INVESTING IN SMALL COMPANIES PRESENTS AN OPPORTUNITY AS INFLATION PERSISTS

Kathryn McDonald - Co-Founder, Head of Investments & Sustainability
Harry Prabandham - Chief Investment Officer

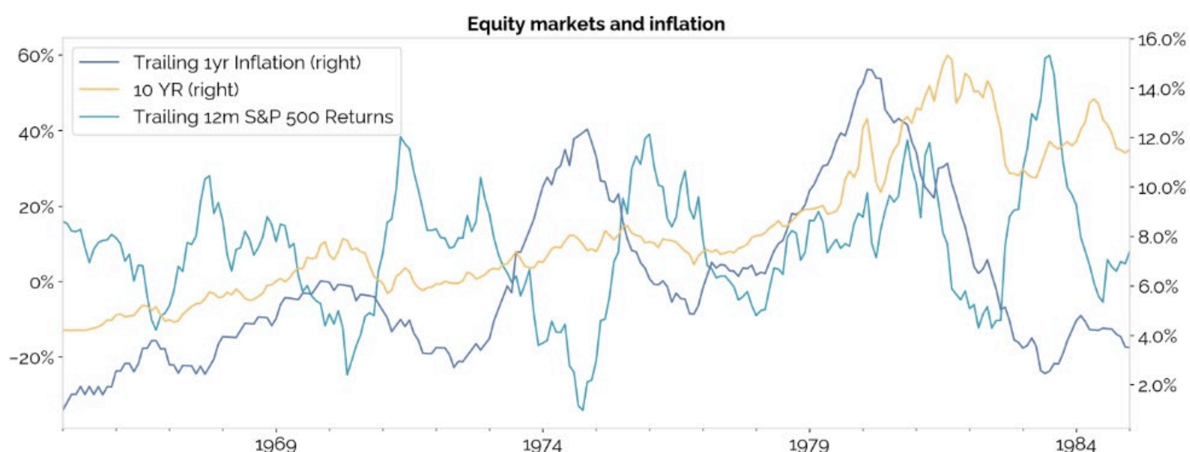
SUMMARY

It is clear that inflationary pressures once deemed “transitory” by the Fed may now be a fixture of the economy for longer than anyone hoped. Inflation negatively impacts most financial assets, and many investors only have theoretical understanding of the effects of swiftly rising prices. In this piece, we look to history as a guide to understanding which portions of the equity market might fare better than others, and why small cap companies present a special opportunity in today’s inflationary environment.

INTRODUCTION

Over the past year, as the US has continued to recover from the COVID pandemic, the Consumer Price Index or CPI has risen 8% and gasoline prices are up over 50%. Inflation has not been on investors' minds for over three decades. Now, it is clear that the inflation genie is out of the bottle. Recent increases in the prices of commodities, food, housing, and crude have shown no signs of abating. The Fed, which initially termed current inflationary trends as "transitory", has changed its stance and initiated long-overdue rate increases to battle inflation.

In general, inflation negatively impacts most financial assets. Equity markets experience significant moves during periods when inflation is unpredictable and large drops in equity markets generally coincide with higher inflation. As inflation expectations in the economy become widespread, capital becomes expensive - bond holders demand higher yields and equity holders demand higher equity risk premiums. The impact of inflation on individual companies varies widely, however: some companies have the pricing power to pass through increases to customers, while those with more limited options face the risk of shrinking margins. At the macro level, inflation disrupts price stability, arbitrarily redistributes income, increases wage disparities and triggers far reaching changes to economic and social systems.



Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

The last two decades were characterized by extremely low inflation, but since the start of the year, as inflation numbers soared, investors have shunned longer duration growth companies and rotated into defensive and value stocks. Currently, P/E multiples for US market are over 30% lower compared to a year ago, and investor sentiment is cautious. Equity markets are struggling to find a direction after a nearly 20% drop from the beginning of this year through May 2022. Other risky assets like bonds and cryptocurrencies have also seen significant decline in prices this year.

