Bear Market Drawdowns & Recoveries in Microcap

August 2022

Matt Nieman, CFA
mnieman@acuitasinvestments.com

With U.S. equities currently in a bear market, we wanted to share some perspective on how U.S. microcap – our area of expertise – tends to behave during these time periods. In our discussions with other industry professionals, we often hear a variety of anecdotes and fallacies about smaller stocks, particularly regarding their performance during periods of market stress. As a multi-manager, we speak with hundreds of investment professionals, who in turn speak with thousands of individual company management teams. This provides us with a unique perspective on not only the current landscape for U.S. microcap, but also the distinct dynamics driving the challenging and unpredictable investment environment we find ourselves in.

While it is impossible to accurately handicap the odds of which economic scenario across the range of outcomes eventually occurs, most money managers we speak with fall in the "middle" on the recession debate: roughly half think a recession will not occur, while the other half think one will occur, but it will be relatively mild compared to recent recessions. Of course, this brings into question the technicalities of what actually defines a recession, which is a topic for another time. Perhaps most important in the recession debate is that very few – if any – of the managers we speak with are calling for a prolonged and painful multi-year recession.

During our countless discussions with industry peers, "timing" an entry point for a new microcap allocation is always front and center. In theory, for asset allocators with an extended time horizon, target allocations across asset classes will be far more impactful to long term results than entry and exit points across individual asset classes. However, the current bear market across U.S. equities along with an elevated degree of domestic and global economic uncertainty has understandably heightened the emphasis on timing. When stated return targets are at risk of not being met, each allocation decision takes on an inflated level of significance. While it is much easier said (or written in this case) than done, we are firm believers that regardless of where the economy and U.S. public equity markets go from here, active U.S. microcap currently presents an incredibly attractive entry point for allocators.

For Institutional Investor Use Only – Not for use with retail investors.

Current Valuations Relative to History

The recent market selloff has provided countless buying opportunities across the microcap universe, as many stocks have been unfairly punished despite continuing to deliver fundamentally and are now trading at discounted valuations. This dynamic has portfolio managers pounding the table on the prospects for the individual stocks in their portfolios. From an index-wide relative valuation perspective, U.S. microcap continues to look quite attractive, especially when compared to other market cap tiers. The Russell Microcap Index is currently trading at its lowest ever P/E and forward-looking P/E, while metrics such as P/CF and P/B look historically cheap as well (bottom quintile of historical ranges). Exhibit 1 below shows this dynamic.

Exhibit 1: U.S. Equity Valuations

6/30/2022 Valuations Relative to Historical (Percentile Rank)

	P/E	P/E (FY1 Est)	P/CF	P/B	P/S
Russell 1000	72.4%	77.5%	84.4%	91.0%	88.3%
Russell 2000	4.2%	4.6%	32.5%	29.4%	83.7%
Russell Microcap	0.0%	0.0%	15.8%	14.3%	71.3%

Source: Acuitas, FactSet. Data represents month end weighted median values for the associated FTSE Russell Index. The % shown is the percentile rank of the 6/30/2022 value relative to all month end values between 12/31/2000 – 6/30/2022. Past performance does not guarantee future results. It is not possible to invest directly in an index.

It goes without saying that investing in areas of the market that are trading at cheap relative valuations is typically a fruitful endeavor due to the strong correlation between increasing valuations and stock prices (price is the numerator in valuation ratios).

History of Bear Market Drawdowns

Another useful exercise to assess the current opportunity in microcap is to look at how U.S. equities have behaved across market cap segments during prior bear markets and the associated recovery periods. Since the inception of the Russell indexes, the large cap Russell 1000 Index has experienced six bear markets (including the current one), compared to twelve for the small cap Russell 2000 Index and seven for the Russell Microcap Index. Each of these drawdowns are highlighted below in Exhibit 2. As a note, the Russell 1000 and 2000 Indexes have an additional ~20 years of history relative to the Russell Microcap Index, so the smaller absolute number of bear markets within microcap should not be interpreted as microcap being less susceptible to them.

