ACG Insights: Has the Game Changed?

Executive Summary

- **A spike in popularity of "meme" stocks has highlighted a recent trend of outperformance for beleaguered companies with poor financials**
- **Small Cap U.S. Equities have been a focal point of the trend, where the percentage of unprofitable companies in the Russell 2000 index has risen near peaks (Exhibit 1)**
- **The relative outperformance of lower quality compared to higher quality stocks in 2020 was substantial, but also a divergence from history (Exhibit 2)**
- **There have been cyclical swings favoring non-earners that have generally been short-lived and concentrated around recessions (Exhibit 3)**
- **Portfolio exposure to quality stocks in the small cap space can depend both on the active/passive decision and which index is followed by a passive manager (Exhibit 4)**

Background

The year or so since COVID-19 burst into the collective world consciousness has seen an increasing number of rare events in markets. Some have been directly related to the pandemic, and some have been only tangentially connected. In the first category, there were examples such as the sharp decline and equally sharp recovery of market indices last spring, and unprecedented support from both monetary and government policymakers. Examples more indirectly related to the pandemic might be oil briefly trading for less than $0, or the renewed interest in all kinds of cryptocurrencies from Bitcoin to Dogecoin. Most recently, struggling companies like GameStop (GME) and AMC Entertainment (AMC) have seen their stock prices soar hundreds or thousands of percent in a few days led by an army of social media-connected retail traders. It has been well-documented how the pandemic and apps like Robinhood led to a flood of small traders in 2020. Smaller players fearful of missing out on quick gains will likely continue to ebb and flow with market cycles. The question here, with GME and AMC being prime examples, is whether the market's recent infatuation with lower quality or unprofitable companies is a paradigm shift or a short-lived phenomenon.

The Rise of Non-Earners

It feels like a successful investment philosophy lately would be to disregard the actual business prospects of a company. A common theme that ACG has been hearing in recent meetings with fund management teams is that strategies based on fundamental research and focused on quality, profitable companies have struggled relative to their benchmarks. This premise has been especially pronounced with small capitalization equities, where businesses may not have the capital buffer relative to larger companies to weather a poor economy. The number of unprofitable companies naturally tends to peak during times of economic stress. Exhibit 1 below (gray bars

represent recessions) shows that during 2020 the Russell 2000 approached a peak number of stocks not earning a profit last seen after the Great Financial Crisis.

Exhibit 1: Percentage of Unprofitable Small Cap Companies [1]

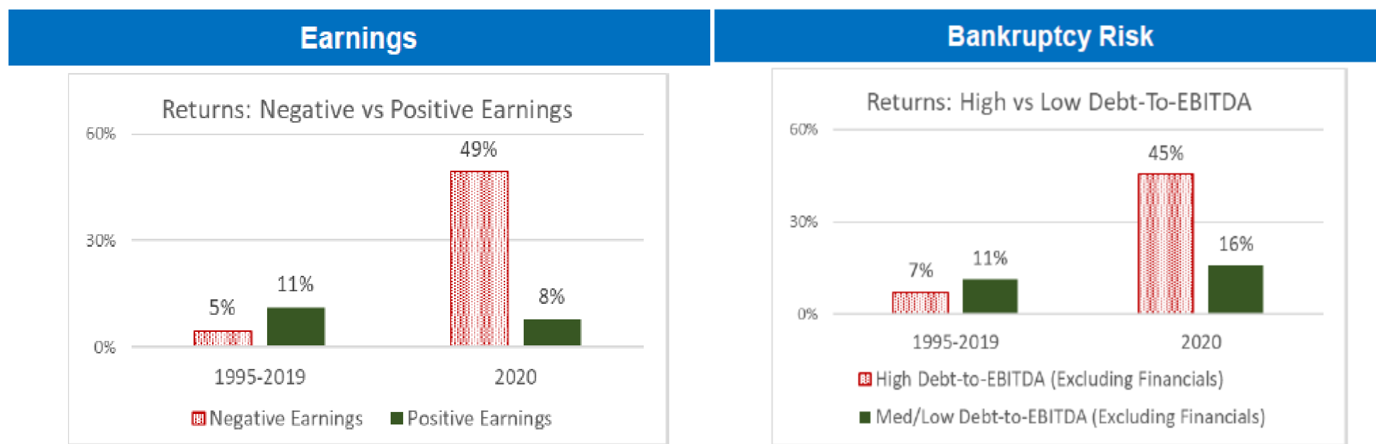
The sheer number of non-earners in a low-growth, low-rate environment is likely one of many reasons for the recent rally in lower quality shares. Money has to flow somewhere, and investors have been willing to pay a premium for the possibility of earnings growth years in the future. It is almost certain that many of these non-earners will turn profitable as the economy bounces back from the pandemic. Will a reversal like this change much about the current environment for low quality stocks?

Quality vs. "Junk" Stocks

There is no established set of parameters for what constitutes a quality company. Most value-oriented asset managers have a proprietary list of data points they compile based on company financial statements to determine the health of a business. Alternatively, there are a couple common ways to screen for low-quality or "junk" stocks. Most filters will examine earnings and debt-levels. Companies with negative net income (usually measured over the previous 12 months), and/or elevated debt would be classified as "junk". Fuller & Thaler Asset Management, who run a successful small cap fund based on behavioral finance, have some interesting data in their 2020 commentary. Exhibit 2 below, again using the Russell 2000, shows the extraordinary dispersion in stock returns last year compared to recent history when controlling for earnings and debt.

