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Prevailing Through Challenges

Interview with Small Cap Manager, Boris Kuzmin, CFA

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Interviewer: What is your overall take on the market's performance in the first half of 2023?

Boris Kuzmin, CFA: It has been a good first half from an absolute return perspective. The market actually has been pretty resilient despite fears of recession and the Fed continuing to raise rates. The S&P 500 has put up really great numbers and is up roughly 16% for the year-to-date period. But, I would question whether that truly represents the market these days, because the Tech sector represents about 28% of the index. And actually, if you add some of the other companies like Amazon, Meta, and a few other tech-like companies that are included in other sectors, the weight goes up to about 37%. So, performance of the S&P 500 has been driven by these large mega-cap tech companies, and this strong performance is not necessarily indicative of the broader market.

If we look at the S&P 500 equal weighted, which we think is a better reflection of the state of the economy and the average company, the story changes. The equal weighted index is up about 7% for the year, while the Russell 2000 Index is up roughly 8%. So for the year-to-date period, small cap actually did relatively well and outperformed the equal weighted measure of the market. Additionally, the Crawford Small Cap portfolio outperformed the Russell 2000 Index during this period.

I: Are you pleased with the strategy's performance so far this year?

BK: We are really pleased with our strategy's outperformance, because there have been several underlying trends in the market working against us. Both higher-quality and dividend-paying stocks generally underperformed. As you know, we are focused exclusively on dividend-paying stocks and have a bias toward high-quality companies, so these have been headwinds to performance. Additionally, given our sensitivity to valuation and our Quality At a Reasonable Price approach, our performance is influenced by how the Value style performs within the market. Growth outperformed Value by a pretty large margin over the first half of the year. Despite these challenges, it has been a positive first half, and the companies we are invested in have held up well. We believe this speaks to the strength of our fundamental research and security selection processes.

I: We touched on a few of them briefly, but what do you see as the primary themes dominating the markets today? How are they impacting the small cap space?

BK: Economic growth overall is the most significant driver for small cap stocks. During the first half of the year, investors have been oscillating between fearing a significant recession and hoping for a soft landing where economic growth would slow but not enough to cause significant downturn in profits for businesses. We have seen the Fed continue to raise rates until recently, and we think inflation and interest rates will continue to exert the greatest degree of influence on the market. That said, recent data is showing that employment remains strong and there are no signs of significant trouble with credit quality in bank loans. All of that is indicative that the soft landing scenario is becoming more likely. This has led to the positive numbers that small cap stocks have put up for the first half.

I: Artificial Intelligence (AI) is another theme we have been hearing a lot about recently. What impact do you think this will have on small cap companies?

BK: The impact of AI has been more pronounced on the large cap side of the market, and it has driven some of the tech outperformance I mentioned earlier. On the small cap side, there are currently very few beneficiaries from the AI push. There may be a few companies in the semiconductor space that are expected to benefit directly from higher demand for computing power. Overall, we think the impact of AI will be delayed for smaller companies, but it could lead to higher overall growth and higher productivity. If our GDP accelerates by a couple of percentage points because of AI, as several analysts have suggested, it will certainly translate to higher earnings growth for small cap companies and stronger stock performance. However, there is still significant uncertainty surrounding the overall impact of AI. There could be some negative implications such as potential loss of high-paying jobs and disruption to certain industries. There is also the possibility of higher taxes down the road if there are outsized profits realized by tech companies. That could slow economic growth and negate some of the benefits of AI. It still remains to be seen how this will play out for small caps.

I: Another factor that contributes to stock performance overall and small cap performance in particular is valuation. How do you view valuation of the small cap space today?

BK: On many measures, small cap stocks appear fairly inexpensive relative to large cap stocks. But here again, we face the same issue we mentioned before. If we are using the S&P 500 as a large cap benchmark, valuation will be dominated by large cap tech companies, many of which are richly valued with high embedded expectations. We continue to believe small cap earnings could surprise on the upside and current multiples may prove to be too conservative.

