ClearBridge Investments

Small Cap Strategy

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Key Takeaways

- Underlying the strong performance of small caps in the first quarter was a more than 16 percentage point outperformance for small cap value over small cap growth.
- The past year has been a remarkable period, during which every one of the factors involved in option valuation has been favorable.
- We are finding no lack of investments with current cash flows and asset values at attractive prices in the market.

Market Overview and Outlook

The Strategy performed well in absolute terms and modestly outperformed the benchmark Russell 2000 Index in a first quarter boosted by continued stimulus and a quickening vaccine rollout, though roiled by speculation in the small cap market.

Consistent with our fundamental approach, strong contributors in the portfolio came from across sectors and were driven by idiosyncratic factors. Higher interest rates and improving credit conditions helped nationwide commercial bank Bank OZK, while materials companies like Commercial Metals benefited from strong demand and pricing drivers as well as the prospect of further infrastructure spending. In health care, Amarin received EU approval for its revolutionary heart medication, icosapent ethyl, which showed a 25% reduction in major adverse cardiovascular events for patients with well-controlled LDL on statins and elevated triglycerides. The drug is already approved in the U.S.

Underlying the strong performance of small caps in the first quarter was a more than 16 percentage point outperformance of the Russell 2000 Value Index over the Russell 2000 Growth Index. While this was a nice reversal for value, we believe the long-awaited rotation from growth to value is still not in full swing for two reasons. First, value's bounce barely makes a dent in the long period of outperformance by growth as the value index still trails growth by 14 percentage points since 2019 and 55 percentage points since 2016, cumulatively. Second, value's returns were skewed toward a relatively small number of stocks that performed exceptionally well, not always for sound, fundamental reasons.

The most infamous example is GameStop, which rose over 900% in the quarter and contributed about 4% of the value index's outperformance. Novavax, which is in the value index despite having no book value prior to an equity raise in 2020 and never having earned a dollar in operating income in more than 20 years, was the second-biggest contributor to the index's performance, as it advanced its COVID-19 vaccine toward approval. Fellow value index component MicroStrategy rose sharply because it bought bitcoin. These are not Benjamin Graham value stocks.

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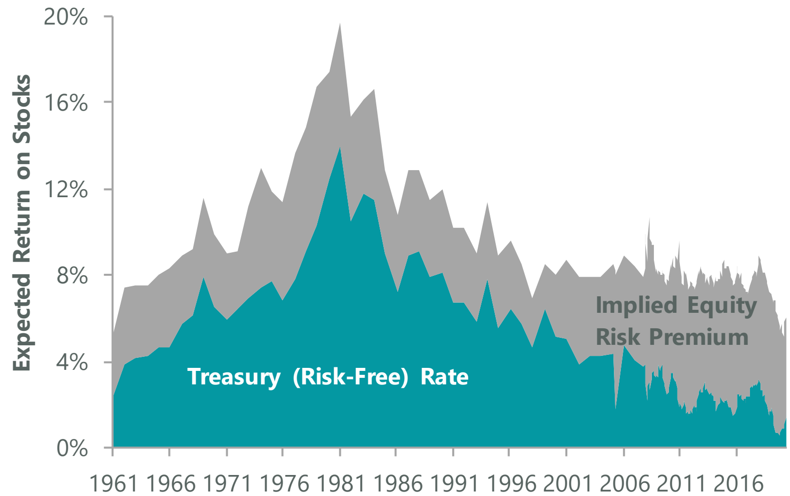
We do not attempt to predict the next style rotation or market fascination. Instead, we invest based on our assessment of long-term cash flows from a business compared to the market's implied estimate of those cash flows. Sometimes that results in a growth tilt for the portfolio and other times it leans value. We simply try to find where the market is offering us the greatest spread between expectations and our assessment of intrinsic business values. For most of the past decade, our Strategy was tilted toward growth stocks, but this position became increasingly untenable amid the massive growth rally of 2020.