[1] Source: Driehaus Capital Management

Exhibit 2: Russell 2000 Returns Based on Earnings and Debt [2]



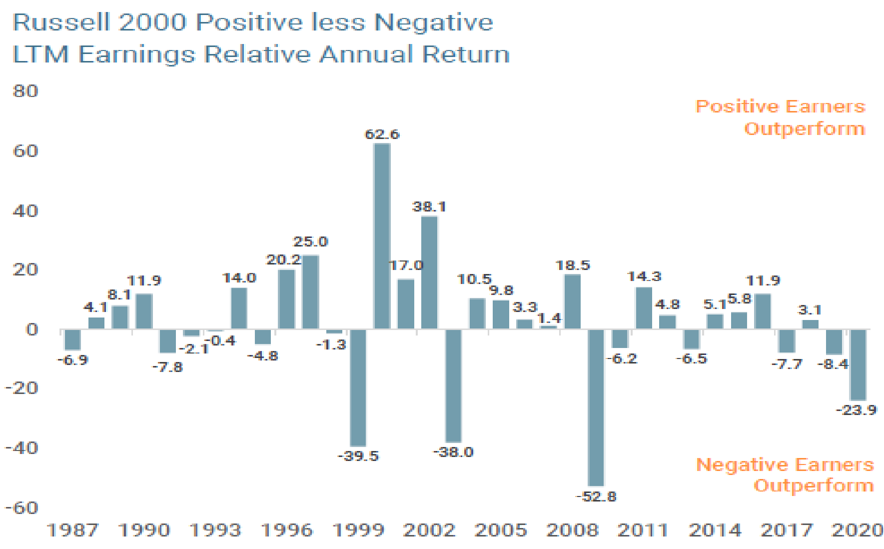
Companies with negative earnings and high levels of debt relative to earnings drastically outperformed in 2020. This difference in returns is a contrast to the prior two-and-a-half decades where quality produced better annual performance on average. Looking back even further, AQR Capital Management conducted a well-regarded study with data spanning 1957-2012 and found significant outperformance amongst small caps when controlling for quality. After establishing the history that quality small cap companies outperform given time, the original question of whether 2020 marked a shift in this rule becomes clearer.

Was 2020 an Inflection Point?

Like most predictions about markets, it is prudent to speak in probabilities rather than absolutes. It is much more likely that non-earner small caps are enjoying a relatively brief period of excess performance given history. Significant outperformance by small cap stocks with negative earnings like we saw in 2020 tends to be concentrated around extreme market/economic environments (Exhibit 3).

[2] Source: Fuller & Thaler Asset Management, Inc.

Exhibit 3: Relative Performance of Earners vs. Non-Earners [3]



The chart above shows similar periods of non-earner outperformance sandwiched around the 1999/2000 internet bubble and 2008/2009 financial crisis. Each period saw some degree of speculative exuberance and an economic recession, much like 2020. The compressed timeframe of the market cycle last year was undeniably unique, but cycles tend to rhyme despite their differences. Stories like GameStop and AMC are usually a temporary symptom of strong speculative markets rather than a cause. Glenmede summarizes the point nicely in their commentary associated with the chart in Exhibit 3 that outperformance of negative earning stocks has been more cyclical than persistent.

Solutions for Thinking About Quality in Small Cap Funds

Now that the case has been presented that long-term strategy favors a higher-quality tilt to small cap allocations, the question becomes how to implement the idea in a portfolio. One solution is to simply favor active management. Active managers will generally have more latitude to favor quality companies or filter out non-earners. Due diligence efforts to select those managers becomes increasingly important. The goal would be to find managers that have a track record selecting quality stocks, and to ensure they have a repeatable process that can be replicated into the future. Surprisingly, index selection can also play a role in exposure to the quality factor. The Russell 2000 and S&P 600 are both widely followed small cap indices. Exhibit 4 below shows that performance differences between the two can be significant.

[3] Source: Glenmede Investment Management LP

Exhibit 4: Annualized Small Cap Index Performance Comparison [4]

Index	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)	15 Year (%)
Russell 2000 TR USD	19.96	10.25	13.26	11.20	8.91
S&P SmallCap 600 TR USD	11.29	7.74	12.37	11.92	9.44

Returns as of 12/31/20

One of the largest differences between the two indices is their exposure to non-earners. The S&P 600 screens out companies with negative net income over the previous year and has a committee that approves new additions. The Russell 2000 aims to be a true representation of the smallest two thousand publicly traded companies. As seen in Exhibit 1, this can lead to a large portion of the Russell 2000 invested in non-earners. Returns of the two indices elaborate on the quality story. The Russell 2000 has far outpaced the S&P 600 in recent years as the speculative cycle has matured. The quality tilt of the S&P 600, however, has still outpaced the Russell 2000 over longer timeframes despite recent relative weakness.

Summary

Of the (many) unique market events in 2020 through the beginning of 2021, one of the most attention-grabbing stories has been the rise of “junk” or negative earning stocks. The trend started with names in the transportation and energy sectors and culminated with rise of downtrodden former shopping mall mainstays GameStop and AMC. Every unexpected market move feels different on the surface, but bursts of non-earner outperformance have been seen before. A tilt towards quality, especially in small cap, has proven to be a relatively successful strategy for long-term oriented investors. Acting on a quality tilt in a broader portfolio often comes down to the choice of manager or index. Anomalies like the rise of non-earners can persist longer than anyone expects, and will likely be seen again in the future, but probabilities remain high that stock prices will follow earnings over time.

[4] Source: Morningstar Direct

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