Small Cap Stocks: Selective Opportunity

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DIAMOND HILL | CAPITAL MANAGEMENT

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As intrinsic value investors, we focus on evaluating businesses with a long-term time horizon. We build portfolios from the bottom up, irrespective of benchmark weights. That said, our fundamental research has periodically led us to identify opportunities in a specific portion of the market. We have begun to find such increased opportunities in small-cap stocks recently.

In 2014, portfolio manager and CIO Austin Hawley wrote a client letter titled, "A Bubble Deflated = Opportunity?" The piece examined how the valuation dichotomy that existed in the early 2000s, where mega-cap companies traded at a premium to the overall market, appeared to have been flipped on its head. A compelling valuation gap had emerged between the largest and smallest companies. In early 2014, the median stock in the Russell 3000 Index—at over 20X trailing earnings and nearly 17X forward earnings estimates—had become increasingly more expensive compared to the largest capitalization firms, which were trading at a meaningful discount to the rest of the market (Exhibit 1).

EXHIBIT 1: A BUBBLE DEFLATED—MEGA-CAP OPPORTUNITY?

	TRAILING 12-MONTH EARNINGS	FORWARD 12-MONTH EARNINGS	# OF COMPANIES	% OF TOTAL INDEX
Russell 3000 Index Median P/E	20.6	16.7		
Top 30 Market Cap P/E	15.6	14.4	30	1%
$50 Billion+ (ex Top 30) P/E	18.3	15.8	53	3%
$10 Billion - $50 Billion P/E	19.8	16.4	293	14%
< $10 Billion P/E	21.0	16.8	1,730	82%

Source: Bloomberg and Diamond Hill analysis; includes all index constituents with positive trailing 12-month and forward earnings estimates. Data as of 1/27/2014. *Market-cap weighted.

In our view, it was an opportunistic anomaly, as over long time periods, small-cap stocks have tended to earn a return premium over large caps, thanks to a combination of reasonable valuations, above-average earnings growth and acquisition premiums. However, as Austin noted in 2014, long-term returns are based on valuations, dividends and earnings growth, and higher returns for small company stocks are not a given. He argued that given the valuation disparity that existed at the beginning of 2014, over the following decade, smaller companies might fail to deliver the premium returns that the market typically expected. Further, he believed that mega-cap companies appeared to be priced for much better results going forward. While we haven't quite hit the decade mark yet, since the beginning of 2014, mega-cap stocks (as measured by the Russell Top 50 Mega Cap Index) have annualized over 11% while small-cap stocks (as measured by the Russell 2000 Index) have annualized 3.3%.

Fast forward to today, and the market looks very different. It is now smaller cap companies trading at a substantial discount to the rest of the market, particularly versus the largest capitalization companies. The median P/E of the largest 30 companies in the Russell 3000 Index currently sits near 20X forward estimates as well as 20X trailing earnings. Meanwhile the median stock in the broader Russell 3000 Index is trading at only 14X forward earnings estimates and 15X trailing earnings (Exhibit 1). And further down the cap spectrum, the smallest companies, under $10 billion, are trading at an even more attractive 13X forward earnings.

EXHIBIT 2: CHEAPER VALUATIONS IN SMALL CAPS

	TRAILING 12-MONTH EARNINGS	FORWARD 12-MONTH EARNINGS	# OF COMPANIES	% OF TOTAL INDEX
Russell 3000 Index Median P/E	15.3	14.0		
Top 30 Market Cap P/E	20.0	20.3	30	37%
$50 Billion+ (ex Top 30) P/E	22.6	19.0	74	25%
$10 Billion - $50 Billion P/E	21.4	18.8	270	23%
< $10 Billion P/E	13.5	12.7	1,581	13%

Source: FactSet and Diamond Hill Analysis. Only includes companies with positive 12-mo trailing and 12-mo forward earnings estimates. As of 3/31/2020.

