METIS GLOBAL PARTNERS

METIS INSIGHTS

JULY 2021

IT'S A SMALL WORLD AFTER ALL

Metis Global Partners believes in the consistent application of valuation-driven decisions, free of behavioral biases, and grounded in the unique drivers of 60+ global industries

"When will the tide turn for small cap and for value?" We've been handling versions of this question for a while now, and especially during the past three years. Metis' previous papers on the subject focused on just how distorted global market valuations were becoming, with small cap and value factors increasingly at new extremes (See METIS THOUGHTS; "BUY OR BAIL? BIG QUESTIONS ABOUT "SMALL" THINGS", September 2019). What was missing earlier was the evidence that something new was happening… a catalyst that would reverse the trend.

Until now...

Since the beginning of 2021, small caps have led equity markets worldwide[i]. The rotation to value that started in late 2020 has enabled value stocks to take over leadership from growth in small caps, after many years in their shadow[i]. Now that we've seen a change in market environment, investors need to assess whether this is a short-term blip, or a long-term shift.

We think just one reason would not be sufficient for a major turning point in world markets. So let us provide you with SIX!

REASON ONE: The Macro-Environment Has Changed And Cyclicals Are The Primary Beneficiary

We've experienced a short, but nevertheless damaging, economic recession caused by the recent COVID-19 pandemic. Governments around the world face significant challenges to keep their economies afloat and their society cohesive. Policy agendas now appear to be focusing on fiscal measures, with domestic priorities on infrastructure investment. The goal is to counteract recessionary forces. The Biden administration's planned infrastructure spending program is one example (and a major one). China has a strong commitment to energy renewables and green infrastructure. The EU has established a recovery fund allocating grants and loans to member states that prioritize green industries and investments.

These programs could be massive and would lead to an increase in demand for concrete, cement, energy, heavy machinery, materials, and industrial products. It's the cyclical sectors that will be helped by the tailwind from these massive programs—sectors traditionally dominated by value stocks. In addition, we think small cap stocks may be clearer beneficiaries than their larger peers, as they tend to have greater domestic exposure.

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[i] Source: Bernstein; "Portfolio Strategy: Re-iterating our positive tactical case on Value". EXHIBIT 3: Performance of Russell 2000 Value vs. Russell 2000 Growth. March 2021.

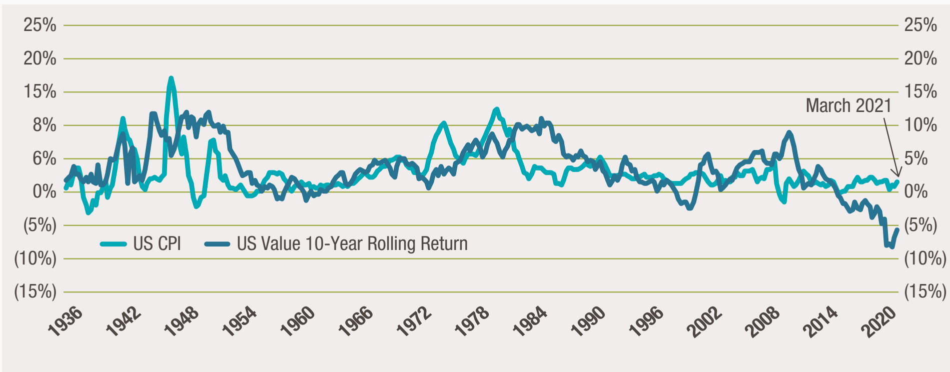
REASON TWO: Inflation And Interest Rates Are Rising And This Has Historically Favored Value

Rebooting the economy towards greener and carbon neutral infrastructures requires a massive quantity of commodity products. The result may be long-term imbalances in commodity cycles, driving up inflation, and the first signs are already visible. The list of beneficiaries may include more than just the “typical” value sectors like Energy, Mining and Materials. Banks may finally be on the cusp of a turn in rates: when inflation edges up then yield curves tend to steepen too.

“ It’s the cyclical sectors that will be helped by the tailwind from these massive programs—sectors traditionally dominated by value stocks ”

Exhibit 1 demonstrates the long-term sensitivity of value stock performance to inflation in the United States, and this has also been evident in Europe[ii].

