METIS GLOBAL PARTNERS

METIS THOUGHTS

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BUY OR BAIL? BIG QUESTIONS ABOUT "SMALL" THINGS

In the past few months, I've been getting frequent questions from clients and consultants on the same topic: "should we abandon small cap stocks?", and "are small cap value stocks a thing of the past?" It is a bit of a shock initially to hear the question, because the historical assumption of the long-term small cap premium is practically biblical. We are all taught, and in fact history has demonstrated, that the additional risk taken by investing in smaller companies should, and historically has, provided a premium over larger companies.[1] So what would cause otherwise experienced and sophisticated investors to consider such heresy?!!

Today's questions about small caps have reason. For US investors post-Financial Crisis, both US and international small cap indices have posted positive single-digit annualized returns (8.8% and 3.7% respectively) from 2011 through August 31, 2019. Conversely, the U.S. large cap market proxy Russell 1000 Index has meaningfully outstripped both, with an annualized return of almost 12% for the same period.[2] Those are big annualized performance differences, and completely upside down from what is expected over longer periods.

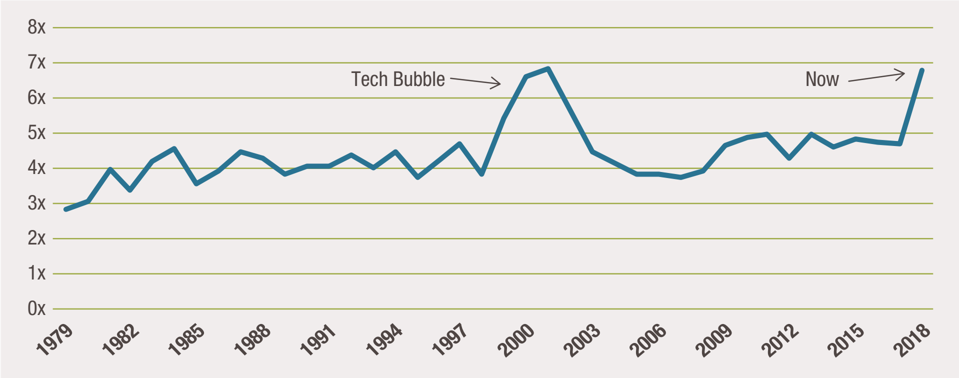
But why? Let's explore this for a moment through the lens of the various asset class "axes": Style (Value/Growth), Size (Small/Large), and Geography (International/USA).

Let's start with the degree to which valuations are stretched in the Value/Growth dimension. **Exhibit 1** illustrates how wide the dispersion has become between the growth and value ends of the US equity spectrum. The chart shows the ratio between the highest PE decile (growth) and the lowest PE decile (value). The slight upward trend in this ratio may be perceived as consistent with the long-term downward move of bond yields over this period, but there are two clear "spikes" in the ratio, to nearly double its long-term average. The first occurs around the "tech bubble" that burst in 2000. The second spike in the ratio is occurring now.

[1] Fama, E. F., and K. R. French. 2015, "A Five-Factor Asset Pricing Model." Journal of Financial Economics 116 (1): 1–22.
[2] Source: Metis Global Partners, Factset - Russell 2000 Index (net), MSCI ACWI ex USA Small Cap Index (net), Russell 1000 Index (net) annualized index returns January 1, 2011– August 31, 2019.

"The reason I'm getting the 'buy or bail?' question now is the recent acceleration of the gap between the extremes"

Exhibit 1: P/E Multiplier: Highest PE Decile (Growth), Divided by Lowest PE Decile (Value) (1979 - 2018)



Source: We used the Ken French data (see web link and source table below). The database used was the CRSP as of June 2019 and the PE groups are defined as every 10th NYSE E/P percentile.
http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html Section: U.S. Research Breakpoints Data (Downloadable Files)

Now let's look at size and geography. The return premium of small cap to large cap has historically had a significant cyclical element.[3] In the years since stock markets stabilized post-Financial Crisis, the cycle has swung strongly towards large cap stocks, with US stocks dominating the leaderboard. This shows up clearly in **Exhibit 2**, and these trends have been even more pronounced so far in 2019.

Given my role as an international investor, I suspect that the reason I'm getting the "buy or bail?" question now is the recent acceleration of the gap between the extremes: US large cap growth and international small cap value. The highlights in **Exhibit 3** show how dramatically this gap has widened in the eight months of this year so far when we add style to the observation.

"Why is the spread between valuations and return premiums suddenly accelerating this year between large and small stocks"

Exhibit 2: US Large Caps have Dominated All Post-Financial Crisis
January 1, 2011 - August 31, 2019

	Large Cap	Small Cap
USA	11.9%	8.8%
ACWI ex USA	3.1%	3.7%

Exhibit 3: Huge Return Style Gap Between Large and Small Caps in 2019
January 1, 2019 - August 31, 2019

