COVID-19 Market Dislocations: Creating Opportunities in Active Microcap

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Matt Nieman, CFA
mnieman@acuitasinvestments.com

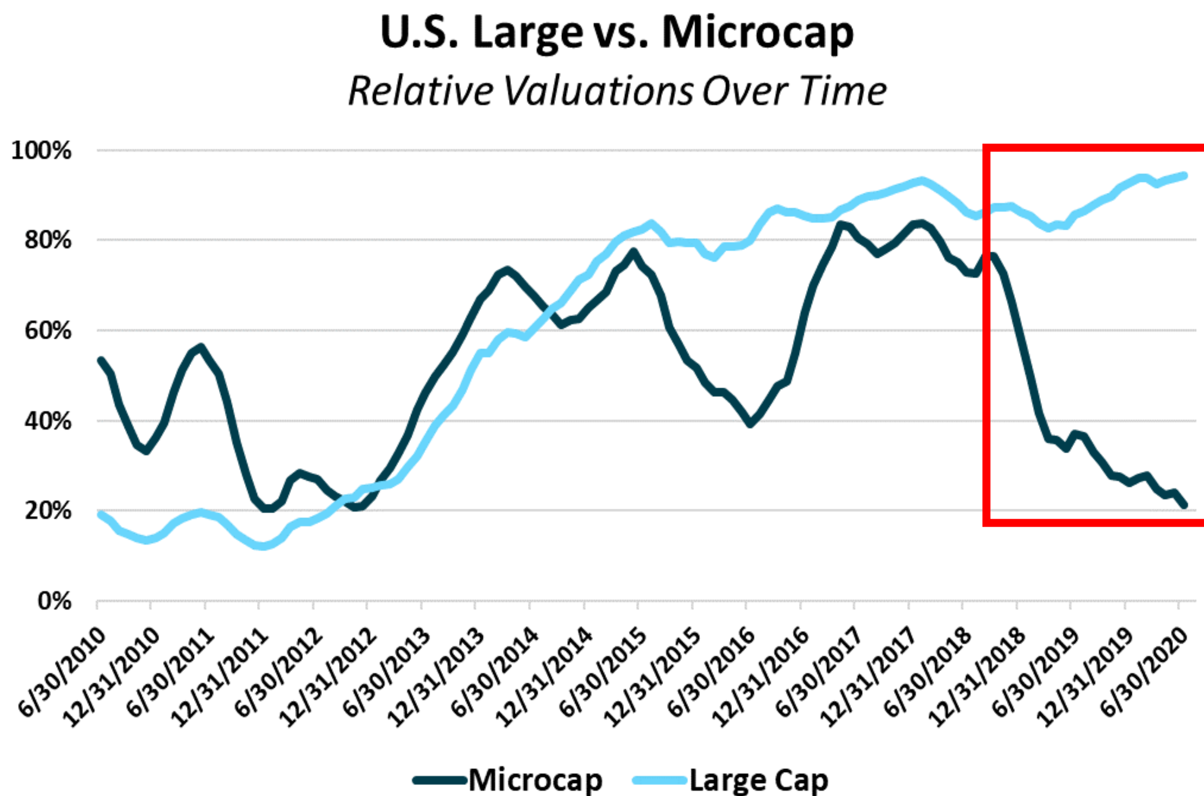
The second quarter of 2020 contained copious storylines spanning equity markets, global financial systems, federal and local governments, social justice protests, a global health crisis, political uncertainty, and a difficult economic landscape for countless individuals, families, and businesses. Each one of these topics deserves a critical deep dive, discussion, and reflection. That said, given our focus on microcap, this paper is a reflection on recent market activity that has created historic dislocations between U.S. microcap relative to the rest of the market and the resulting opportunities for active microcap managers.

