What Is a Quality Small Cap Company?

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Quality small cap companies are generally well-managed businesses with reasonable growth outlooks and the financial strength to be investable over the intermediate term.

The following three characteristics are common with high-quality stocks that demonstrate greater consistency and lower downside risk over multiple market cycles:

Profitability

In the new economy, analyzing return on invested capital (ROIC) and cash flow generation can be a better way to value a company’s intellectual capital and ability to generate profits from assets. Consequently, GAAP earnings can distort the “true economic” profitability of a company making traditional valuation methods such as Price to Book (P/B) misleading.

Financial Strength

Strong balance sheets, including the appropriate leverage ratios and ability to service debt throughout the investment cycle and cyclicality of cash flows.

Understanding how management is allocating capital to expand its business, including their ability to use equity and debt, is essential.

Competitive “Moat”

A company’s ability to maintain its advantage in order to protect long-term profits and market share from competing firms is critical. This is most important for maintaining strong fundamentals related to sustainable and predictable growth, stability of cash flows, earnings and capital expenditures.

Why Invest in Quality Small Caps Today?

1.
High-Quality Companies Have Delivered Higher Stability and Outperformance During Periods of Distress

Markets place a premium on high-quality companies during economic downturns or periods of risk aversion. Figure 1 illustrates quality and value factor performance following the last three inversions of the yield curve over 3-month, 6-month and 12-month periods. What has disappointed many traditional value investors is that Price to Book (P/B) and Forward Price to Earnings (P/E) ratios failed to produce alpha while EV/EBITDA proved to be a better measure of value.

Unfortunately, changes in accounting rules and the types of assets that create value for many companies have made P/B a flawed metric leading to underperformance relative to the performance of “true” economic profits.

Figure 1: Factor Performance During Periods of Distress

Factor Performance Following 10-Year Treasury / 2-Year Treasury Yield Curve Inversion
(U.S. SmallCap Universe)

Data run: Nov. 6, 2019. Source: Strategas Research Partners. The averages referenced above are the averages of the three previous 10-Year Treasury/2-Year Treasury inversion periods that occurred in 1998, 2000 and 2005. U.S. SmallCap Universe is represented above by the Russell 2000. High debt refers to the highest leverage quintile.

As you can see in Figure 1 above, quality factors such as ROE, FCF growth and financial strength were highly prized investor metrics. Furthermore, the ability to service debt and with "true" economic profits was accretive to investors during periods of distress. ROE is a critical factor because it assesses quality by rewarding high economic return companies while penalizing excessive leverage. Style box investors who build portfolios within a strict value-growth framework should take note of this evidence in the small cap asset class specifically. While in theory, the style box helps investors construct a more diversified portfolio, the lack of specificity within the allocation appears to be limiting small cap managers and hurting investment performance.

We therefore affirm that while small cap value investors have used valuation as a framework to outperform more expensive stocks, "quality" as a factor is less widely understood and can offer a compelling return profile. Data has shown that over the long term, narrowing investment candidates by the above quality characteristics has also contributed to returns in excess of the cost of capital and in turn created a wealth generation effect for investors.

2.

Economic Profitability and Financial Strength Will Be Essential over the Next Five Years