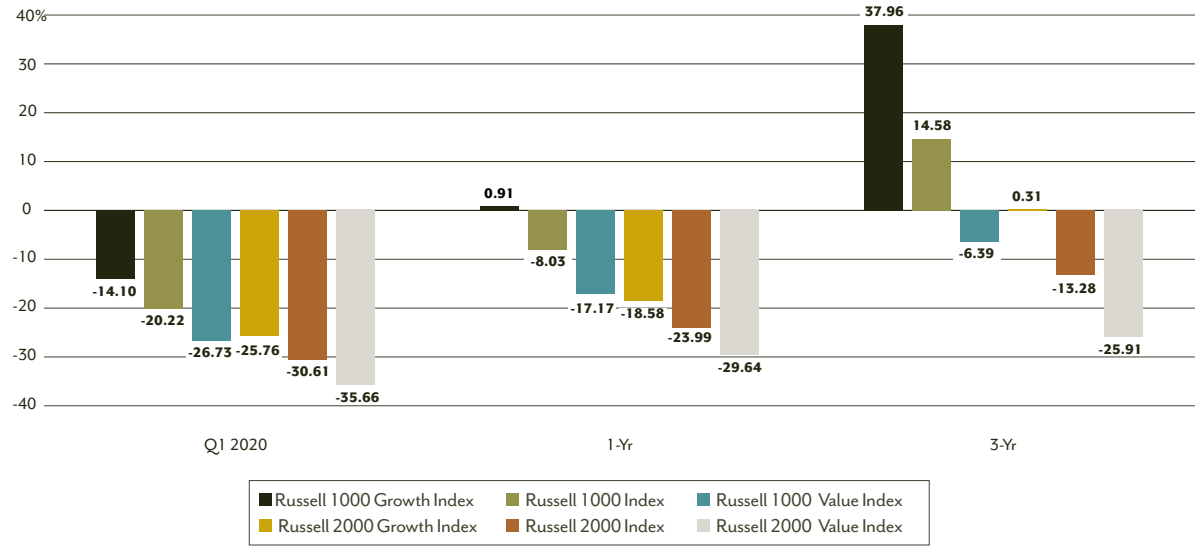
Are we headed for a resurgence in small-cap stocks like we saw in the early 2000s? As Austin pointed out in 2014, no one knows the path that the market will take over the near term. As we have seen for the past three years, the cheap can become cheaper and the expensive more expensive. What we do know is that over the past 18 months, our fundamental research has increasingly led us to opportunities down the capitalization spectrum, particularly within that last bucket in Exhibit 2—companies under $10 billion in market cap. Here we discuss three key considerations in assessing the potential opportunity in small caps: the recent market landscape, how we got here and how Diamond Hill is well-positioned to take advantage of the opportunities that exist in smaller companies today.

Small Cap Stocks: Selective Opportunity

The Market Landscape

The reality of a global pandemic setting in during Q1 kicked off an unprecedented market environment. Market moves that historically happened over a number of quarters, or at least months, occurred in a matter of weeks. Given the sudden-stop nature of the global shutdowns and the uncertainty that remained surrounding overall economic activity, a clear investor preference developed for defensives over cyclicals on both a sector and capitalization level. The result has been a wide performance disparity between large caps and small caps as well as growth and value. We can see this easily by comparing asset classes that sit on opposite ends of these spectrums—large cap growth and small cap value (Exhibit 3).

EXHIBIT 3: LARGE GROWTH VS. SMALL VALUE—TRAILING CUMULATIVE PERFORMANCE



Source: Morningstar Direct, through 3/31/2020. **Past performance is not indicative of future results.**

The performance differential is massive—over 20% in just one quarter. However, this trend isn't new. The pandemic-related panic merely accelerated a trend that had been going on for some time. Over the past 3 years, the performance differential between these two asset classes has been north of 60% cumulatively and 20% annualized.