The most common line of questioning that we have received lately is about why the equity markets have rebounded so aggressively since their March 23 lows, and whether they will come crashing down again? Admittedly, there is no perfect (or even correct) answer to these questions. There are numerous challenges at the core of this debate, especially when attempting to fundamentally assess current market valuations. When investors think of valuation, they typically look to the traditional metrics of price/earnings, price/cash flow, price/book, and so on. Unfortunately, the denominators in these popular valuation metrics have been upended due to COVID-19 and a mix of the other headline topics mentioned earlier. Additionally, forward looking metrics are skewed as the level of uncertainty moving forward has driven many companies to pull guidance altogether. It is easy but dangerous to look at any one of these metrics in isolation when trying to explain what has transpired.

Our valuation scores show a historically wide divergence. In an attempt to combat some of these challenges and answer the question at hand, we built a value score for both U.S. large cap and microcap using a composite of popular metrics since the inception of the Russell Microcap Index (equal weighted trailing and forward looking P/E, P/CF, P/B). Although not perfect, this provides a less biased view of where things currently stand and helps mitigate some of the issues associated with skewed data points. Exhibit 1 below shows a rolling six-month average over the past ten years for this valuation score for both micro and large cap relative to their own histories. Looking at the scale, 100% is the most

expensive possible score and would represent every individual metric being the most expensive they have ever been, 50% is the median, and 0% is the cheapest. While the explanation may be a bit complex, the takeaway is quite simple: from a valuation perspective large cap continues to look unreasonably expensive, while microcap looks quite attractive relative to both its own history and the rest of US equity.

Exhibit 1: Relative Valuations



Source: Acuitas, FactSet, FTSE Russell

Microcap fell more dramatically during the crisis and remains cheap. There are additional takeaways from this data, which the red box highlights. First (readers of our recent papers will already know this) is that microcap already looked quite attractive before COVID-19 hit. The Russell Microcap Index peaked at the end of August 2018 before markets sold off aggressively into the end of the year. Large cap companies were able to quickly shrug off the decline, needing only three months to recover all of the losses by the end of the first quarter of 2019. Microcap, however, never did fully recover. The Index was still meaningfully below the 2018 peak when the dramatic COVID-19 selloff hit

in late February of 2020. Despite this, the Russell Microcap Index was pummeled and experienced its worst quarter in its history, falling -32% between January and March of 2020. The snap back in the second quarter has been dramatic as well, as the three-month return of +30.5% was the best quarter ever for the Microcap Index. Despite the rebound, the Microcap Index remains well below its highs from two years ago, and the disconnect on both an absolute basis and relative to the rest of the U.S. equity market persists.

The broad market anticipates a robust recovery. An additional critical takeaway from Exhibit 1 is that large cap has come out of the COVID-19 pandemic virtually unscathed (so far). The S&P 500 started the year just north of 3,200 and as of this writing is now above 3,350; an upward move hardly indicative of a global health and economic pandemic the likes of which the world has not seen in over a century. In addition, the year began with accommodative monetary policies, corporate profits at record levels, and unemployment at historical lows, all of which helped justify the S&P's levels in the eyes of numerous industry pundits. Fast forward a few months and the global economy is now in shambles, over 20 million people have contracted COVID-19, over 700,000 have died, millions have found themselves unexpectedly unemployed, countless businesses have had to file for bankruptcy, and there does not appear to be a near-term end in sight. Many investors, us included, are trying to make sense of this. Granted there are some green shoots hinting at early signs of a recovery, such as housing starts and pockets of positive economic data (ISM manufacturing numbers). However, given what has transpired and the continued lack of clarity moving forward, it is tough to reconcile that the market (S&P 500) has managed positive returns for the year. This clear divorce between Main Street and Wall Street certainly raises a number of questions.

