SMALL COMPANIES AND SMALL CAP STOCKS IN TIMES OF ECONOMIC DISTRESS

For those of us with decades of experience investing in the small and micro-cap end of the investible equity world, it feels like we are living in the epicenter of the markets' turmoil. Small cap stocks have witnessed the perfect storm as investors have chosen to shelter in larger, well-recognized brand name companies with perceived safety and thus shunned stocks that were under-followed, under-owned, under-appreciated. Lack of coverage, lack of news, lack of sponsorship acted as factors that exacerbated selling pressure as investors uniformly rushed for the exits in March.

In fact, small cap stocks acted as a canary in a coal mine as they peaked on January 16th, well before the broader market showed any signs of distress. Since then, they declined by more than 40% to the short-term trough on March 23 with over 31% of that decline during the month of March alone, not only the worst performance of any market cap sector, but the worst monthly performance for the small cap benchmark since 1931. Just to add some fuel to the fire, the relative performance, a full 1000 basis points behind the larger cap benchmarks, is the worst that we have seen since 1999/2000.

What does this mean for performance by small and micro-cap stocks going forward? In normal times, these short-term periods of underperformance typically would indicate that this sector should outperform in the future, particularly when they coincide with an economy that will be coming out a recessionary period. This phenomenon proved true in 9 of the last 10 recessions. In addition, <u>with more than 50% of stocks in the universe selling at less than 1 times book value, there is more than ample valuation support for a robust small cap rebound</u>. And finally, many private equity players have ample capital having recently raised large funds and they could be opportunistic buyers of many small cap companies.

As growth investors, though, we wanted to understand whether or not these same characteristics would be true for the growth elements of our universe and whether or not small growth companies can not only survive but perhaps even thrive in a period of economic dislocation, especially one as dramatic as this current cycle is likely to be. We decided to look back at previous economic panics to see what we could learn and discovered that many companies which went on to become household names and great iconic growth companies were in fact founded during recessions and depressions. A short list of representative companies is shown below:

- General Electric was started in the panic of 1873
- IBM was started in the panic of 1910-1911
- Disney was started in the recession of 1923-24
- Hewlett-Packard and United Technologies were started in the Great Depression

- Microsoft was started in the recession of 1975
- Electronic Arts and Adobe were started in the 1982 downturn
- Airbnb in the 2008-09 financial crisis.

It is our view that even during a challenging environment companies with disruptive technologies and innovative ideas can not only survive but can potentially set the stage for long-term success. As we look at those companies that are already public and that exist within our own small and micro-cap space, we go back to names that we were able to buy during previous crises where the companies were selling near the bottom of our market cap range. During these disruptive periods (for example: end of the tech bubble in the early 2000's, financial crisis in 2008-2009, mini recession in 2015-2016), we have been able to identify promising small and micro-cap companies that were disrupting their industries and able to gain market share even in challenging times. A few examples are listed below, we note that all of these companies were purchased when their market caps were less than $500M and all are selling at multi-billion-dollar market caps today:

- Illumina (2002) –innovative tools for genetic analysis and personalized medicine
- Concur Technologies and Ultimate Software (2003)—software as a service disruptors
- Ulta Beauty (2008)—value-based retailer in cosmetics
- Evercore (2010)—market share gainer in mergers and acquisitions
- Novanta (2015)—robotics component supplier

Will past be prologue? Of course, we do not know which of our small and micro-cap companies will be the next disruptors who go from unknown to best-in-class market share leaders. But we are highly confident that we have planted the seeds for the next great growth stories as we identify small and micro-cap companies with improving growth rates, secular positive change, and valuations that do not fully reflect their future growth prospects.

It is our belief that we should benefit as our undiscovered growth names not only see improving business fundamentals as their strong secular growth prospects deliver results, but also as they get rediscovered by investors more broadly and valuations have an opportunity to expand.

As in the past and as proven in studies since 1926, this phenomena of discovery, investment, and recognition is what has led to strong small and micro-cap outperformance over time and what should lead to a new small and micro-cap cycle this time as well.

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