Underperformance of this magnitude, not only by small caps but by small-cap value stocks in particular, has increasingly generated interest in this area of the market. We are excited about a number of businesses down the cap spectrum that appear to be available at very attractive discounts to intrinsic value. However, we must also acknowledge that there have been several fundamental factors, beyond the sentiment-driven selloff, contributing to the performance gulf between large caps and small caps over the past few years—some of which have been more structural in nature, and many of which still exist today.

The Drivers: How Did We Get Here?

What has been driving this performance gap between small and large? To assess the attractiveness and potential opportunity that exists in the current landscape, it is important to examine some of the factors that have led us to this point. We believe there have been three overarching and interrelated themes that contributed to the current environment:

1. Fundamental advantages in large cap.
2. Lower quality small cap bucket.
3. Sector/opportunity set differences.

Fundamental Advantages in Large Cap: Bigger Has Been Better…

Over the past few years, many mega-cap, technology-driven companies have gotten increasingly larger—making up a larger portion of the overall market (Exhibit 4).

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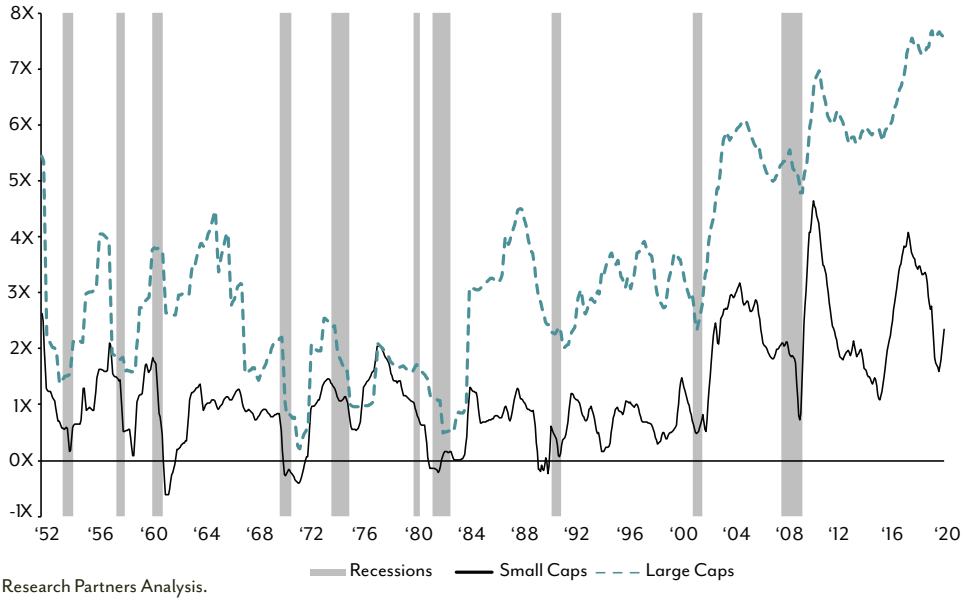
EXHIBIT 4: S&P 500® INDEX NOW MORE CONCENTRATED IN THE 5 LARGEST STOCKS THAN EVER

Source: BofA Merrill Lynch Global Research, Bloomberg.

While there are many factors at play, a material benefit to the five companies in Exhibit 4 and large caps more generally has been the increasing advantages of scale in a technology-driven world. The globalization trend, lower borrowing costs and technological disruption have allowed larger companies to drive down costs. Many large companies have increasingly taken market share and been able to expand profitability through the current market cycle in a way that small caps have not. As shown in Exhibit 5, the difference in free cash flow margins between large and small has never been wider.

EXHIBIT 5: SMALL-CAPITALIZATION STOCKS FREE CASH FLOW MARGINS[1]—1952 THROUGH MARCH 2020



Source: Empirical Research Partners Analysis.
[1]Data smoothed on a trailing three-month basis.

