



Capital Bytes – October 20, 2022

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Capital Bytes: Why High-Quality Small Caps Should Have Your Attention

Capturing large, prolonged sector rotations can have a great impact on your portfolio. And given the increasing global risk landscape, the domestic economy may be one of the better ways to capture alpha — if you know where to look. There's been a fair amount of talk around how a strong U.S. dollar (USD) is negatively impacting things like U.S. manufacturing, exports and the earnings of large, multinational companies that generate revenue outside America's borders. On top of that, we're all aware of the growing recessionary risks across Europe, Asia and South America. As investors, it's important to always follow the money and realize that just about every bit of bad news has a silver lining or at least, a beneficiary. One group that may be at least partially insulated from the surge in the USD are small cap stocks. Some in this group may also benefit from the resilience of the American consumer, at least in key subsectors.

Smaller American companies tend to be less sensitive to currency fluctuations as a larger part of their revenue is generated domestically. For example, companies in the S&P 600 (small-cap index) generate just 20% of their revenues outside our borders, compared with more than 40% for the S&P 500. And though America certainly has its risks, our economy is one of, if not the

strongest in the world, for the moment. It's important to mention that we do believe consensus estimates for the full-year 2023 are still optimistic. That said, stateside economic durability has led investors to take another look at this group of businesses as currency imbalances and other global economic headwinds take their toll on larger enterprises. As of Oct. 17, the S&P 600 had jumped 2.5%, while the S&P 500 declined 0.1%. Small-cap companies are also relatively cheap compared to their larger brethren as investors sold the group heavily earlier in the year on fears that economic recession could come hard and fast.

We believe and have observed that quality tends to outperform in slower-growth environments. In an uncertain economic environment, with higher interest rates increasing the cost of capital, we believe quality businesses that have sustainable competitive advantages, strong cash flows, attractive dividends and a history of execution tend to perform better and can limit downside risk. Mid-cycle tends to be where quality emerges as a larger tailwind, persisting until the end of the cycle, as investors gravitate toward companies that are better positioned to navigate slowing growth and the rising cost of capital, and stock picking will be paramount in driving future returns. It's important to note that investors tend to move in and out of smaller companies first and economies ebb and flow, but for those with a sound investment approach, some small caps may offer tremendous value here.

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