SEGALL BRYANT & HAMILL

Small Cap Insights

Volatility. Rising Rates. Market Dislocations. What Lies Ahead for Small Caps?

Brian C. Fitzsimons, CFA
Director of Small Cap Growth Strategies, Principal

"We focus on being early in the identification of companies that exhibit fundamentally stable growth prospects and that are disruptors or leaders in their industries."

Derek R. Anguilm, CFA
Director of Dividend Value Strategies, Principal

"We invest exclusively in dividend-paying stocks because of their attractive risk/return profile, and look to build portfolios with high-quality, attractively valued companies with strong and consistent cash generation."

Mark T. Dickherber, CFA, CPA
Director of Small Cap Strategies, Principal

"We utilize a contrarian investment approach to identify out-of-favor companies with improving business models and the potential to improve Return on Invested Capital (ROIC)."

Portfolio managers from SBH's domestic small cap teams met in September for a roundtable discussion on the current environment for small cap stocks. The bull market is in its tenth year, volatility has returned, and there are significant market dislocations. Against this backdrop, our managers remain optimistic regarding opportunities for small cap stocks.

- *Director of Small Cap Growth Strategies Brian Fitzsimons* believes the structural changes in the economy and focus on innovation will continue to support small cap growth stock performance moving forward. His team's approach of investing in fundamentally stable growth companies has shown to be a successful strategy across market cycles.
- *Director of Dividend Value Strategies Derek Anguilm* is finding attractive small cap value stocks that have been "cast aside" by the market, which is more focused on near-term growth than valuation. In addition, and given that dividend-paying companies have historically performed well during rising rate environments, he is excited about the team's exclusive focus on dividend payers given the potential for higher rates.
- *Director of Small Cap Strategies Mark Dickherber* continues to find out-of-favor companies with the potential to improve Return on Invested Capital (ROIC). These companies have management teams that are investing capital wisely and can add value regardless of where we are in the market cycle.

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What are the challenges and opportunities you see for small caps?

Brian Fitzsimons: We have struggled a bit with the high valuations and expectations we've seen in small cap growth stocks, particularly in the information technology sector, in software and Internet services. We have been disciplined about managing valuations. As we move forward, we believe the structural changes in the economy and focus on innovation, which have led to small cap growth outperforming in recent years, remain intact and provide a backdrop of continued support for growth investing. Our approach to investing in fundamentally stable small cap growth companies has shown to be a successful strategy across a market cycle. We continue to find attractive companies with durable growth opportunities that are leaders or disruptors in their industries.

Derek Anguilm: One challenge is not knowing how much longer the market is going to continue in the mindset of "growth at any cost or at any price." However, as a result of market volatility and dislocations between price and value, we are finding some interesting businesses that have been "cast aside" by the market. For example, we have stocks in our portfolio that are trading at five, six, or seven times cash flows that we are really excited about. We also believe dividend payers may be improperly valued based on the market's outlook for interest rates. It is a myth that dividend payers perform poorly with higher rates. In fact, the opposite is true and that's why we couldn't be more excited about our approach in a potentially rising rate environment.

Mark Dickherber: For us, one of the challenges is investing in a market that continues to reward companies we believe are bad capital allocators (i.e., investing into declining ROIC projects/divisions). Flows into passive strategies have given many companies access to capital at a cheaper level than they may "deserve" and some are deploying it in ways that are destroying capital. Over time, we believe the market will stop rewarding these types of companies. However, the success of our investment approach is not dependent on where we are in the cycle. We are confident we will continue to find companies with positive ROIC inflections where we can arbitrage the unexpected ROIC improvement while managing risks not only at the company level but also at a more macro level, by understanding what is priced into a company's expectations.

What is your view on the current market environment?

Brian Fitzsimons: The current bull market is the second longest on record (over 110 months so far) and already double the length of the average expansion. We believe we're late in the market cycle and are keenly aware of risk and positioning the portfolio to protect capital in the event of a downturn. Volatility has started to pick up and we've seen significant dispersion across sectors and industries in small cap growth this year. We believe volatility creates opportunities, particularly for active managers like us who employ a disciplined process.

Derek Anguilm: We are seeing many instances of meaningful differences between a company's stock price and the underlying value of the business. We see this in both directions. There is strong investor interest in growth companies, regardless of valuation, and we view this situation as a misallocation of capital by investors. The long-term implied growth rates of many "Wall Street darlings" eerily remind us of what we saw in the 1999-2000 period. We think it will lead to disappointing returns for investors in most of these companies, even if the companies go on to do well from a fundamental standpoint. We believe, with enough time, stock prices will gravitate to the present value of their future cash flows, and we continue to own a diversified portfolio of strong businesses with realistic embedded expectations.

Mark Dickherber: It's very dangerous for investors to think they can time the late-cycle dynamic or definitively know if/when a market will top. We aren't market timers. We are, however, risk managers with the goal of navigating the market at various points in a cycle. We are willing to take risk when we're confident we can be paid handsomely for investing in companies we believe have the potential to improve ROIC over time. These management teams can add value regardless of where we are in market cycles