The liquidity flood from the Fed has provided fuel for the market. First, and perhaps most obvious, is that markets are forward-looking. Conversely, economic turmoil is felt in real time for consumers fighting through forced business closures, layoffs, and stay at home orders. The market has responded incredibly well on days where incremental positive news on vaccine development is announced, which makes sense. However, we are at least months away from an effective vaccine, and trial results have little impact on the day to day lives of everyday citizens. Second, there has been an unprecedented level of fiscal and monetary stimulus pumped into the economy, which has directly benefitted equities. It is worth noting that as of this writing, an additional stimulus package is being debated within Congress and further requests have been pitched from the Oval Office. This massive liquidity injection into both the markets and households' checking accounts has, at least for the time being, helped prevent the COVID-19 health crisis from turning into a full-blown financial crisis. All things considered, these efforts appear to have been quite successful in supporting the financial system over the short term, while the long-term ramifications remain less clear.

The largest names dominate the indexes and market leadership. Naturally, the

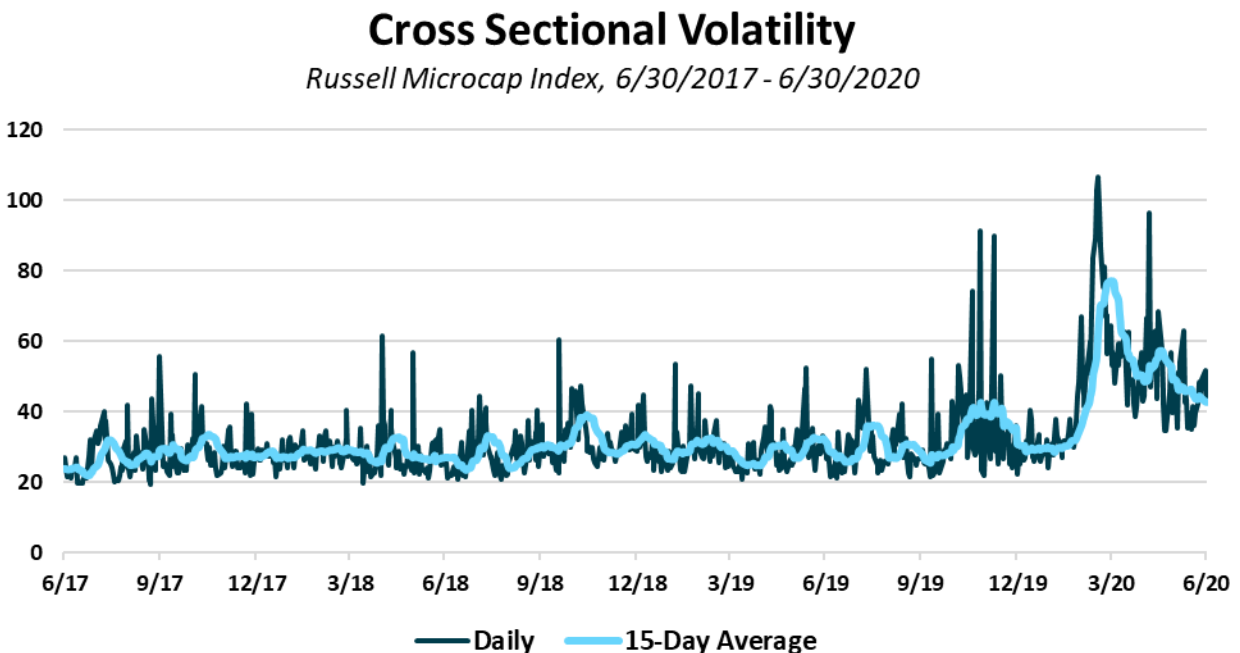
unprecedented level of stimulus has supported the rebound in equity markets and contributed to the disconnect relative to the economy. A third key driver of the divergence is that headline market indexes have become less representative of the economy than they have been historically, and the large cap indexes are increasingly concentrated in a handful of technology companies. To attempt to put it into perspective, Microsoft, Apple, Amazon, and Google now represent over 20% of the S&P 500 Index. Additionally, these companies each have market caps worth more than the entire energy sector within the U.S. public equity markets (Russell 3000 Index). Perhaps the most remarkable data point is that in aggregate, these four companies are now larger than four entire sectors combined: utilities, energy, materials & processing, and consumer staples. A handful of these large tech companies are in the enviable position that they can continue to thrive during the pandemic: Microsoft, Apple, and Amazon grew their top lines at 13%, 11%, and 40%, respectively, for the June 30, 2020 quarter compared to the June 30, 2019 quarter. Incredibly, before declining on July 24, the NASDAQ Index had gone 50 trading days (more than 10 weeks!) without back to back days of negative returns. Admittedly, prospects for a continuation of an ultra-low rate environment (and even negative real rates) can be used to justify the valuation of growth stocks due to the longer duration of their future expected earnings, but we believe their valuations have reached levels that are disconnected from their fundamentals. Additionally, despite the success for these companies, the fact remains that an overwhelming majority of businesses are being hurt by the crisis. The increased concentration of the NASDAQ, S&P, and other headline indexes into a handful of tech companies has only magnified the gap between Wall Street and Main Street.