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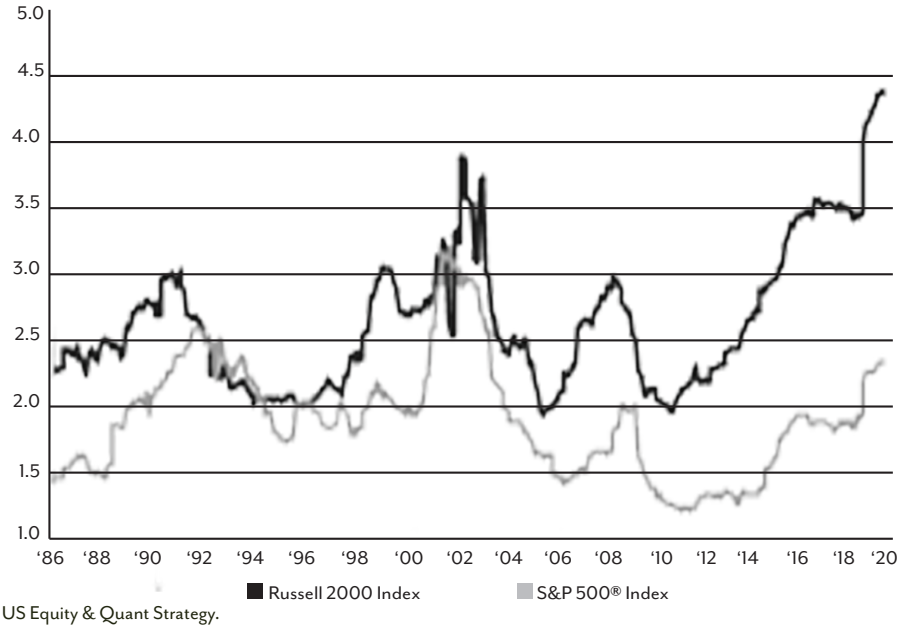
Smaller Cap, Higher Debt

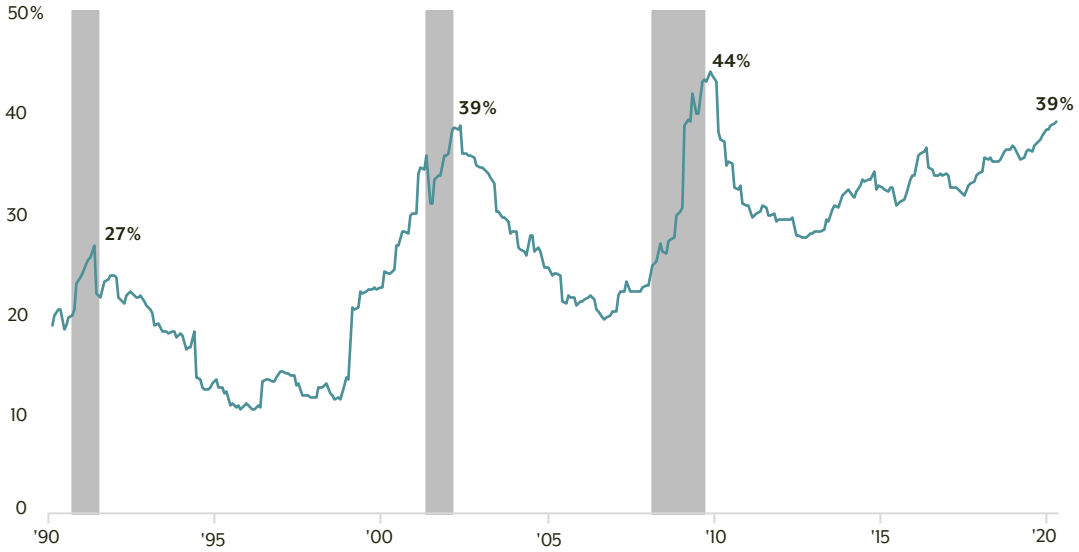
Due to a decade of easy money as well as some of the fundamental headwinds discussed previously, the small-cap bucket has been a bit lower in quality than in previous cycles (Exhibit 6). The proportion of the Russell 2000 Index that does not currently earn money (non-earners) has been creeping up to levels not seen since the Great Financial Crisis (Exhibit 7). In addition, small-cap companies in general tend to carry more leverage than their large cap counterparts, another characteristic that will be exacerbated by the pandemic-driven slowdown.