I: What do you see as the biggest risks associated with small cap investing today?

BK: From our viewpoint, small cap investors historically tend to underestimate the risks involved in participating in the space, as they tend to focus more on exciting opportunities and the possibility of earning outsized returns. In reality, 40% of the Russell 2000 Index companies are unprofitable, which obviously creates a higher risk of failure. This needs to be taken into account and considered as a counterbalance to lofty growth expectations, particularly in the current environment where we have seen higher interest rates, limited availability of financing, and could potentially see regional banks reduce their lending for smaller businesses. Lower-quality companies that may have more levered balance sheets or do not generate sufficient cash flow could be at risk, especially if the Fed continues to raise rates. Despite this, we believe our approach which is focused on companies with stronger balance sheets and steadier profits and cash flow generation helps us mitigate this risk on behalf of our clients. We definitely believe that an active approach with a focus on quality contributes to long-term success in small cap investing.

I: What is your near-term outlook for small cap performance?

BK: We are cautiously optimistic regarding the small cap outlook. Primarily, this is because we think the U.S. economy is resilient and the employment outlook remains very strong. We believe the Fed is likely nearing the end of its fight against inflation. Though there is still a risk inflation may surprise on the upside, we still have not seen the full anti-inflationary impact of prior increases in rates.

We will also note that small caps have been out of favor over the past few years. As investors become more confident in the economic outlook, we think they will be attracted back to the space. We believe there is significant room based on historical patterns for small caps to deliver substantial outperformance.

I: What do you look for when considering purchase candidates for the portfolio?

BK: When we put together the small cap portfolio we are laser-focused on quality, and at the same time, we take valuation into account. We are happy to pay a reasonable price for high-quality companies, but we certainly do not want to overpay for companies where investor expectations are too high. As previously mentioned, we like to call this approach Quality at A Reasonable Price. We continue to find opportunities to purchase companies with these characteristics, which are often neglected by other investors. Despite the pattern of long-term outperformance, these companies are traditionally a bit more mature and less exciting to the majority of small cap investors, which creates attractive investment opportunities for us. We believe the quality factor has been one of the more durable and persistent contributors to long-term outperformance in small cap investing, and we intend to take full advantage of trend.

I: Can you give a recent example or two of companies that fit your Quality At A Reasonable Price approach?

BK: One of our recent additions to the portfolio is household name WD-40 Company (WDFC), which also sells products for industrial applications. This is a high-quality company that generates high returns on equity and invested capital of 35%+ and 20%+, respectively. It has also demonstrated steady growth over the years with relatively little sensitivity to the economic cycle. Recently, WD-40 has experienced some pressure on input costs due to supply chain issues after the pandemic and higher commodity prices. This has resulted in what we believe is a temporary decline in the stock price. Even though the stock was not necessarily cheap by traditional measures, we felt valuation multiples were very reasonable relative to the business quality and long-term growth potential. We added the stock in the second quarter, and it has performed quite well since then.

Another company we recently added is in the Financials sector, Hamilton Lane, Inc. (HLNE). This is not a household name, but they have created a great brand for themselves in the alternative investment space, which involves investments in equity and debt of private companies. In essence, by maintaining good relationships with private equity firms and leveraging its scale, Hamilton Lane provides opportunities for smaller investors to access the alternatives space that they otherwise would not have. Here again, we have a business model that generates high 40%+ margins, has low capital intensity, carries very little debt and produces strong cash flow. During the market downturn last year, the stock declined due to concerns over valuations, potential fundraising, and their ability to realize investments at attractive prices. This has somewhat obscured the longer-term growth story even though they continue to gain new clients by offering an attractive value proposition. We believe Hamilton Lane will continue to benefit from increased interest in alternative investments, and we saw this as an attractive opportunity to purchase the stock. The multiple was not as low as that of traditional Value stocks, but it was attractive relative to where the stock has traded historically.