Exhibit 1: The Long-Term Cyclical Patterns of Value Performance (Low P/B Minus High P/B Quintiles) and Inflation (US CPI) Have Been Similar



Source: Ken French Data Library, Datastream, Bernstein analysis (6/30/1936 – 3/31/2021).

Interest rates and bond yields have been at extremely low levels after a decade of artificial central banks’ support. Recent sharp upticks in 10-year government yields in the US and Europe suggest the trend is now reversing[iii]. Value stocks are seen as shorter duration assets than growth, and a rising trend in rates is supportive of the move away from growth to value (See METIS THOUGHTS; “BUY OR BAIL? BIG QUESTIONS ABOUT “SMALL” THINGS”, September 2019).

REASON THREE: Value Stocks Are Seeing Rapid Earnings Upgrades From Last Year’s Lows

The pandemic turned out to be supportive for “new economy” and other growth stocks that benefited from online business in 2020 during lockdown. With economies reopening and an already high earnings base, it may be hard for those companies to match the levels of growth reported last year. On the other hand, for cyclical value companies the situation is very different.

[ii] Source: TRADING ECONOMICS.COM EUROSTAT, Inflation Rate YoY (Monthly Series). https://tradingeconomics.com/euro-area/inflation-cpi#stats.
[iii] Source: FactSet US and German 10-year yield January 1, 2021 to May 31, 2021.

The gradual return to "normalization" may enable many "beaten down" stocks to post strong top and bottom-line growth. In both the US and Europe, many value sectors feature prominently in the sector rankings of "biggest discount to peak EPS" (**Exhibit 2**).

"The gradual return to "normalization" may enable many "beaten down" stocks to post strong top and bottom-line growth"

Exhibit 2: Industry Earnings Upside – Current Discount From Peak EPS Pre-Pandemic (since 2019)

Europe		U.S.	
Industry	Current/ Peak EPS	Industry	Current/ Peak EPS
Cons. Services	0.4	Cons. Services	0.4
Energy	0.6	Energy	0.5
Media/ Ent	0.7	Real Estate	0.8
Retailing	0.7	Cap Goods	0.8
Banks	0.7	Transport	0.8
Software	0.8	Banks	0.8
Real Estate	0.8	Telecom Services	0.9
Autos	0.9	Autos	0.9
Telecom Services	0.9	Prof. Services	1.0
Transport	0.9	Food/Drug Retail	1.0
Cap Goods	0.9	Media/Ent	1.0
Cons. Durables	1.0	Software	1.0
Prof. Services	1.0	Cons. Durables	1.0
Health Equip/Services	1.0	Diversified Financials	1.0
Food,Bevs, Tobacco	1.0	Food,Bevs, Tobacco	1.0
Pharma/Biotech	1.0	Health Equip/Services	1.0
Hhold Personal Products	1.0	Hhold Personal Products	1.0
Diversified Financials	1.0	Insurance	1.0
Food/Drug Retail	1.0	Materials	1.0
Insurance	1.0	Pharma/Biotech	1.0
Materials	1.0	Retailing	1.0
Semiconductors	1.0	Semiconductors	1.0
Tech Hardware	1.0	Tech Hardware	1.0
Utilities	1.0	Utilities	1.0

MSCI European and US Industries with the ratio of current to post Jan 2019 peak earnings. Earnings are 12m forward IBES consensus EPS.

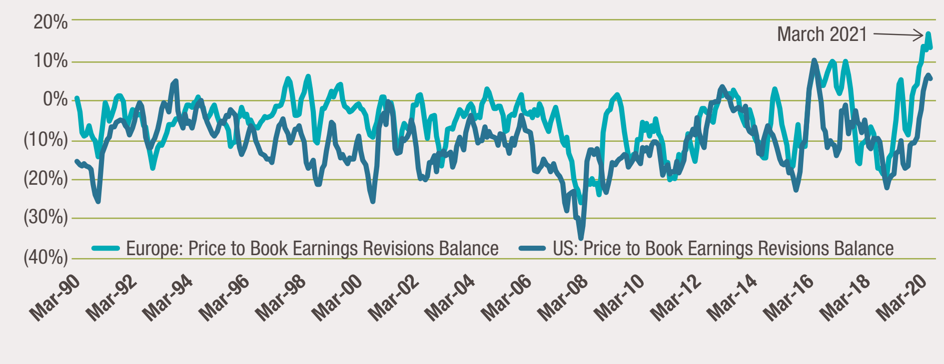
Source: MSCI, IBES, Bernstein analysis.