EXHIBIT 6: RUSSELL 2000 INDEX VS. S&P 500® INDEX NET DEBT/EBITDA—1986 TO PRESENT



Source: Factset, BofA US Equity & Quant Strategy.

EXHIBIT 7: PERCENT OF RUSSELL 2000 INDEX NON-EARNERS



Source: Strategas. Based on companies with available data.

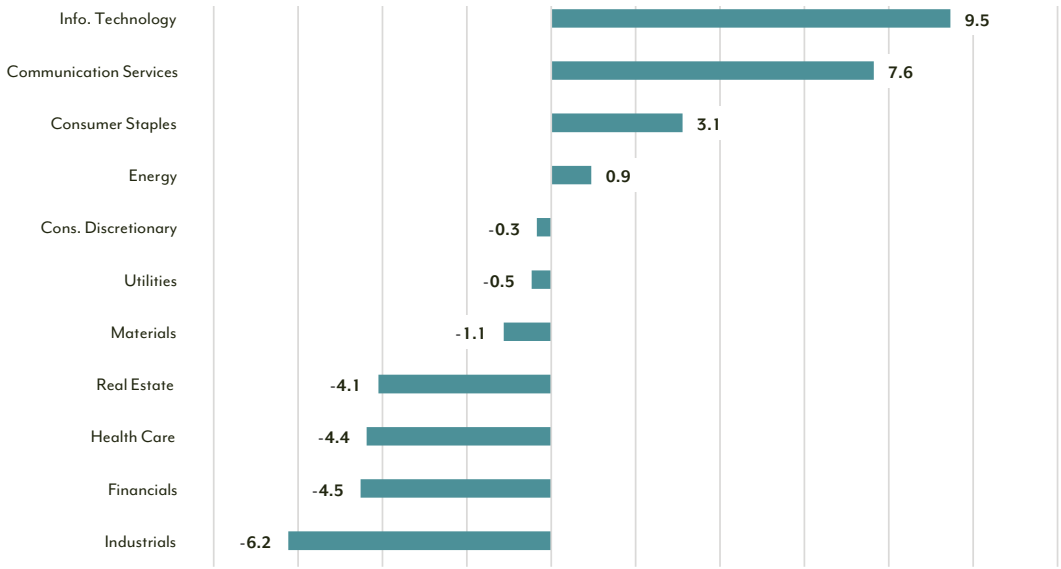
Small Cap Stocks: Selective Opportunity

Sector/Opportunity Set Differences

Differences in the opportunity set and sector weights that exist in the large-cap and small-cap universes have also been somewhat of a headwind for small caps. The past few years have been characterized by historically low interest rates and tepid economic growth which has not been aided by lingering concern surrounding the impact of trade wars and tariffs. These conditions have contributed to investor willingness to pay a premium for growth and stability. When discounted back at historically low interest rates, growth in the future is worth more today, all else equal.

These conditions existed before the COVID-19 pandemic, which has only intensified this trend. Economic uncertainty is high, and there will undoubtedly be significant near- and medium-term impacts from the shutdowns and shut-ins globally. As such, investors have fled anything with higher economic sensitivity and flocked to areas deemed more stable. While companies in different sectors have varying economic sensitivities, this has largely led to a preference for technology and closely related communication services over areas like financials and industrials. So part of the difference in the performance in large over small as well as growth over value has been the sector differences that make up these two areas. Exhibit 8 shows sector weights of the Russell 1000 Index minus the Russell 2000 Index at year end. The Russell 1000 Index has much more technology and communication services exposure while the Russell 2000 Index is more heavily weighted in industrials and financials.