The growth-stock boom in 2020 is understandable in retrospect. Michael Mauboussin of Counterpoint Global wrote a very interesting report in December that described the situation well. In classical valuation frameworks, a stock's price represents a combination of the value of current earnings power plus the present value of future value creation. The latter is composed of further value creation in the existing business, as well as what is known as real option value. A real option is the right but not the obligation to invest in something — an acquisition, capital project, R&D in a new product, etc. For example, the market may value a casino company by assessing the value of its existing casinos and their potential to expand profitability, plus it may also include the value of future casinos it may build. The value of new casinos would be based on the time and effort it would take to get a license and build them, the cost of the projects and the potential future cash flows. This real option is very similar to a stock option, whose value is derived according to the Black-Scholes model. The value of both kinds of options rises when the stock price (or project value) rises, the cost falls, the life extends, volatility increases, and/or the risk-free rate falls.

The past year has been a remarkable period, during which every one of the factors involved in option valuation has been favorable. First, the risk-free rate (the 10-year U.S. Treasury note) fell to its lowest level in history. Second, corporate bond spreads fell and the equity risk premium (ERP, the excess return investors require to own stocks instead of a risk-free bond) has declined. Under normal circumstances, when the risk-free rate declines sharply, corporate debt spreads and ERP rise, because downside risks have increased. In 2020, however, ERP didn't change much when the risk-free rate fell. NYU's Stern Business School Professor Aswath Damodaran has data going back 60 years, and the last year stands out as having the lowest cost of equity (the risk-free rate plus ERP) on record (Exhibit 1). The low cost of capital in 2020 increased the value of long-duration assets, including real options.

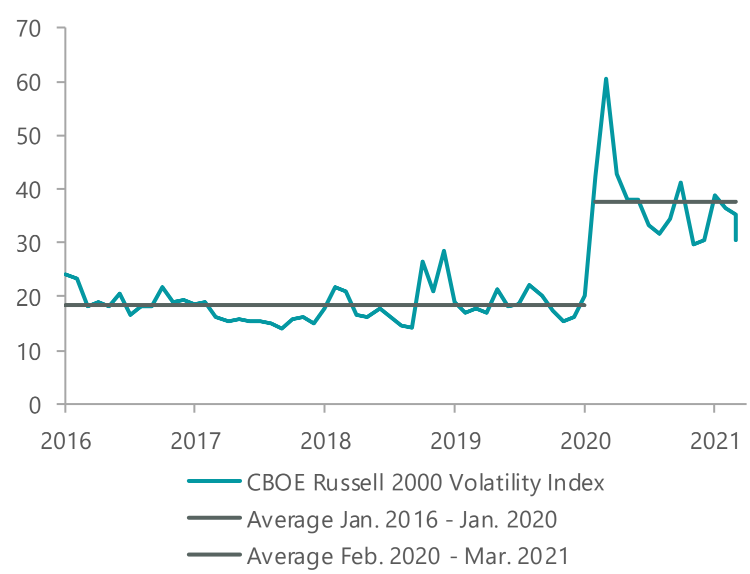
Exhibit 1: Cost of Equity since 1961



Source: Aswath Damodaran; Bloomberg. N.B.: For ERP, we use the estimate that Aswath Damodaran, NYU Stern School of Business professor and premier authority on equity valuation, posts on his website monthly.

Volatility also increases the value of a real option, just as it does for a stock option. However, the impact on a real option is asymmetric as higher upside risk means bigger profits, while higher downside risk means simply foregoing the option at little or no cost. Of course, the past year has seen a marked increase in volatility (Exhibit 2). Average volatility of the Russell 2000 Index has run roughly 2x its five-year average since February 2020.

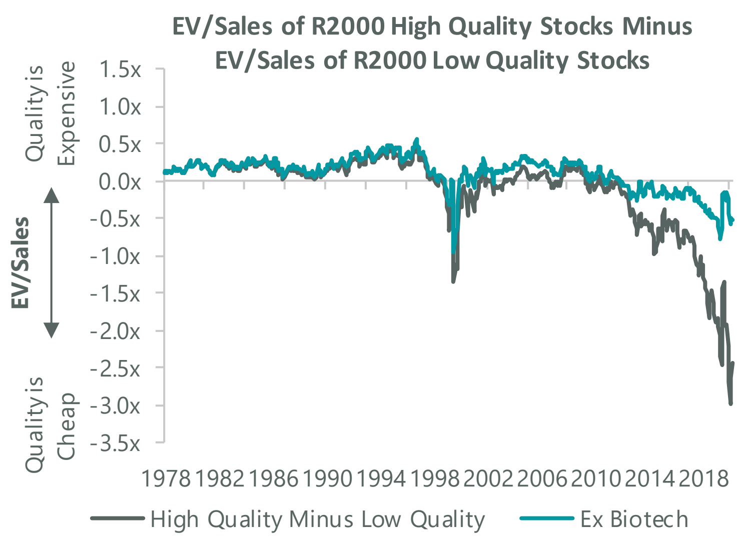
Exhibit 2: Russell 2000 Index Volatility