Exhibit 2: History of Bear Markets (Russell Indexes)

History of Bear Markets (-20% Market Declines)

Since Inception of Each Index

	Russell 1000 (Large Cap)		Russell 2000 (Small Cap)		Russell Microcap *(Inception: 6/30/2000)*	
	Mkt. Bottom	***Drawdown***	***Mkt. Bottom***	***Drawdown***	***Mkt. Bottom***	***Drawdown***
	8/12/1982	-21.88%	3/27/1980	-26.26%	12/20/2000	-22.70%
	12/4/1987	-32.66%	8/12/1982	-26.18%	9/21/2001	-25.17%
	10/9/2002	-48.09%	7/25/1984	-24.12%	10/9/2002	-33.61%
	3/9/2009	-55.41%	10/28/1987	-38.94%	3/9/2009	-64.26%
	3/23/2020	-34.58%	10/31/1990	-32.54%	2/11/2016	-28.59%
	6/16/2022	-23.92%	10/8/1998	-36.46%	3/18/2020	-47.75%
			10/9/2002	-44.12%	6/16/2022	-33.70%
			3/9/2009	-58.89%		
			10/3/2011	-29.13%		
			2/11/2016	-25.71%		
			3/18/2020	-41.75%		
			6/16/2022	-31.92%		
Avg. Drawdown	**-36.09%**		**-35.18%**		**-36.54%**	

Source: Acuitas Investments, FTSE Russell. Inception date/historical data for the Russell 1000 and Russell 2000 Indexes begins on 12/29/1978, while the Russell Microcap Index data begins on 6/30/2000.

On average, bear market drawdown amounts tend to be quite similar regardless of cap tier, with less than 50 basis points separating the average drawdown for large cap (-36.09%) and microcap (-36.54%). That said, these figures are a bit deceptive at face value. Small and microcap experience a higher frequency of -20% drawdowns, which distorts the aggregate figures as large cap also declines during these environments but might not eclipse the -20% threshold. It should come as no surprise that during periods where the *overall* market declines into bear territory, smaller stocks sell off more aggressively than larger stocks. Most recently, investors experienced this very dynamic during the 2020 COVID selloff (micro -47.75% vs -34.58% for large), and again to start 2022 (-33.70% for micro and -23.92% for large). This meaningful selloff in 2022 is a direct

contributor to why microcap is trading at a historically extreme discount relative to large cap, as shown earlier in Exhibit 1 with the relative valuations. Of course, we still do not know if June 16, 2022 truly was the market bottom. As of this writing, markets have recovered a portion of their losses, but still sit well below their prior peaks.

While each bear market has a multitude of unique characteristics and driving forces, the current environment is worth addressing as there are numerous compelling tailwinds for microcap. For example, the recent strength of the U.S. dollar has been a constant talking point for industry pundits and for those looking for a suddenly “discounted” trip to Europe. The U.S. dollar is stronger than it has been in decades, and recently reached parity with the euro. A strong dollar presents challenges for companies that rely on exports/foreign sources of revenue, as their goods and services become less competitive to domestic alternatives. Nearly 40% of revenues for companies across the Russell 1000 Index are generated outside the U.S., while this number drops to less than 15% for microcap companies. Simply put, U.S. microcap companies have far more domestic exposure (and less global exposure) than large cap companies, which is a clear relative advantage during periods of strength for the U.S. dollar. This concept extends beyond just the strength of the dollar, as recent trends of deglobalization (particularly regarding supply chains) also place numerous microcap companies in a stronger competitive position than they were pre-pandemic due to the greater degree of leverage to the domestic economy.

Microcap Recovers Significantly Quicker than Large Cap

Microcap’s tendency for larger drawdowns means the recoveries are significantly larger as well (a 50% drawdown requires a 100% return off the bottom to fully recover), which presents a great opportunity for investors. The main question then becomes the speed at which these drawdowns and recoveries occur relative to one another, as a larger recovery loses its benefit if it occurs over a significantly longer time horizon. Exhibit 3 below shows the prior timelines of bear market drawdowns, recoveries, and “peak to peak” for historical bear markets.