	Large Cap Growth	Small Cap Value
USA	23.0%	6.9%
ACWI ex USA	14.9%	5.2%

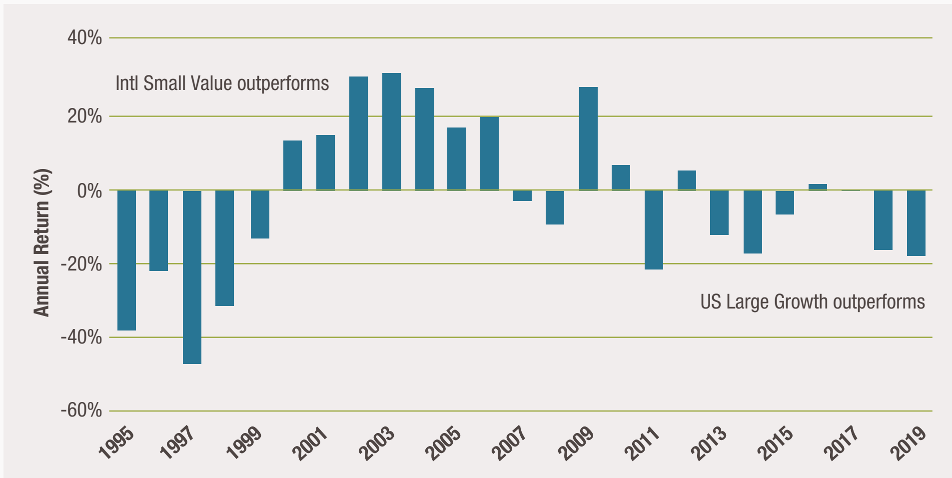
Source: Metis Global Partners, Factset. MSCI Indexes: MSCI ACWI ex USA Large and Small Cap Indices, and Russell 1000 Index, Russell 2000 Index, annualized index net returns January 1, 2011 – August 31, 2019.

[3] The Callan Periodic Table of Investment Returns 2019, https://www.callan.com/wp-content/uploads/2019/03/Classic-Periodic-Table-2019.pdf.

> Comments like 'this time it's different' are often the first signs of the light at the end of a tunnel

An even more visually telling illustration is seen in **Exhibit 4**, which shows the annual performance difference between indices for international small value and US large growth since 1995.

Exhibit 4: Annual Return Differences, International Small Cap Value vs US Large Cap Growth
January 1, 1995 - July 31, 2019



Source: Metis Global Partners, Factset. MSCI Indexes: MSCI ACWI ex USA Small Cap Value and Russell 1000 Growth annual returns, 1995–August 2019. 2019 returns represent January 1, 2019–August 31, 2019.

The international small value index significantly trailed US large growth in the late 1990s until the tech bubble burst (as noted earlier in **Exhibit 1**, around the previous spike in the growth/value PE comparison). The rebound for small cap was powerful, for seven straight years (2000-2006) of outperformance, with another strong year (2009) immediately after the Financial Crisis of 2007-08. Since 2011, it's been mostly downhill with international small value trailing as US large growth stocks have led all markets upwards.

> Otherwise rational players can be tempted to dance with irrationality when late cycle fatigue is at a crescendo

While equity investors seem mesmerized by possible shifts in fixed income yields, a turn in this cycle does not necessarily require an interest-rate trigger (although an unanticipated interest rate spike could certainly do it). Note that reversals in the past two decades have occurred during a long-term decline in bond yields that dates back to 1982.

Like the chart above, in the past, I've found that a flurry of questions about bailing out of an asset class often presages a sharp rebound, and comments like, "'x' is dead", or "this time it's different" or "it's a paradigm shift" are often the first signs of the light at the end of a tunnel for the asset in question. The psychological impact of extended cycles is a real thing, and otherwise rational players can be tempted to dance with irrationality when late cycle fatigue is at a crescendo. It has been my own observation, over the multiple market cycles of my career, that it is in exactly those times of fatigue that the "great investors", whom we all admire and whose feet we sit at, have created great wealth. So before a decision is made to "bail" (on 85% of the world's publicly traded companies!), perhaps the better time spent is reflecting on what market history has to tell us about extreme and fatiguing times like those on display in this thought piece, and the highest probability action to capitalize on it. I think the question to ask is "why is the spread between valuations and return premiums suddenly accelerating this year between large and small stocks, and what do previous extended cycles tell us about what has historically happened next?"

-Machel Allen

About Us

Metis Global Partners is an independent, employee-, and woman/minority-owned firm focused solely on the management of global and international equity portfolios. The firm believes that the consistent application of valuation driven decisions that strive to be free of behavioral bias is the most effective way to create wealth for its clients.

The Metis Team's roots are firmly grounded in a rich history of both academic and practitioner research at the intersection of global equity markets and investor behavior. By applying global fundamental knowledge in a systematic manner to large opportunity sets, the team is able to find undiscovered value opportunities around the globe. With an average of 20+ years of investment experience, the team maintains an active research role, being responsible for numerous industry and academic publications on the topics of global markets, value investing, and investor behavior.

Please contact us at info@metisgp.com or 858-436-3030 for questions or inquiries.

Metis Strategies

International Equity

International Small Cap Equity

International Micro Cap Equity

Emerging Markets Equity

Global Equity

Global Micro Cap Equity

INDEX DEFINITIONS

MSCI AC World ex U.S. Small Cap Index: The MSCI All Country World ex-U.S. Small Cap Index with gross dividends measures equity market performance of small capitalization companies in developed and emerging markets excluding the United States.

MSCI AC World ex U.S. Index: The MSCI All Country World ex-U.S. Index with gross dividends measures equity market performance of developed and emerging markets excluding the United States.

The Russell 1000 Index: The Russell 1000 Index is a subset of the Russell 3000 Index, and tracks approximately 1,000 of the largest listed U.S. stocks. It typically represents about 90% of the total market capitalization of all listed U.S. stocks.

The Russell 2000 Index: The Russell 2000 Index is a subset of the Russell 3000 Index, and tracks approximately 2,000 of the smallest listed U.S. stocks.

The Russell 3000 Index: The Russell 3000 Index is a stock market index that tracks the performance of the 3,000 largest listed U.S. stocks as determined by market cap. The index represents about 98% of all publicly traded U.S. equity securities.