Source: ClearBridge Investments, Bloomberg Finance.

Normally, volatility spikes at times of uncertainty and such spikes are accompanied by an increase in the cost of capital. But that's not what happened in 2020. As volatility increased, the cost of capital fell, creating ripe conditions for valuing real options at very high prices. The market took its cue and 2020 saw the biggest spread since the dot-com bubble in 1999-2000 between the valuation of low-quality stocks with low/negative returns on assets (stocks with high embedded real option value), compared with high-quality stocks with high returns on assets (stocks with low embedded real option value).

Exhibit 3: High-Quality Stocks at Deep Discount to Low-Quality



As of March 31, 2021. Source: Kailash Concepts.

Although it's understandable why stocks with real option value outperformed last year, it's difficult to feel good investing in them today when the real option value as a percentage of market value is much higher. In general, we want to pay as little as possible for real options. By definition, they could end up completely worthless. If 25% of the stock's current valuation is explained by real options, that's a potential permanent capital impairment from which it could take years to recover. If real options constitute 80% or more of the valuation, as they may for, say, GameStop, that loss may never be recouped. That is simply not a risk we want to take with our clients' money, or our own.

The good news is that there are still a lot of investments with current cash flows and asset value at attractive prices in the market. Their relative value is not apparent at the moment, but we believe it will show through in the long run.

We were active in adjusting the portfolio in a volatile quarter that opened opportunities. The stock price of restaurant owner/operator and new position Bloomin' Brands has been discounting very modest long-term margin improvement, though our analysis of Bloomin' Brands' cost reduction, changes in operations, and long-term growth opportunities show that under most scenarios the stock is undervalued. As commodity markets strengthen, we believe new management at Olin can structurally change the profitability of its chlor-alkali business in the U.S., following its combination with Dow's chlor-alkali assets. We also bought Masonite, which has a variety of new products to add value to its core door business. We believe it can substantially improve returns on capital over the next five years.

Several names reached the upper end of our valuation distribution during the quarter — for example insurance company Essent, financial service company OneMain, automotive retailer Lithia Motors and Itron, whose technology aids in energy and water resource management — and were sold to fund new opportunities.

Portfolio Highlights

The ClearBridge Small Cap Strategy outperformed the Russell 2000 Index, the Strategy's benchmark, during the first quarter.

On an absolute basis, the Strategy had gains in all 11 sectors in which it was invested for the quarter. The primary contributors to the Strategy's performance were the industrials, consumer discretionary and health care sectors. The communication services and real estate sectors were the main laggards.

On a relative basis, the Strategy outperformed its benchmark due to sector allocation, while stock selection was negative. Stock selection in the financials, communication services, energy, consumer discretionary and real estate sectors detracted the most. Conversely, stock selection in the health care, industrials, utilities and materials sectors proved beneficial. An underweight to health care and an overweight to energy also were positive for relative results.

On an individual stock basis, Bank OZK, Commercial Metals, Amarin, Textainer and TTEC Holdings were the largest contributors to absolute performance. The primary detractors were Metromile, Quotient, Vertex, Deerfield Healthcare Technology Acquisitions and Real Matters.

Besides names discussed above, more significant names initiated during the quarter included Primoris and Shoals Technologies in the industrials sector, Landcadia Holdings in the financials sector and Urban Outfitters and Goodyear in the consumer discretionary sector. More significant positions sold during the quarter included NIC and WNS in the IT sector, NextEra Energy Partners LP in the utilities sector, Blucora in the financials sector and OUTFRONT Media in the real estate sector.