

Anticipate the Alpha Opportunity in Small Cap: Tighter Credit Conditions

westwoodgroup.com/insight/anticipate-the-alpha-opportunity-in-small-cap-tighter-credit-conditions/



>100%

Debt to Equity Ratios

31%

of Debt is Floating for Small Cap Companies

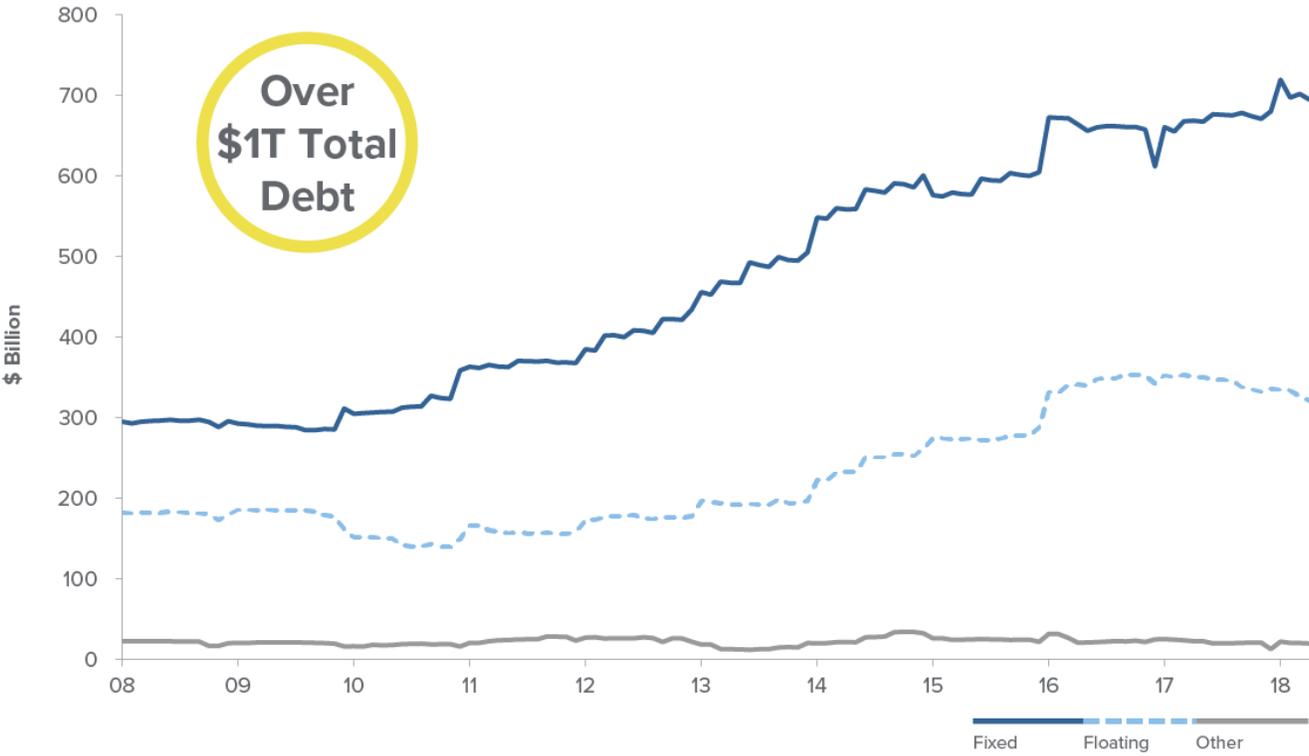
↓ 35%

of Companies are Unprofitable

Small Caps: What You Need to Know

The debt load continues to remain elevated with over \$1 trillion in loans outstanding, negatively impacting debt to equity ratios. This obviously matters in a rising rate environment. Rising rates will continue to challenge small cap companies as 31 percent of their total debt outstanding is floating-rate compared to just 9 percent for larger companies. Net debt in the Russell 2000 is higher than it was in 2007, and financial leverage now needs to be front and center as asset allocators think about portfolio positioning in 2019 and beyond.

Small-Capitalization Stocks (ex-Financials) Total Debt by Coupon Type
 2008 through Late-April 2018



Source: FactSet, Empirical Research Partners Analysis.

