No Earnings? Big Problem:
The Impact of Negative Earnings Stocks in Microcap

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Introduction

The dominant broad market themes over the last decade have been sustained but low economic growth and persistently low interest rates. The low growth environment has led investors to seek out stocks with higher expected long-term growth above those that generate current earnings, and the low interest rates have justified higher valuations for these growth stocks due to the associated low discount rate on future cash flows. This phenomenon has accelerated recently, and as it has gained steam it has led to an increasing number of large, unprofitable companies coming public in the equity markets, Given this trend we thought it was an appropriate time to reflect on how negative earnings stocks have performed over the long run. In this paper we will explore the non-earning exposure of large cap and microcap indexes and provide some context on the performance differential between companies that make money and those that don't in each space. Additionally, despite strong long-term returns, microcap stocks generally attract less investor attention in the U.S. equity markets. We think investors will continue to be rewarded over the long run for investing in microcap stocks. However, given the large proportion of microcap stocks that have negative earnings and the performance reward to avoiding and/or effectively navigating negative earnings stocks, we believe it is particularly critical to utilize active managers when investing in microcap stocks.

Growth Markets and Negative Earnings Stocks – Throwback to the '90s

Over the last few years the largest growth stocks have led the markets higher. Investors have increasingly sought out stocks with more favorable perceived long-term growth opportunities at the expense of current valuations. This has resulted in generationally extreme dislocations such as the performance differential between the largest and smallest stocks, as well as a return disparity between growth and value stocks, especially in larger stocks.

During more recent periods non-earning companies have not only kept up with the market, but in some cases outperformed, garnering top dollar initial public offerings and boasting high market valuations despite still not executing on what the market (theoretically) pays them to do: generate profits and return value to shareholders. One important attribute of recent market leading IPOs and headline grabbing companies has been that they do not generate positive earnings. Prior to an IPO, privately held companies with over $1 billion valuations have been dubbed "unicorns" due to their scarcity. These companies are often characterized by their lack of profitability and outsized valuations, but high optimism over their long-term prospects. Many of these unicorns have gone public, bypassing the microcap space entirely due to investor demand for growth, market share and disruption over earnings.

It is hard to think of a handful of companies with no earnings leading the market without thinking back to the Internet bubble in the late '90s and the following correction. This parallel has been more on point recently given the market leadership of companies with high P/Es like the FAANG stocks or those with no earnings at all like many biotech companies.

Amazon may be the most famous company that for years re-invested in growth and despite soaring revenue, generated negative earnings. The company went public on May 15, 1997. It didn't generate positive earnings until the third quarter of 2001 and continued to dip into negative earnings for the occasional quarter until fourth quarter of

2014. While technology and internet-based companies are usually associated with negative earnings, there are traditional household names that transition to and from profitability. More recently, CVS, GE, Qualcomm and perhaps most famously Uber were all companies worth more than $50 billion in 2019 that generated a loss for the full year 2018.

Investors typically value companies based on earnings. It therefore seems counterintuitive to point to some of the largest companies in the financial markets that have yet to reach profitability. In place of earnings, investors are often willing to focus on growth and the anticipation of future earnings. In the 1990s investors talked about "eyeballs" and stocks often traded at robust revenue multiples when earnings were scarce or non-existent. One note about the present environment is that when interest rates are low and financing is plentiful, it is easier to sustain a company to profitability. Also, when investors have an appetite for risk, there is more focus on growth expectations and less on current earnings. Investors like David Einhorn have speculated that equity value may stem more from the ability to be disruptive, provide social change or advance technologies than to generate economic gain. In the long run, we believe it comes back to earnings and in microcap a focus on earnings pays.

