Schroders

Schroder US Small Cap Equity

Quarterly Commentary

3Q 2018

Market review

Trade tensions with China escalated in September as the Trump administration implemented 10% tariffs on an additional $200 billion of Chinese imports. This move resulted in China cancelling all trade negotiations and announcing another round of 5-10% tariffs on an additional $60 billion of US goods. There does not seem to be any prospect of a near-term solution with China. There was, however, some positive news on the trade front as President Trump and EU President Juncker announced progress on a "new phase" in their trade agreement and on the last day of the quarter, a deal was reached between US and Canada to restructure NAFTA.

The #metoo movement dominated headlines this month as Supreme Court Justice Nominee Brett Kavanaugh was accused of sexual misconduct during his high school and college years. In an already polarized nation, the result of both the investigation and confirmation hearing could have a significant impact on the looming November mid-term elections.

Despite the drama in Washington and growing trade concerns, the underlying US economy remains strong with Q2 GDP of 4.1% the best number since 2014. Also, both business and consumer confidence has been strong. The NFIB's August small business optimism index surpassed the previous record high from July 1983. The report highlighted the change in the tax and regulatory landscape as the big driver. In addition, the Conference Board's consumer confidence index hit a new cycle high in September.

We believe the Federal Reserve (the Fed) has been able to manage monetary policy such that it is staying ahead of inflation so far. As expected, the Fed raised rates by another 25 basis points in September and left intact the projections for four rate hikes in 2018 (one more to go), three in 2019 and one in 2020.

Inflation remains a primary concern. At the moment it is a lingering risk as the official data shows at best modest wage increases. However, there has been a clear uptick in mentions of inflation in small cap earnings calls from companies citing that they are experiencing rising wage and input costs in various industries that have yet to be reflected in the US government data. We think that increases will appear in the official data before too long.

Performance and strategy

The S&P 500 finished in positive territory all three months, posting its biggest quarterly gain in nearly five years. However, US small caps cooled in September. This was a reversal from the first half of 2018 when microcaps surged and led the market. The second stanza of 2018 has seen larger cap names outperform as small cap exchange-traded fund (ETF) flows moderated this quarter (small cap ETF flows often drive up performance in the smallest, most illiquid stocks).

The highest growth and highest beta names continued to outperform this quarter as the market remains agnostic to valuation. According to investment bank Jefferies, the highest price to earnings (P/E) names are beating the lowest p/e names by the widest annual margin since 1999!

Second quarter corporate earnings were strong across the capitalization spectrum with small, mid and large caps in aggregate all reporting over 23% earnings growth. US small caps saw the best earnings growth since 2010 after posting earnings growth of 26.8% and sales growth of 9.8% (source: Jefferies). It was also the first time that small caps beat large caps in the past two years driven by strong growth in healthcare and consumer staples. Estimates for 2019 are also solid for small cap (not as good as 2018, but still growing at a significant rate).

The Schroder US Small Cap Strategy outperformed the Russell 2000 Index before fees this quarter. Stock selection was additive to returns with the strongest contributions to return from the healthcare, energy and producer durables sectors. Within healthcare holdings medical & dental instruments & supplies (Bio-Techne Corporation) and pharmaceuticals (Pacira Pharmaceuticals, Inc.) drove performance. Underweights to real estate investment trusts (REITs) and energy (the worst performing sector in the Russell 2000 this quarter), also aided results. However, lackluster stock selection within consumer discretionary and staples along with an average cash position of 7.3% detracted in the third quarter.

Among our alpha categories, mispriced growth, the largest portion of the portfolio, outperformed the index this quarter by over 300 basis points. Integrated Device Technology, Inc. and Cavco Industries, Inc. were the largest contributors to the return. "Steady Eddies" also outperformed, driven by Acxiom Holdings, Inc. and Bio-Techne Corporation from the producer durables and healthcare sectors respectively. Turnarounds had a tough quarter driven lower predominantly by Del Frisco's Restaurant Group, Inc.

There were modest changes to our sector positions relative to the benchmark over the quarter.

More noteworthy shifts included an increase in the underweight to technology, having previously been in line with the benchmark. This was driven by exiting a position in Maxar Technologies Ltd. (discussed below). We also saw a reduction in the consumer discretionary weight after exiting positions in Jack in the Box Inc. and Match Group, Inc. (discussed below).

Outlook

We recently spent a week in Europe and the UK meeting with clients. We were asked regularly about the state of the US economy, risks we see in the system, where are we in the cycle, when the next recession will occur and whether we are more cautious now. Taking those in order:

US economy

The US economy is in good shape: GDP growth and job creation remain strong and unemployment is low. Capital expenditure is rising, as are wages – although they are only just now being reflected in US government data (we have been hearing about it from the corporate world for the last 3 years). We view valuations through the lens of interest rates, and from that perspective valuations in our space are not cheap but manageable. Relative to the Russell 1000 Index (large cap), the relative valuations are near the long-term average so there are no warning signs here. Finally, the bond market is not showing any signs of serious stress.

US equity market

So far this year the equity market has been characterized by several unsustainable trends. In particular, companies without earnings have outperformed companies with earnings. This is counterintuitive and unlikely to continue. It has been driven in part by the high proportion of initial public offerings which do not have any earnings. Biotechnology companies are heavily represented in this list.

Another quality measure which has lagged this year is companies with stable cashflows. Companies in the most volatile quintile of cashflows have been the best performers to this point. We also view this as unsustainable.

Risks

Debt: debt levels amongst companies are high, particularly in our space. While the S&P 500 has a debt/earnings-before-interest-tax-depreciation-and-amortization (EBITDA) ratio of 2.32x the Russell 2000 ratio is 4.37x. EBITDA is cyclical, debt is not. We are concerned that these ratios will rise further when EBITDA starts to falter and interest rates continue to grind higher. The solution is for companies to pay down debt.

Floating Rate Debt: Companies with higher percentages of floating rate debt are more likely to have problems as interest rates rise and earnings falter. In our space (Russell 2000) 44% of total debt is floating in contrast with large cap companies (17%). We have made a concerted effort to make sure our companies have lower levels of floating rate debt than their peers.

Trade wars

Much has been written and said, and what we've seen to date is that the US has taken an initially aggressive bargaining position and then moved back during negotiations. The conclusion of recent trade agreements with Mexico and Canada (our two largest trading partners) is an example. China is the key exception. The Administration continues to advance a hard line against the Chinese. If it continues on this path we can expect to see some effect on US, Chinese and global GDP. We suspect this will not be enough to trigger a recession however.

Where are we in the cycle?

This question was asked at almost every meeting. Our view is that we are late but not at the end of the economic cycle. Credit markets typically display distress at that point and we are not seeing that.

Overall, the market backdrop is encouraging and we remain reasonably positive for the intermediate term on US equities.

Risk disclosures

The market value of the portfolio may decline as a result of a number of factors, including adverse economic and market conditions, prospects of stocks in the portfolio, changing interest rates, and real or perceived adverse competitive industry conditions. Investments in small capitalization companies generally carry greater risk than is customarily associated with larger capitalization companies, which may include, for example, less public information, more limited financial resources and product lines, greater volatility, higher risk of failure than larger companies, and less liquidity.

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Source: Schroders, as of June 30, 2018. Firm assets include assets under management and administration.

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