Percent of Russell 2000 Non-Earners
 (Based on Companies with Available Data)

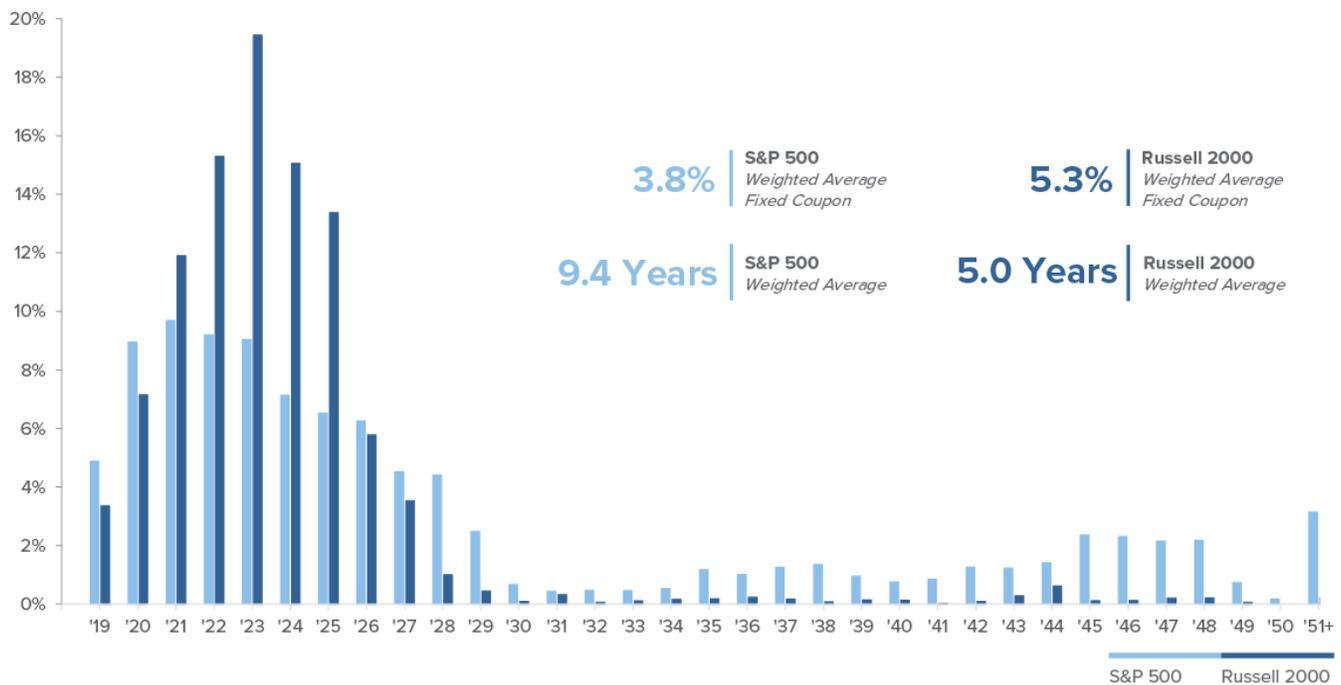


Time Period: 1/1/1990 – 3/31/2019. Source: Strategas.

Small Caps Have Higher Rates and Shorter Maturities

Since 2009, low interest rates and attractive credit conditions have helped small cap companies expand with increased borrowing, M&A and corporate buybacks. Nearly 10 years later, we can see this has been a windfall for shareholders as stock prices have soared. When you look at the fundamentals of the companies in the Russell 2000, we see a different story. Profitable companies today are spending roughly a third of their earnings on interest payments, which is the worst data point we have seen since 2008. Additionally, the leverage has not helped the underlying operating nature of the business with return on assets dropping to as little as 2 percent. As we look forward over the next two to three years, we see that debt maturing for companies in the Russell 2000 skyrocketing five to seven times. Highly leveraged companies tend to default or may see their stock prices decline creating an opportunity for asset allocators to shift their allocations as we enter into a new market regime.

Percent of Debt Due by Maturity (S&P 500 vs. Russell 2000)



As of 3/31/2019. Source: Strategas.

Small Caps: The Alpha Opportunity

Valuations matter.

Profitability matters.

And credit quality may matter even more.