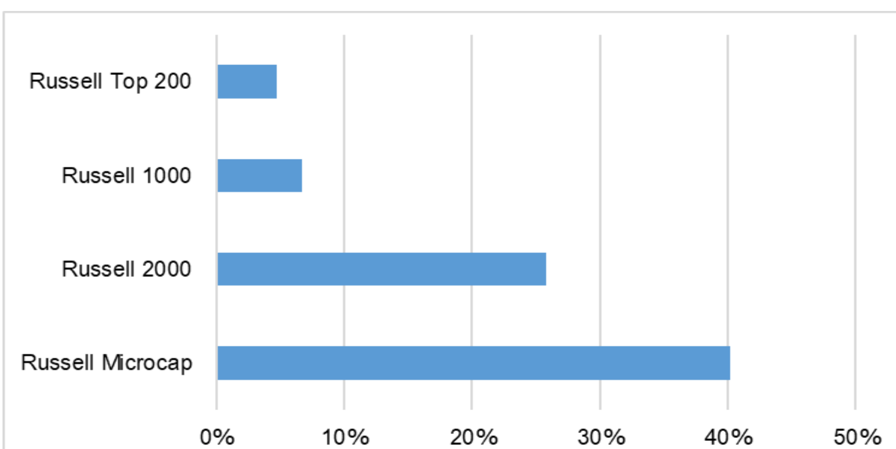
One also can't help but notice other similarities between this market behavior and that of the late 1990s and early 2000s, as unprofitable companies raised money at the fastest pace since the dot-com bubble. In fact, the IPO class of 2019 to-date is the least profitable since the tech bubble, with less than a quarter of the newly tradable companies expected to reach positive net income by 2020 (Goldman Sachs). While still not as extreme as during the dot-com bubble, a few unprofitable company IPOs have surged since the financial crisis. Investors have not been deterred by this lack of profitability as evidenced by the fact that IPOs since 2017 outperformed the market by an average of 27 percentage points in their first month (Bloomberg.com). Third quarter of 2019 saw a notable shift as investors became more cautious and sold out of non-earning companies.

The poster child for non-earning, growthy, overvalued companies this quarter was the private company WeWork. There was no shortage of news articles detailing the fiasco, as one of the most anticipated IPOs of the year was periodically devalued and eventually cancelled. Previously celebrated unicorns like Uber and Lyft also lost up to half their stock value in a matter of months as the growth and momentum trade paused and some of the highest valuation stocks in the market were punished.

Negative Earnings Stocks in Microcap – More of Them, Worse Performance

While high-profile companies like WeWork gather headlines, the majority of non-earners are nowhere near the Russell 1000 in terms of market cap. In fact, as shown below, the Russell 1000 Index is largely profitable, with over 93% of companies in the Index generating positive net income. Compare this to the Russell Microcap Index and the percentage of profitable companies quickly deteriorates. In microcap, even more companies trade on the promise of long-term growth as opposed to current earnings. While earners still make up over half of the Index, in relation to other cap tiers, the difference is clear, with the Russell Microcap Index containing six times the weight of large cap in non-earning companies.

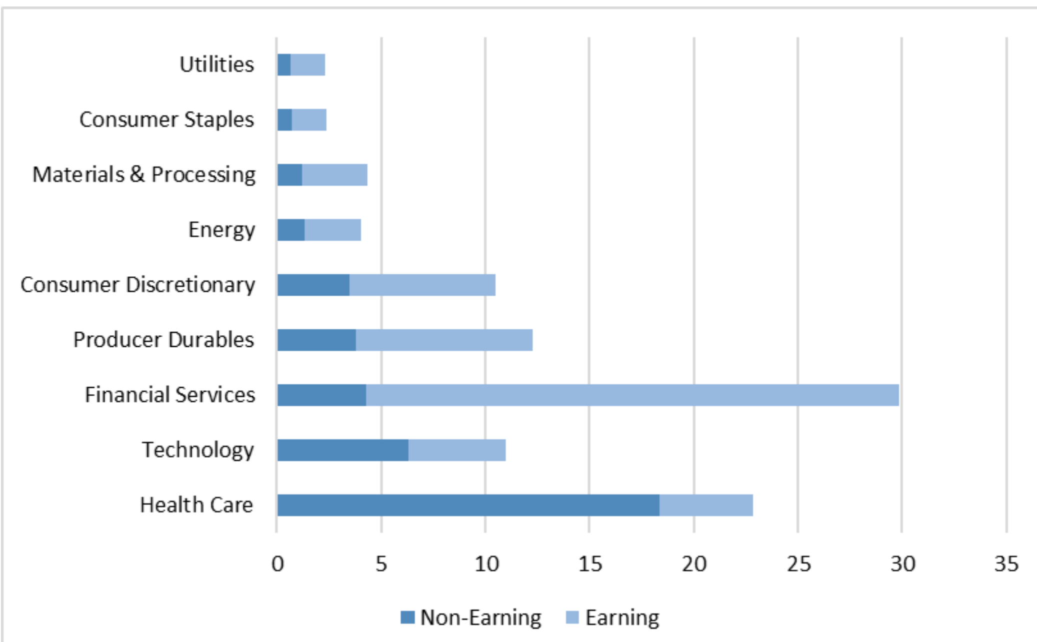
Exhibit 1. Non-Earner Exposure by Index (As of 9/30/19)



Source: Acuitas Investments, FTST Russell, FactSet

Within the Russell Microcap Index, unsurprisingly, most non-earners reside in health care, making up nearly half of the total companies. Under 20% of health care companies within the Index turned a profit. In Exhibit 2, we show technology is a distant second and is closely followed by financial services and producer durables. This helps characterize the importance of active management in the microcap space. If over 22% of the Index is comprised of health care companies, 18% of which are non-earning, there is a clear advantage to navigating this space with a skilled manager that can successfully invest in biotech stocks that don't trade on earnings, but account for a notable weight in the Index.