EXHIBIT 8: DIFFERENCES IN SECTOR WEIGHTS—RUSSELL 1000 VS. RUSSELL 2000 INDICES



Source: FactSet as of 12/31/2019.

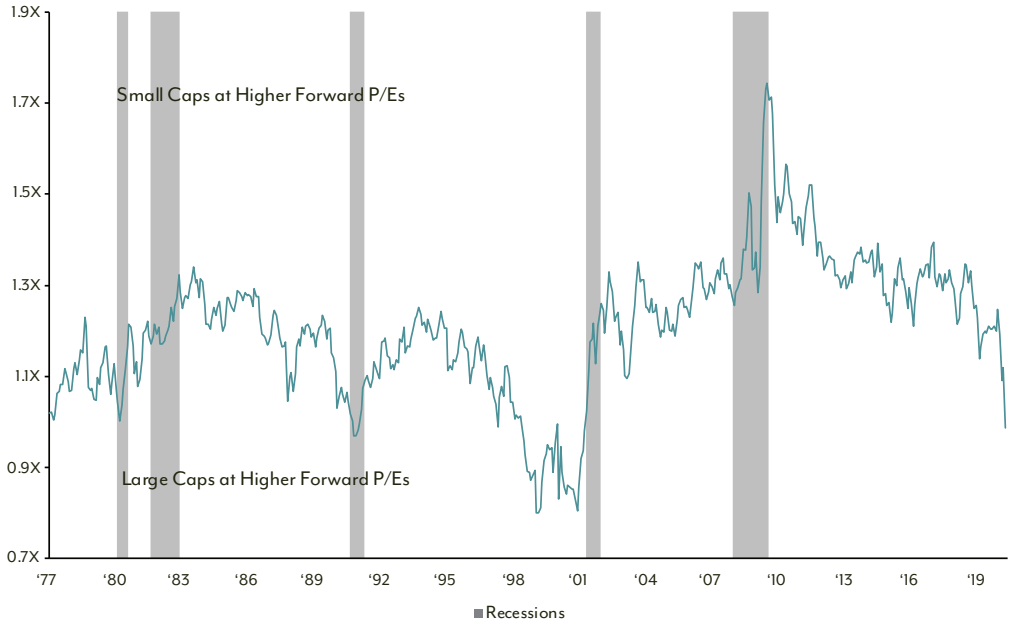
While these factors help explain some of the fundamental tailwinds a number of larger companies have had over smaller ones in recent years, that does not mean that large caps are destined to outperform small caps ad infinitum. As mentioned, long-term returns are determined by valuations, dividends and earnings growth, and we are now at a point where our focus on intrinsic value is uncovering increased opportunities in smaller capitalization companies.

The Opportunity: Where We Stand Today

Today we sit at the widest valuation gap between small caps and large caps in nearly two decades (Exhibit 9). However, historically cheap valuations alone are not enough in our opinion. Companies are often cheap for a reason, and risks are elevated for many small-cap companies given the prevalence of increased leverage and cyclicality that exists down the cap spectrum. This is a time where being patient and selective is key. For those with a long-term time horizon, a focus on the intrinsic value of a business and the bandwidth to sift through the short-term noise, there are indeed a number of attractive opportunities.

Small Cap Stocks: Selective Opportunity

EXHIBIT 9: SMALL-CAP STOCKS FORWARD P/E VS. LARGE-CAP STOCKS[1]—1977 THROUGH EARLY-APRIL 2020



Source: Empirical Research Partners.
[1]Capitalization-weighted data.

At Diamond Hill, we are well-suited to take advantage of this environment. We build high-conviction portfolios without regard to a benchmark, and we are typically looking to identify 50 to 60 businesses trading at a discount to what we think they are worth. With our centralized research team of industry specialists, we are able to do the deep, detailed research necessary to identify opportunities that quantitative screens may miss, as well as to avoid companies with high leverage or cyclicality that are automatically included in a passive vehicle.