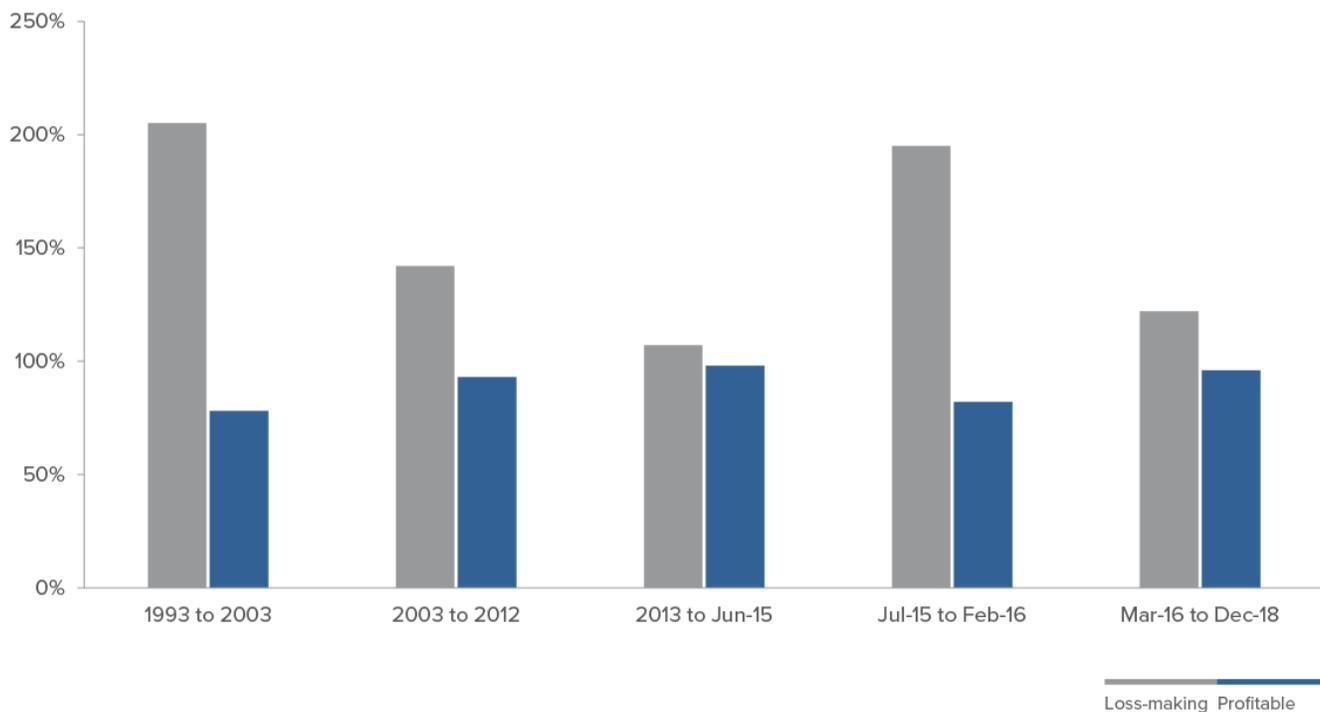
Passive investing in small caps at this stage in the cycle exposes you to unintended risks and larger drawdowns. We believe the shift in asset allocation needs to emphasize higher quality versus growth and momentum at any valuation that has dominated the landscape.

High-quality earners are in relatively short supply at this stage in the cycle, and we believe will be bid higher as profitability across the broader index continues to come under pressure. In this scenario, growth and momentum stocks will likely underperform, unmasking what's really happening beneath the surface across the small cap spectrum, exposing leveraged companies. Identifying companies with attractive relative value and credit quality characteristics is an edge at this stage in the market. History has shown that unprofitable companies have much higher downside capture ratios than profitable companies and could underperform during the next downturn if past is prologue.

Quality and value will be an important part of the asset allocation mix as we look out the next three to five years in the small cap asset class and anticipate the new alpha opportunity.

Russell 2000

(Monthly Downside Capture Ratio)



Source: FRP and FactSet; as of 12/31/18.

Take Action: Learn More About Our Emphasis on Quality & Value in Small Cap

There are specific risks inherent in small cap investing such as greater share price volatility as compared to other funds that invest in stocks of companies with larger and potentially more stable market capitalizations.