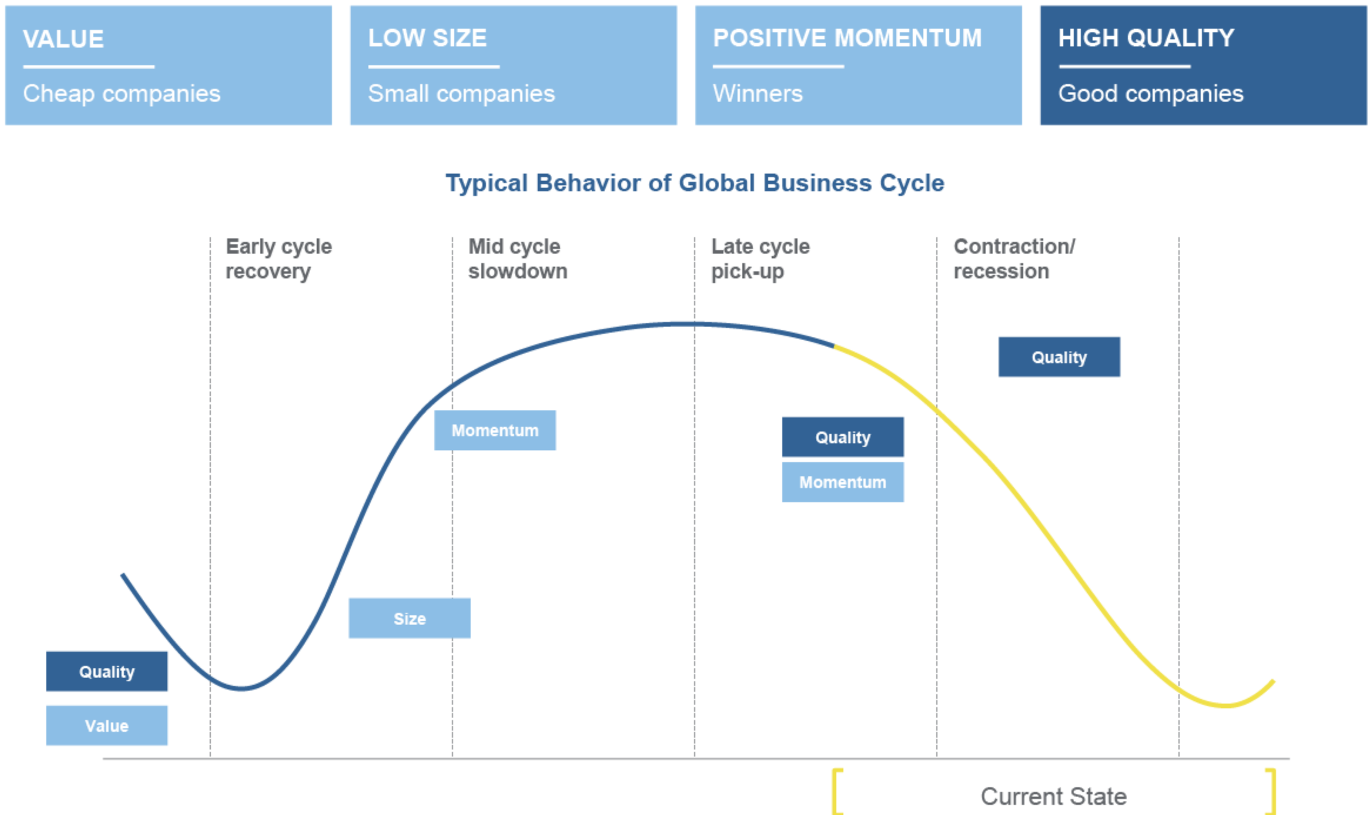
Strong balance sheets allow a small company to control its own destiny. On the other hand, highly leveraged businesses lack the flexibility to fund their businesses and lose flexibility when the unexpected happens. The current shorter-term trends and structural debt issues in the small cap asset class are concerning. The percentage of companies with no earnings at the current level is close to past market peaks. ROE has generally been on the decline since 2011 as companies reach multi-year peaks in leverage. To make matters worse, the looming $1 trillion wall of debt for small cap companies has 58% coming due within the next two to five years. In summary, quality as a factor is quickly deteriorating across the small cap asset class and specifically the Russell 2000 Value Index, where ROEs are declining at the same time cash flow generation is in negative territory. We affirm small cap Value investors need to include quality as a new dimension that is “married” to valuation.

3.
Better Consistency Across the Economic Cycle

After a decade-long bull run in small cap stocks with growth outperforming value (13.5% annualized return for the Russell 2000 Growth Index vs. 10.4% for the Russell 2000 Value Index from 2009 to 2018), investors underappreciate the value of consistent and sustainable high-quality small cap investments as we enter the later stages of the economic cycle.

Historically, investors become myopic during extended periods of bullishness, chasing performance in the highest-performing strategies, believing that recent observations will persist long into the future. After a long-secular rise in small cap growth stocks, strategic investors need to consider the importance of both performance, absolute downside risk and the consistency of returns, which tend to be underappreciated at this stage in the cycle. Given the consensus view that we are in the later stages of the economic cycle, we believe slower growth, lower quality and higher volatility will lead to lower returns for traditional value/deep value companies. See Figure 2 below.

Figure 2: Sample Factor Performance Across the Economic Cycle



For illustrative purposes only. Source: Westwood, BlackRock.

Investing in higher-quality fundamentals with attractive valuations in the small cap asset class has historically performed better than traditional value or momentum styles at the peak of the cycle. Traditional Value or deep Value stocks tend to perform better during the early cycle recovery since many are sensitive to economic growth. Investing in high quality means avoiding cheap companies with potentially broken business models that may be “cheap” for a reason, while targeting good companies at attractive values.

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