One example is Cal-Maine Foods, a business we first purchased in 2018 and own in our Small Cap, Small-Mid Cap and All Cap Select strategies. Cal-Maine Foods is the largest shell-egg producer in the U.S. and is the top player in both branded (think Eggland's Best) and private-label eggs. Egg prices can be highly cyclical—which when combined with leverage (common among staples companies' balance sheets), can be problematic. However, Cal-Maine maintains a very strong balance sheet with a significant net cash position, allowing the company to be opportunistic during trough periods of the egg cycle as other producers may be struggling or pulling back. With a long-term mindset, the founding family (which still controls the company) has been able to create value and consolidate market share during downturns and come out the other side of a cycle in a stronger competitive position.

Our deep fundamental research allowed us to uncover this opportunity amid an egg bear cycle. Near-term earnings were depressed, but we were able to use our long-term mindset to see through that short-term noise to assess the normalized earnings power of the business. We were also able to leverage our understanding of the company's culture and management to build confidence that Cal-Maine would be well-positioned to take advantage of challenging conditions—which we have seen during the recent market downturn. While eggs are a cyclical business, the egg cycle is largely independent from the broader economic cycle, and the company appears quite resilient to macroeconomic shocks.

Another example, and one many readers may not be aware of, is Live Oak, a Wilmington, North Carolina-based bank. Many times, spending time to dig deep into the fundamentals and attributes that we find attractive about one business can lead us to uncover additional opportunities. Our small/mid cap bank analyst was meeting with management of an existing Small Cap strategy holding and discussing recent innovations in the banking industry. One of the most impressive innovations is the technology platform developed by Live Oak to streamline the small business association (SBA) lending process. As we dug

deeper, we discovered that Live Oak is a uniquely positioned franchise with strong organic growth prospects and optionality from a number of investments it is making on the tech side. Live Oak has developed a carved-out lending niche as the largest SBA 7(a) lender in the country. The company targets industry verticals where it has the ability to hire individuals with specific industry knowledge or experience. This expertise combined with cutting-edge technology has Live Oak well-positioned to be the bank for small business nationwide. Historically, Live Oak has traded at a premium valuation, but an evolution in its balance-sheet strategy starting in late 2018 caused a transitional/lower year of near-term earnings creating what we viewed as an attractive entry point.

In addition to our dedicated Small Cap and Small-Mid Cap strategies (which are already focused on smaller cap companies), our Mid Cap and All Cap Select strategies also provide evidence of this trend. Our All Cap Select strategy currently holds 33 securities, 16 of which are companies with a market cap under $10 billion. That means nearly half of our best ideas out of the entire Russell 3000 Index have been identified in smaller cap companies, many of which (7) have been initiated in the last 18 months. In our Mid Cap portfolio, nearly 80% of the businesses we own (as of 3/31/20) had a market cap under $10 billion. Again, we build portfolios without regard to a benchmark—we are going where we believe we are finding the most attractive values. The fact that the Mid Cap portfolio has a weighted average market cap over 40% lower than the Russell Mid Cap Index suggests a meaningful difference in where we are finding value across the capitalization spectrum. Our investment approach was designed to allow for that flexibility.

Conclusion

These have been unprecedented and unsettling times. It is times like these where our long-term time horizon and relying on our intrinsic value investment philosophy and discipline are especially key. The range of outcomes has indeed widened in the past two months for many industries and many companies. However, when uncertainty and short-term risks are elevated, as long-term investors we can aim to take advantage of opportunities we believe can drive favorable long-term results for our investors. Today many of those opportunities are emerging in smaller cap companies where our deep, fundamental research allows us to sift through the noise to find businesses at very attractive prices that have been passed over in recent years.

The Russell Top 50 Mega Cap Index tracks the performance of the 50 largest stocks in the Russell 3000 Index.

As of 4/30/2020 Diamond Hill owned equity shares of Cal-Maine Foods, Inc. and Live Oak Bancshares, Inc.