SEGALL BRYANT & HAMILL
ASSET MANAGEMENT

The Active Advantage

Small Cap Sector Themes

What’s Played Out and What’s to Come

Industrials | Technology | Financials | Consumer

Although the impact of higher year-on-year interest rates continues to filter through the economy, lower inflation and economic resilience have improved the U.S. economic outlook. While the Federal Reserve (Fed) thinks the interest rate cycle is closer to easing than to tightening (which reduces the likelihood of a “hard landing” for the economy this year), it cautions that any further steps remain “data dependent.” Investors continue to weigh the prospects for rate movements and analyze statements regarding “economic resilience” at a macro level and deteriorating fundamentals at the company level. The consensus is that while some risks have diminished, many remain. In this context, investment professionals for our Small Cap Core, Small Cap Growth, and Small Cap Value strategies continue to closely examine the impact of various sector trends within the small cap universe, aligning their analysis with their fundamental research approach. The following discussion delves into their perspectives on the current market environment and the potential opportunities they see moving forward.

Industrials

The Industrials sector faced opposing forces in 2023. While long-term trends like automation and infrastructure spending emerged, a contracting Purchasing Managers’ Index (PMI) and inventory destocking dragged on the sector. As 2024 continues, the global economy remains sluggish. Despite this, we believe opportunities exist. Government spending, opportunities to support generative artificial intelligence (AI) data center buildouts, and companies embracing “Industry 4.0[1]” offer potential growth. We prioritize companies with strong cash flow but anticipate potential shifts later in the year as the inventory cycle abates or the macroeconomic outlook improves. This could open doors for cyclical businesses with improving returns.

— Small Cap Core Team

There are several pockets of strength within Industrials that continue to perform and demonstrate long-term potential following a strong close to 2023. One such area is HVAC and electrical installation providers, specifically those that target commercial and industrial end markets. High-growth segments of the market, such as data centers, continue to provide robust demand and visibility given their requirements, scale, and long-term build cycles. Demand also continues to be more broadly supported by previously passed legislation (IIJA, IRA, CHIPS Act[2]), which is still providing various support and incentives across the Industrials landscape. We remain optimistic about our portfolio holdings that have exposure to the current strength and potential future growth of the HVAC and electrical end markets.

— Small Cap Growth Team

> **Government spending, opportunities to support generative artificial intelligence (AI) data center buildouts, and companies embracing "Industry 4.0" offer potential growth in the Industrials sector.**
>
> **— Small Cap Core Team**

Technology

Over the past two to three years, the software industry has faced headwinds from a softening economy, rising interest rates, and post-pandemic rightsizing. The initial COVID lockdowns fueled a surge in software buying as companies scrambled to digitize and move to the cloud. This rapid growth led to inflated corporate growth expectations and unattractive valuations. As the economy cooled, customers prioritized cost optimization and vendor consolidation, hindering growth across the industry.

At the current time, the software sector, historically favored for its niche markets, competitive advantages, and high returns, now shows promise. Lower valuations, signs of recovering demand, and potential tailwinds from generative AI have created a more optimistic outlook for the first time in several quarters.

— Small Cap Core Team

During the fourth quarter of 2023, we noticed that technology companies with exposure to telecom spending struggled, such as providers to the large telecom companies. The large telecoms had ramped up budgets dramatically during supply chain disruptions, which occurred as massive investments were being made in 5G infrastructure. This created an unsustainable spending bubble, which has now burst. Telecom companies are cutting inventories and reducing expenditures, and technology supplier stocks have plunged back to pre-run lows.

Despite these challenges, certain telecom-exposed tech names still warrant attention. For example, we believe companies that develop equipment, software, and services for the telecommunications industry have promising AI potential given customer spending trends. They facilitate data center connectivity, partially relying on telecom customers. While 5G rollout continues and $65 billion of broadband funding flows over the next few years, select telecom capital spending will persist. When fundamentals are combined with management teams focused on return on invested capital (ROIC), the outcome can be rewarding when cycles provide such opportunities.

— Small Cap Value Team

> **Lower valuations, signs of recovering demand, and potential tailwinds from generative AI have created a more optimistic outlook in Technology for the first time in several quarters.**
>
> **— Small Cap Core Team**

Financials

While there has been a significant focus over the last 12 to 18 months on the regional banking industry, given the turmoil in the spring of 2023 and concerns over commercial real estate (CRE) exposure, we believe that investor attention has been diverted from other parts of the Financials sector. As we look at the sector, one area of interest is capital markets. Given two difficult years for M&A and new capital issuance, we believe that budding "green shoots" are likely to result in increased activity in capital raising and therefore improved profitability within the industry. In addition, we remain bullish on the continued expansion of private markets and the increased allocation to the asset class. More specifically, we believe increased allocations will drive continued robust growth for private markets distribution and consulting companies. Rising interest rates, in addition to economic, political, and other pockets of uncertainty, derailed M&A, IPO activity, and private markets, but we believe all three areas are starting to improve.

— Small Cap Growth Team

> **Given two difficult years for M&A and new capital issuance, we believe that budding "green shoots" are likely to result in increased activity in capital raising and therefore improved profitability within the financial industry.**
>
> **— Small Cap Growth Team**

Consumer

Our management approach focuses on researching management changes to determine whether such changes could lead to material improvements in ROIC over the coming years. Recently, our analysis has found more opportunities in Consumer Discretionary companies that have undergone management changes. Often companies whose management teams have mismanaged their capital strategy can provide opportunities for improvement when they refocus on pragmatic returns-based decisions and restoring a culture of innovation and discipline.

We believe companies in the sector that have large amounts of self-help (in terms of managing the business more efficiently) and significant risk already priced into valuations, where even if economic growth is not a tailwind, can still see opportunities to create value due to underperformance of prior management teams. With divestitures acting as significant deleveraging events coupled with improving operational aspects, the ROIC improvement of these companies can be quite surprising compared to market expectations.

— Small Cap Value Team

Companies in the Consumer Discretionary sector that have large amounts of self-help (in terms of managing the business more efficiently) and significant risk already priced into valuations, where even if economic growth is not a tailwind, can still see opportunities to create value due to underperformance of prior management teams.

— Small Cap Value Team

Looking Forward

Despite the (ever-present) potential for market volatility going forward, we believe attractive opportunities exist in small cap companies across different sectors that exhibit high ROIC, solid balance sheets, and the ability to generate solid free cash flow. A key focus of ours is on management teams that can help their companies not just weather a broad variety of storms but also become stronger organizations. While performance as measured by the stock market can and will fluctuate from quarter-to-quarter and year-to-year, we believe that a process grounded in these philosophical beliefs may provide attractive risk-adjusted returns over the longer term.

Please reach out to your SBH contact with any questions or visit www.sbhic.com to learn more.

[1] Industry 4.0—also called the Fourth Industrial Revolution or 4IR—is the next phase in the digitization of the manufacturing sector, driven by disruptive trends including the rise of data and connectivity, analytics, human-machine interaction, and improvements in robotics.

[2] Infrastructure Investment and Jobs Act (IIJA), Inflation Reduction Act (IRA), and CHIPS and Science Act (CHIPS Act).

SEGALL BRYANT & HAMILL
ASSET MANAGEMENT

540 West Madison Street
Suite 1900
Chicago, IL 60661

Phone (312) 474-1222
Toll Free (800) 836-4265
www.sbhic.com