For example, the Energy sector is expected to deliver strong earnings growth in 2021 as the price of oil has already rebounded from its lows of $20 in March 2020. Bank earnings were hit hard last year (and during the last decade) but currently seem well positioned thanks to aggressive loan-loss provisions taken in the first half of 2020, unprecedented policy support, and now lower levels of non-performing loans than expected.

Value stocks are also being upgraded more, and at a faster pace than other stocks, especially in Europe. **Exhibit 3** shows that after a decade largely of downgrades, the pace of upgrades is notable. Nevertheless, there may still be room for further increases. Analysts' earnings estimates for value stocks both in Europe and the US are still below pre-pandemic levels. The magnitude of the current round of upgrades does not seem extreme given the extent of the earnings drop last year during the pandemic.

"Value stocks are also being upgraded more, and at a faster pace than other stocks..."

Exhibit 3: The Pace of Value Stocks Earnings Upgrades is Now High



US: the net earnings revisions balance of cheap vs. expensive stocks. Value defined as Price to Book. Universe is the MSCI US. Source: MSCI, Factset, Bernstein analysis.

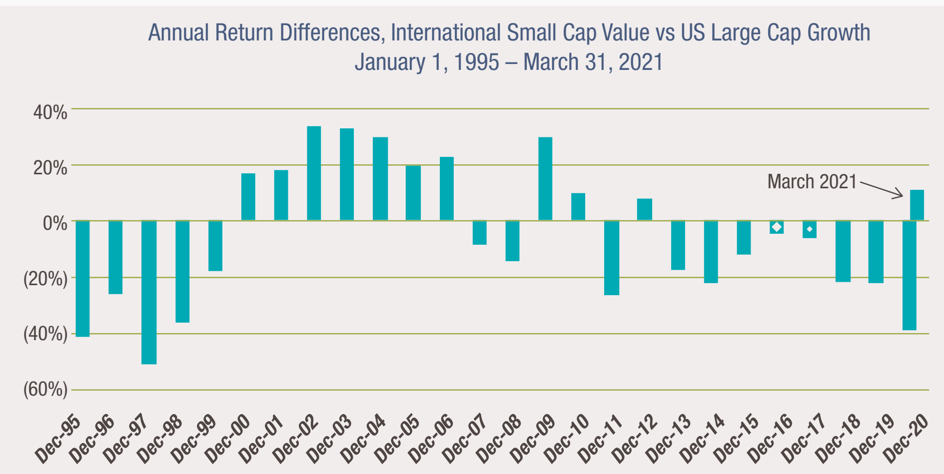
Europe: the net earnings revisions balance of cheap stocks relative to expensive stocks. Net earnings revisions balance is defined as the number of fy1,fy2 upgrades minus the number of fy1,fy2 downgrades expressed as a percentage of total earnings estimates. Value defined as Price to Book. Universe is the MSCI Europe largest 300 stocks. Source: MSCI, Factset, Bernstein analysis.

REASON FOUR: International Small Cap Value Has Had A Ten-Year Cycle For US Investors: The Pattern Suggests Scope For A Long-Term Reversal

International small caps have underperformed US large caps for more than ten years since the financial crisis in 2008. Worldwide, accommodative central banks' QE programs have favored growth, especially large multinationals, to the detriment of domestically-focused small caps and value stocks. That trend accelerated in the past three years (see **Exhibit 4**) but inverted at the beginning of 2021, for the reasons explained earlier. If the tide has turned, we could be embarking on a multi-year small cap rally, similar to the experience of 2001 to 2006.