Exhibit 3: Bear Market Timelines

Bear Market Timelines

Average Number of Months

	R1000	R2000	RMicro	RMicro - R1
Peak to Bottom (Drawdown)	13.4	11.9	10.0	**-3.4**
Bottom to Peak (Recovery)	21.6	11.1	14.3	**-7.3**
Peak to Peak (Total)	35.0	23.1	24.3	**-10.7**

Source: Acuitas Investments, FTSE Russell. Inception date/historical data for the Russell 1000 and Russell 2000 indexes begins on 12/29/1978, while the Russell Microcap Index data begins on 6/30/2000.

As shown above, there is a meaningful difference in the speed of both drawdowns and recoveries when comparing large cap to microcap. As to be expected, drawdowns occur at a faster pace in microcap than large cap, as the higher beta from smaller stocks shows up during these periods. Most important however, is that despite having more ground to make up during recoveries (i.e. requires greater absolute returns), microcap tends to recover all of its losses far more quickly than large cap does, with an average recovery time of 14 calendar months for microcap compared to nearly 22 for large cap. In total, the "round trip" time horizon for microcap is nearly 11 months faster than it is for large cap. Said another way, bear markets last much longer in large cap than microcap.

Simply put, allocations to microcap have historically paid off incredibly well coming out of bear markets, as returns are both larger in magnitude and achieved at a quicker pace. As such, we feel the current drawdown presents a fantastic timing opportunity to allocate to microcap, regardless of when the recovery occurs (this assumes allocators believe that markets will, at some point, eventually recover).

Active Microcap Managers Meaningfully Outperform Throughout Bear Markets

Another critical element of bear market drawdowns and recoveries is how fruitful they are for active managers to add alpha on top of the benchmark returns. While each bear market is unique, there are always a variety of factors at play that impact certain parts of the market and economy to different degrees. In turn, the impact on individual companies can vary significantly, as certain economic dynamics can put individual companies at risk of bankruptcy while other companies find themselves in a position of competitive strength. Additionally, active managers tend to be biased towards "quality" companies – such as those with strong and defensible balance sheets – which tend to outperform during drawdowns. These dynamics (and others) provide a distinct advantage for active managers during periods of market turmoil relative to passive investing. The historical active returns during these time periods demonstrate this very dynamic, as highlighted below in Exhibit 4.

Exhibit 4: Active Manager Performance in Bear Markets

Historical Excess Returns During Bear Markets

Active U.S. Microcap Managers

	Average Excess Return	Outperformance Hit Rate (Avg Mgr)
Peak to Bottom (Drawdown)	5.54%	100.00%
Bottom to Peak (Recovery)	6.97%	66.67%
Peak to Peak (Total)	**9.21%**	**100.00%**

Source: Acuitas Investments, eVestment. Manager data is from the entire U.S. Microcap universe on record in the eVestment database, including closed products, from 6/30/2000 through 6/30/2022.

When looking at the relative returns of every active microcap product (in eVestment's historical database), the average active manager outperformed the Russell Microcap Index by 554 basis points during bear market drawdowns. Given the tendency for active managers to have a modestly defensive posturing, their ability to protect capital during drawdowns isn't terribly surprising. What is a bit surprising from the historical data is that active managers have fared even better during recoveries than they have drawdowns, with average excess returns of nearly 7% over the benchmark. This dynamic does come as a surprise to many allocators, as market recoveries are often accredited to junk rallies and "risk on" environments, where active managers can struggle to keep pace with the index. In total, from the beginning of bear market drawdowns to the point of full recovery, on average active microcap managers have added 921 basis points of excess returns over the index. Point being, in addition to investors being rewarded with stronger absolute returns within microcap, they also receive a significant boost from active managers' ability to add alpha in excess of the index returns.