Exhibit 2. Russell Microcap Index Sector Breakdown of Earners and Non-Earners (As of 9/30/19)



Source: Acuitas Investments, FTSE Russell, FactSet

Delving further into the return and industry dynamics that impact the Russell Microcap Index, the relationship that illuminates this recent shift perfectly is the Russell Microcap Index in comparison to biotech and pharmaceutical companies. While the Russell Microcap Index fell moderately during the third quarter of 2019, the pharmaceutical and biotech industry within the Russell Microcap Index returned -16.86%, underperforming the Russell Microcap Index by 11.41%. This is one of the widest spreads observed since the Index's inception in 2000, and the widest since the end of 2016. It is less surprising when we note that earnings were rewarded, and Russell Microcap pharmaceutical and biotech companies are made up of over 90% of companies whose EPS are less than zero. In contrast, this percentage drops to just over 40% for the Russell Microcap Index as a whole.

Over the long run, when dissecting the premium associated with investing in higher quality companies and subsequently reducing exposure to non-earners, the data is clear. Since the year 2000, the average return advantage associated with positive versus negative earners is about 2% per quarter, whether in microcap or large cap. Using cash flows instead of earnings produces a similar result, with positive operating cashflow stocks also outperforming negative operating cash flow stocks by about 3% per quarter in microcap, and 2% in large cap (Source: Matarin Capital Management). This is also true over shorter periods such as the trailing ten years. As shown in Exhibit 3, when looking at the average quarterly returns since third quarter 2009, the data indicates that it pays to avoid non-earners, especially in microcap. While non-earners in large cap etched out an average positive return of 1.28%, non-earners in microcap produced *negative* returns over the same time period, and the spread between non-earner and earner returns was double that of large cap. The long-term advantage to investing in quality companies that generate a profit is compelling. To us this supports the case for remaining an active investor in U.S. microcap. It is a clear way to reduce exposure to companies without earnings, to capture the return premium over time, and to allow an opportunity to differentiate between companies with temporarily depressed earnings versus those with permanently impaired earnings power.

Exhibit 3. Average Quarterly Returns Over the Last 10 Years (9/30/09-9/30/19)

	Micro	Large
Earnings	4.56%	3.51%
Non-Earnings	-0.05%	1.28%
Spread	4.61%	2.23%

Source: Acuitas Investments, FTSE Russell, FactSet

Earnings power is only one company characteristic that impacts security returns, and as one of our quantitative managers reminds us, "we live in a multi-factor world". As we touched on above, the third quarter of 2019 saw an extreme reversal from the dominant market trends of the last several years. Within U.S. microcap, non-earning companies lagged those with earnings by -11.69%. This performance gap was consistent across cap tiers to varying degrees (the Russell 1000 Index non-earners lagged by -4.95%.) Other associated factors that significantly impacted returns included a sharp reversal in momentum and growth preferences. While we may or may not look back at the third quarter as a longer-term inflection point, one thing is more certain; over the long-term, earnings generally determine market prices and stocks with earnings generally outperform those that don't. That said, we are aware that particularly in health care and technology there are disruptive forces at work and our investment managers must be diligent in gauging the growth prospects for the companies they monitor.

Conclusion

In microcap there are simply more companies without earnings, and their stocks tend to persistently underperform profitable stocks over the long run. In our view, this dynamic allows for more room for active managers to make thoughtful determinations on stock selection. Given that, we feel it is important to highlight the benefit of active managers favoring stocks with earnings and of the associated long-term performance. Many of these microcap companies are in the early stages of growth and seek to transition to profitability. Others have declining profitability and are less attractive or have hit a difficult patch that makes their valuation attractive. Wherever they stand in their life cycle, periods with a preponderance of IPOs without earnings and strong performance of non-earning growth stocks will generally be a headwind for us and for active management. Over time, however, we believe these periods present valuation opportunities in companies with resilient fundamentals. We believe managers with strong research and a consistent process will be able to exploit these opportunities by identifying and investing in companies that generate strong earnings at attractive valuations.