"....we could be embarking on a multi-year small cap rally, similar to the experience of 2001 to 2006"

Exhibit 4: Feast or Famine: The Long-Term Pattern of Performance of International Small Cap Value vs US Large Cap Growth



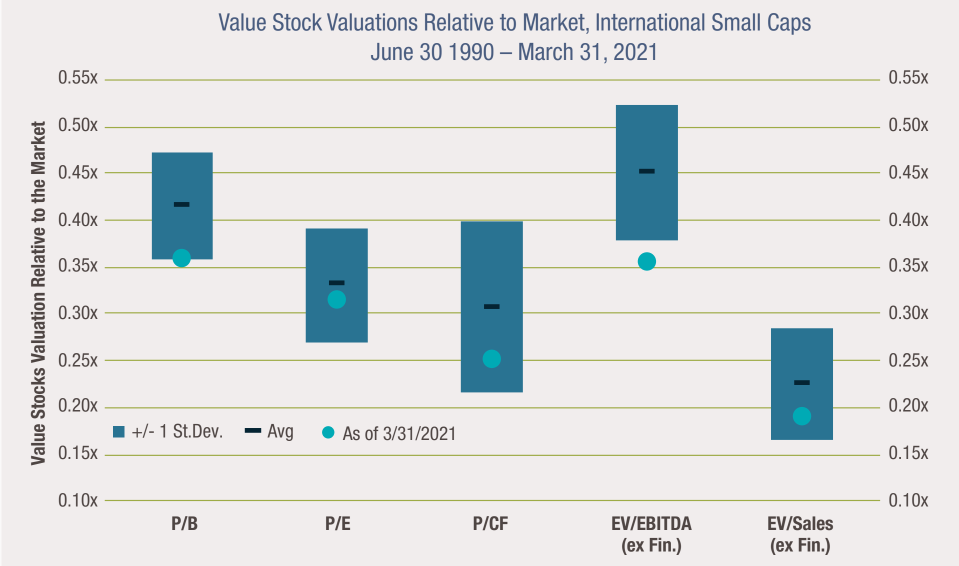
Source: Facset, MSCI AC World ex USA Small Cap Value and Russell 1000 Growth.

"...the impact of the Covid-19 pandemic on valuations opened even larger valuation gaps between losers and winners"

REASON FIVE: International Small Cap Valuations Are Still At Or Near Extreme Lows

The bounce in value so far in 2021 has not made much of a dent in the historically extreme undervaluation of international small cap value stocks. From what were already low levels, the impact of the Covid-19 pandemic on valuations opened even larger valuation gaps between losers (e.g., Energy and Financials) and winners (e.g., IT and Communication Services). **Exhibit 5** shows that valuations are well below their 30-year averages relative to the broader market for almost all the metrics shown.

Exhibit 5: Most Valuation Measures of International Small Cap Value are Well Below Their 30-Year Averages Relative to the Broad Market



Source: S&P Compustat via Clarifi, as of 3/31/2021.
Value stocks are defined as the cheapest decile of companies by each respective metric in the market measured monthly.
The market is defined as the 10th-25th percentile of stocks internationally by market capitalization.

REASON SIX: The Price Of Quality (P/E Spreads) And The Measure Of Quality (ROE Spreads) For International Small Cap Stocks Are Way Out-Of-Line

Although **Exhibit 5** shows the P/E of international small cap value stocks is hovering around its historical average, the P/E multiple spread between small cap growth and its value counterpart has increased significantly since the financial crisis of 2008.

Historically, international small cap growth P/Es have been at a premium over value. Part of this is driven by market perception and expectation that growth companies should score higher on quality metrics, typically measured by return on equity (ROE). But this premium has now moved to extremes. This is tracked in **Exhibit 6**, as the spread between average growth and value P/Es of international small caps. It is now at its highest level since the excesses of the tech bubble of 2000[iv].

[iv] Source: FactSet, S&P Global Ex US Small Cap Index. Return on Equity (ROE) Spread is defined as the rolling 6-months average ROE of the Growth stocks minus the average ROE of the Value stocks, rebalanced monthly from January 31, 2000-March 31, 2021. (Value stocks are defined as the cheapest Price/Book quintile (Q5) of companies while Growth stocks are defined as the most expensive Price/ Book quintile (Q1)).

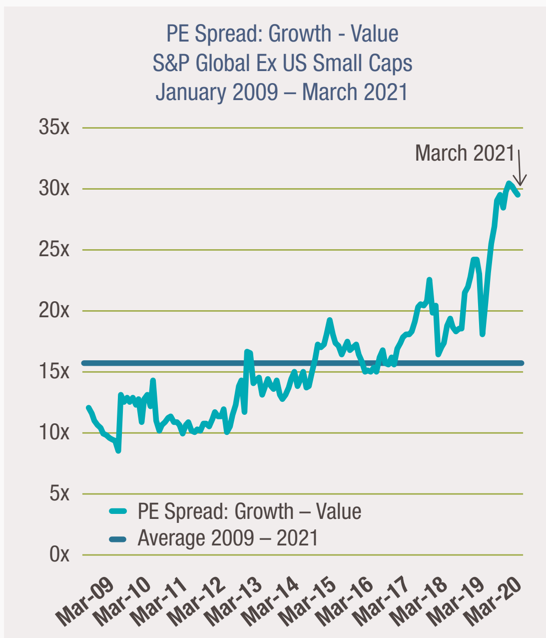
“This inversion of historical relationships smacks of a classic value opportunity”