Lucrative Microcap Active Environment Exists During and After Bear Markets

It is important to highlight that while these excess returns during bear market drawdowns and recoveries are impressive, they are not an anomaly by any means. Active microcap managers tend to outperform their benchmarks during "normal" market environments as well. Exhibit 5 below shows cross-sectional volatility – a measure of return dispersion across the individual stocks within the Russell Microcap Index (a decent proxy for measuring how friendly the active environment is) – within U.S. microcap during bear market drawdowns and recoveries. The final "Post Recovery to Next Drawdown" column represents cross-sectional volatility for the time periods after a full recovery of a bear market until the beginning of the next bear market drawdown (i.e. all time periods not contributing to nor recovering from a bear market).

Exhibit 5: Active Environment in U.S. Microcap

Cross-Sectional Volatility

Russell Microcap Index

Russell Microcap Index Trough	Peak to Bottom (Drawdown)	Bottom to Peak (Recovery)	Post Recovery to Next Drawdown
12/20/2000	45.3	39.4	60.6
9/21/2001	36.0	37.8	32.4
10/9/2002	38.4	33.8	26.5
3/9/2009	35.8	28.2	24.8
2/11/2016	30.5	26.1	26.2
3/18/2020	29.3	43.0	44.5
Average	**35.9**	**34.7**	**35.8**

Source: Acuitas Investments, FactSet.

The similar volatility within microcap across these different market environments was somewhat surprising to see. The COVID selloff and recovery during 2020 was a notable outlier however, as the drawdown was incredibly indiscriminate in nature during the market collapse (low cross-sectional volatility supports this), which is typical during a crisis. Meanwhile, the $5 trillion in stimulus provided unprecedented tailwinds to certain companies and industries during the recovery and post-recovery periods (as shown by the elevated cross-sectional volatility post market bottom). While outlier scenarios such as 2020 will occur, on average there hasn't been a significant difference during historical bear markets. The fact that active microcap managers have shown the ability to consistently outperform the index during these periods highlights the inefficiencies that they are able to capitalize on over full market cycles.

Style/Sector Performance During Bear Markets and Recoveries

The last item we wanted to discuss on this topic is how different styles (value and growth) behave during recovery periods, as we often hear a variety of misconceptions about these time periods. Exhibit 6 below shows the style performance during the recovery period of each bear market since inception of the Russell Microcap Index.

Exhibit 6: Microcap Value vs Growth During Market Recoveries

U.S. Microcap Style Performance

During Bear Market Recoveries

Russell Microcap Index Trough	Russell Microcap Value Index	Russell Microcap Growth Index	Growth - Value
12/20/2000	37.29%	24.36%	-12.93%
9/21/2001	36.15%	30.95%	-5.21%
10/9/2002	46.12%	57.26%	11.13%
3/9/2009	183.07%	173.31%	-9.76%
2/11/2016	43.43%	35.64%	-7.79%
3/18/2020	77.64%	107.55%	29.90%
Average	**70.62%**	**71.51%**	**0.89%**

Source: Acuitas Investments, FTSE Russell.

Microcap value has traditionally been the strongest performing segment of U.S. equity markets (slight lead over microcap growth), however once again, the recovery off the COVID bottom in March 2020 was an outlier event for the performance of growth (+29.9%), which distorts the historical averages. Of course, there was an extraordinary set of circumstances that provided tailwinds for 'growth' companies, including zero interest rates and unprecedented stimulus which acted as a life-saving bailout for many non-earning growth companies.

As discussed earlier, inflation is at the heart of the current drawdown, and typically during these environments energy and materials outperform. Owning physical assets and commodity-linked businesses benefits investors when the value of assets increases. On the other hand, some

traditionally defensive sectors such as consumer staples and utilities could face potential headwinds due to being consumers of commodities.

