven [one], which can be a much more long-lived cycle. And again, we need to remember that as good as small-cap stocks have been recently, it is still an under-owned asset class in the market overall. The long-term average of small-cap stocks as a percentage of the overall market is about 7%.

At peak times in markets, it's been as high as 10%, and today it sits at about 4.0% to 4.5%. So that is at the very lowest. And it actually has not been that low since, the late 70s, early 80s and the period before that was after the Great Depression. So there have been very few periods in time when small-cap stocks have been so small as a percentage, which we believe gives tremendous runway as the earnings growth comes through and more investors want to get involved.

Jessica

Wow, that was incredible. Both of you really helped to set the stage for what sounds to be a very optimistic outlook on the markets, and particularly the opportunities for small cap. Sounds like we have a few factors in play: lower taxes, a more favorable regulatory environment, lower rates, attractive valuations (though not the only factor, of course, that we need to consider). We are seeing, onshoring opportunities that are reshoring and that's going to benefit small businesses. And we've been talking about AI with large-cap firms. But it's a small, small companies that are going to bring that AI to life through their technology innovation; and, importantly, how M&A is picking up.

So we've covered I think so much ground in just a very brief amount of time with you both. I so appreciate you just spending a little bit to let us get inside what you're thinking about, where you see the opportunity. And again, I just want to thank you both for your time. And at this point, I'm going to turn it back over to Ken.

Ken

Thank you. Jess, that was a great discussion. And I couldn't be more proud to show the diversity in our line up through these professional women. We work diligently to offer a broad array of portfolios and experts, and this discussion featured one of our longest standing sub advisor relationships with GAMCO and Janice, as well as one of our newest with Nancy and Essex Investment Management.

Thank you, Jessica, for facilitating the discussion and representing true leadership and support within Equitable Investment Management.

To our listeners: Make it a great day and stay tuned for our next podcast which will speak to alternative strategies and investments. Thank you.

1 A company is considered to be a "small-capitalization" company if, at the time of purchase, its market capitalization is less than or equal to the market capitalization of the largest company included within the Russell 2000® Index. U.S. microcap companies are considered companies, which at the time of purchase, have capitalizations that place them among the smallest 5% of companies listed on U.S. exchanges.

2 The Russell 2000® Growth Index measures the performance of those Russell 2000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000® Value Index includes those Russell 2000 companies with relatively lower price-to-book ratios, lower forecast medium-term growth, and lower sales per share historical growth.

3 The S&P 500 Index is a weighted index of common stocks of 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. The index is capitalization weighted, thereby giving greater weight to companies with the largest market capitalizations.

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