As of March 2021, the average spread between international small cap growth and value stands at 30%, well above its 20 years average of 14%. This high spread should imply that these growth companies are now delivering correspondingly higher quality metrics. But they aren't.

On the contrary, this quality spread between growth and value has narrowed materially over the last decade, as measured by ROE. **Exhibit 7** shows that the ROE spread was consistently above 13%, mostly fluctuating around 15% between 2009 and 2014

However, the spread has narrowed significantly since 2014 dropping fast in 2018 and 2019 to reach just over 6% as of March 2021. The primary reason for this collapse in spread is a fall in the international small cap Growth ROE from 17% in 2011 to 9.5% currently, while its Value counterpart has been steady. As a result, Growth investors in this sector are not only paying a higher than usual price in terms of P/E multiple, but the quality benefit of Growth that they usually require seems to have collapsed relative to Value. This inversion of historical relationships smacks of a classic value opportunity.

Exhibit 6: The Spread Between Growth and Value P/Es in International Small Cap is at 20-Year Highs



Source: Factset, S&P Global Ex US Small Cap Index. Price/Earnings (P/E) Spread is defined as the average P/E of the Growth stocks minus the average P/E of the Value stocks, rebalanced monthly from January 31, 2009 – March 31, 2021. (Value stocks are defined as the cheapest Price/Book quintile (Q5) of companies while Growth stocks are defined as the most expensive Price/Book quintile (Q1)).

Exhibit 7: The ROE Spread Between Growth and Value in International Small Cap is at 20-Year Lows[v]

Source: Factset, S&P Global Ex US Small Cap Index. Return on Equity (ROE) Spread is defined as the rolling 6-months average ROE of the Growth stocks minus the average ROE of the Value stocks, rebalanced monthly from January 31, 2009 – March 31, 2021. (Value stocks are defined as the cheapest Price/Book quintile (Q5) of companies while Growth stocks are defined as the most expensive Price/Book quintile (Q1)).

Conclusion

We opened this paper with an assertion that there is not just one reason for investing in International Small Cap Value now, there are six. The first three relate to the fundamentals of the macro-picture and of the companies. The last three relate to valuations. As long-term fundamental investors, we believe that the best opportunities emerge when a brighter investment outlook coincides with a major pricing aberration.

REASON ONE: The Macro-Environment Has Changed And Cyclicals Are The Primary Beneficiary

REASON TWO: Inflation And Interest Rates Are Rising And This Has Historically Favored Value

REASON THREE: Value Stocks Are Seeing Rapid Earnings Upgrades From Last Year's Lows

REASON FOUR: International Small Cap Value Has Had A Ten-Year Cycle For US Investors: The Pattern Suggests Scope For A Long-Term Reversal

REASON FIVE: International Small Cap Valuations Are Still At Or Near Extreme Lows

REASON SIX: The Price Of Quality (P/E Spreads) And The Measure Of Quality (ROE Spreads) For International Small Cap Stocks Are Way Out-Of-Line

-The Metis Team

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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 23+ 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.

INDEX DEFINITIONS

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

The MSCI Europe Index captures large and mid cap representation across 15 developed markets countries in Europe.

The MSCI ACWI Small Cap Value Index captures small cap securities exhibiting overall value style characteristics across 23 developed markets countries and 27 emerging markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

The Russell 1000 Growth Index measures the performance of the Russell 1000's growth segment, which is defined to include firms whose share prices have higher price-to-book ratios and higher expected earnings growth rates.

The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the US equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000 Value Index measures the performance of the small-cap value segment of the US equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

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

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.

The S&P Global ex US Small Cap Index is a comprehensive, rules-based index measuring stock market performance of small capitalization companies from developed and emerging markets throughout the world, with the exception of the United States.

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