The next question is where this dynamic leaves us, and what comes next? While we try to avoid speaking in absolutes, especially during a period of such uncertainty, it is hard for us to imagine a time in our careers where we have been more excited about the prospects for both U.S. microcap relative to the rest of the U.S. equity market and the active return opportunity within the space. As discussed earlier, microcap was attractive relative to large cap before the COVID-19 selloff. Since then, this disconnect has only grown in magnitude. Broadly speaking, we believe microcap remains incredibly attractive relative to the rest of the market from a valuation standpoint.

Higher volatility means a better stock picking environment. In addition to the valuation opportunity within microcap, we are even more excited for the prospects for active management within the space. Cross-sectional volatility can be a litmus test of sorts to gauge the potential for active managers to add value above their target investment universe. When stocks start behaving in more idiosyncratic ways, active managers have a greater opportunity to discern the winners from the losers and therefore add value through stock picking. Exhibit 2 below shows this metric over the last three years for the Russell Microcap Index. Unsurprisingly, volatility had remained consistently low leading into 2020. Additionally, the early days of the COVID-19 selloff were quite

indiscriminate in nature, causing lower cross-sectional volatility than what may be expected during such a chaotic market environment. This remained true up until the middle innings of the market panic in March, with this measure ultimately peaking on March 18, 2020.

Exhibit 2: Cross Sectional Volatility



Source: Acuitas, FactSet, FTSE Russell

All else equal, this uptick in cross sectional volatility should provide a riper environment for stock picking relative to the past several years. Of course, all else is not equal, as numerous health, economic, fiscal, and political uncertainties remain in place, making it challenging to accurately project the future. However, uncertainty brings opportunity. What we are confident in is the prospects for active managers broadly, and particularly within U.S. microcap given how mispriced the asset class appears to be.

Active management can thrive in this environment. It is important to also recognize that there remains a very real risk that some companies will not survive this current environment, and therefore a handful of the companies deserve to be priced as cheap as they are. On the other hand, large economic disruptions – both positive and negative – always present investment opportunities. There will be a number of microcap companies

that can and will come out of this pandemic in a position of strength. What makes it challenging is the sheer number of outstanding variables and unknowns, each of which presents meaningful and unique risks. Active management thrives in these types of environments where stock performance is driven by company specific factors as opposed to the low volatility, momentum driven environment we have experienced over the past several years. Active managers who can skillfully sift through the rubble, discern the winners from losers, and invest in companies based on their due diligence will be rewarded.

Looking forward we truly feel optimistic that the landscape will offer opportunities for active managers, and particularly active microcap managers, to make up ground. As always, thank you for your support. We hope you and your families are healthy and safe. For additional research papers and commentary on the global microcap market please visit our website at www.acuitasinvestments.com.

Disclosures

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