Most important regarding sectors is the composition difference between large and microcap, where there are three significant differences in terms of sector weightings. The most prominent deviation is technology, as the tech weight in large cap is nearly three times as large as it is in microcap (+17.3%). All else equal, the current environment of rising and elevated interest rates after an unprecedented period of low-zero rates could continue to pressure large growth companies that have been on an unstoppable rally over recent years. The second largest deviation is health care, with microcap having an +11.5% relative weight difference versus large cap. Since February 2020 (pre-COVID), health care is the only sector within U.S. microcap with negative absolute returns. Given that we just had a global health pandemic unlike anything we have seen in our lifetimes, the underperformance of health care is perplexing at face value to many allocators. Health care's underperformance has been driven by a myriad of issues, including uncertainty regarding drug price reform and a lack of stability and action from the FDA, in part due to the politicization of policy from both the Trump and Biden administrations. Collectively, our managers are beginning to see some catalysts shaping up within the health care space, and we are optimistic that the depressed valuations will experience positive mean reversion. Additionally, there has been a notable pickup of positive analyst revisions within health care and M&A activity, which are healthy signs.

	R 1000	R Microcap	R1 - Micro
Technology	27.5%	10.2%	**17.3%**
Health Care	14.1%	25.5%	**-11.5%**
Financials	11.1%	20.6%	**-9.5%**

Source: Acuitas, FTSE Russell, FactSet. As of 6/30/2022

Lastly, financials is the third outlier, with the weight in microcap nearly doubling that of large cap (+9.5%). Banks are the main driver of this difference, as they make up nearly 16% of the Microcap Index compared to less than 4% of large cap. Due to banks tending to be a cyclical industry, regional and community banks have been hit hard during the recent drawdown. Investors are worried that if we enter a recession it will only be a matter of time before we see an increase in credit issues in the banking industry (which has historically been the case). That said, so far there has been little evidence of credit issues outside of a few isolated pockets (such as auto loans). We are always extremely skeptical of the phrase "things are different this time", but coming into this downturn banks are significantly better reserved and have much stronger balance sheets than the last few recessions, with much of that still a positive overhang from the Global Financial Crisis (2007-2008). As a result, the banks have much better cushion for absorbing economic weakness than is typically the case. Additionally, consensus thus far seems to be that any recession would likely be a relatively mild one. Collectively, we feel the sector makeup of the microcap universe is better positioned than large cap in the current economic environment. A meaningfully lower tech weight, nearly double the financials weight in the face of rising rates, and a greater weight in health care with depressed valuations and catalysts in place all present, in our opinion, opportunities for microcap to outperform.

Summary

The current U.S. equity bear market has been painful for allocators from an absolute return perspective. During these time periods, allocators can often be reluctant to make new allocations due to the fear of potentially getting the timing wrong. In our view, as long as allocators believe that markets are not headed towards zero and instead will eventually recover, bear markets present some of the most compelling and rewarding times to make an allocation to microcap. Historically, microcap has provided greater absolute returns during recoveries than other segments of U.S. equity and has done so at a far quicker pace. Additionally, many of the individual driving forces of the current drawdown provide compelling tailwinds for microcap to perform well during a recovery. For those investors that have been sitting on the sidelines and waiting to allocate to microcap, it would be difficult to imagine a better time than now.

Disclosures

Past performance is not a guarantee of future returns. Investing in securities involves risk of loss that investors should be prepared to bear. Investments in small and microcap companies may be less liquid and prices may fluctuate more than those of larger, more established companies.

This information is for institutional use only and should not be reproduced or distributed. This material contains the current opinions of Acuitas and is presented solely for informational purposes. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable in the future.

Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. Charts and graphs maybe limited by date ranges specified on those charts and graphs; different time periods may produce different results. All information is current as of the date of this material and is subject to change without notice.

Index returns do not reflect any fees or expenses and are not directly available for investment.

Acuitas Investments, LLC is a registered investment adviser headquartered in Seattle, WA serving institutional and individual investors. For more information please visit our website at www.acuitasinvestments.com or contact us at 206-299-2070.