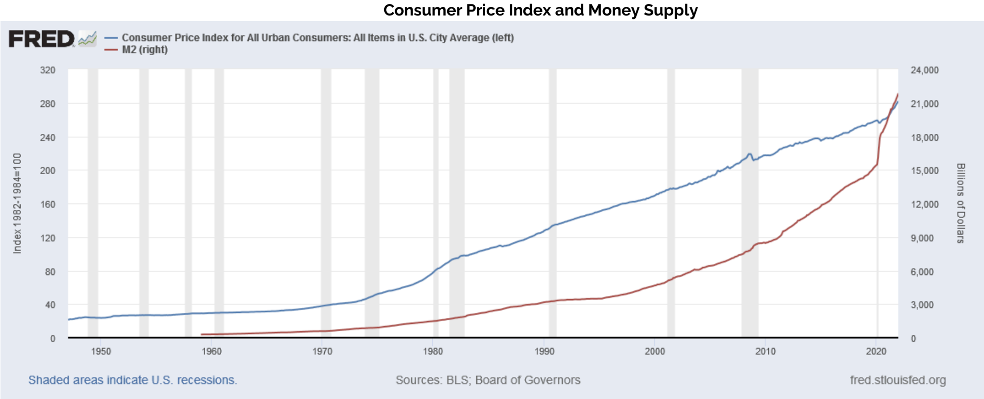
HISTORICAL PERSPECTIVE

The last period of high Inflation, which started in the mid-1960s, lasted for almost two decades. Inflation soared from 1.6% in 1965 to 13.5% in 1980. Inflation remained high throughout the 1970s until the Fed, under Chairman Paul Volcker, took the drastic measure of raising short term rates to nearly 20% in an effort to control it. There were two surges of inflation between 1965 and 1985 – the first one from 1974-1975 and the second from 1979-1980.

During the first inflation surge, the Fed's tepid response to inflation and oil crisis in the early 1970s resulted in stagflation – a period marred by low GDP growth and rampant inflation. In 1979-1980, the Fed's aggressive actions to control inflation triggered two recessions and pushed the unemployment rate to over 10% (from below 3% in 1965). However, with its assertive actions, the Fed brought inflation under control, and it has been relatively tame ever since.

Recent inflation has been fueled by several rounds of quantitative easing, accommodative monetary policies, and fiscal stimulus instituted during 2020-2021 in response to the pandemic. There has been a sharp increase in money supply (M2), and the US Debt has increased by nearly USD $8 Trillion between 2020 and 2021. Labor participation rates in the US have not recovered to pre-pandemic levels and this combined with low unemployment rates have the potential to further increase labor costs for companies. Supply chain woes from the pandemic continue to persist, and geo-political issues from the Russia-Ukraine War have pushed prices of food, oil, commodities, and fertilizer higher. As the issues with globalized supply chains have become more apparent, we can expect some companies to re-shore or near-shore their production. This may further push inflation higher and make it harder to maintain low inflation than was possible historically.

Consumer Price Index and Money Supply



One of the lessons learned from fighting inflation in the 1970s is that controlling inflation is not easy; it takes time and sustained policy discipline by the Fed. Investors worry that a dovish or hesitant Fed could find itself behind the curve on stubborn, non-transient inflation and prolong the battle, or worse, push the economy into stagflation. Several economists[1] have predicted that a soft landing is less likely, and that the current episode will culminate in a recession, as longer duration rates rise to account for the expected inflation.

While the Fed has signaled aggressive action to control inflation, the effectiveness of the tools that the Fed has at its disposal remains to be seen. Unfortunately, neither geopolitics nor supply chain issues can be fixed readily by monetary tightening! However, second order effects from monetary tightening could help reduce already stressed supply chains as pent-up demand for goods and services has surged in a post-pandemic era. If the Fed does push the economy into a recession to reduce aggregate demand, the resulting recession may be shallow or deep. Regardless, we can rest assured that the days of easy money and zero interest rates are behind us, and we should certainly expect higher equity risk premiums until inflation stabilizes. As we observed in Q1 and Q2 of 2022, we expect the markets to remain volatile as investors consider macro-economic data alongside corporate earnings over the next few quarters to gauge the outcome of the Fed's policies.

With this context, we consider how to position equity portfolios during periods of high inflation.

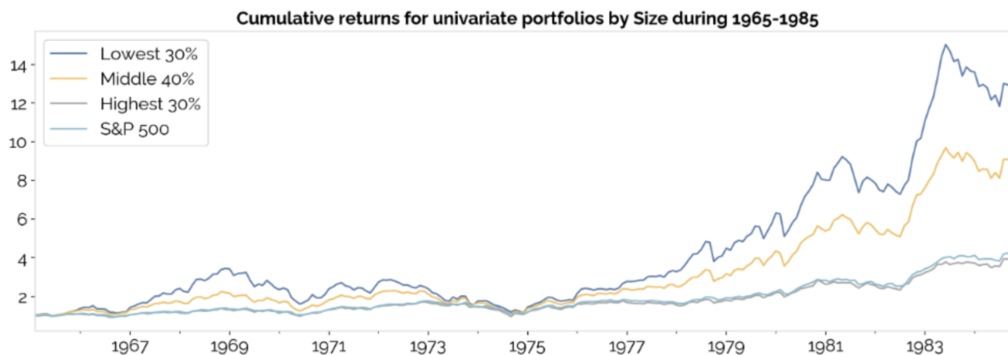
WHAT TO AVOID?

During times of heightened inflation, companies that do not have pricing power tend to fare poorly during periods of high inflation, as they cannot pass on the higher cost of goods, labor, or manufacturing. Companies that do not have stable earnings or are highly levered tend to be shunned by equity investors, as capital becomes both expensive and scarce. And as rates rachet up, growth stocks that trade at high multiples and speculative growth companies without positive earnings tend to go out of favor as investors grow impatient and demand shorter payback periods on their investments. And it suffices to say, companies with lower margins and/or poor financial health or discipline may also find inflationary environments less forgiving.

[1] https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Recession_blog.pdf

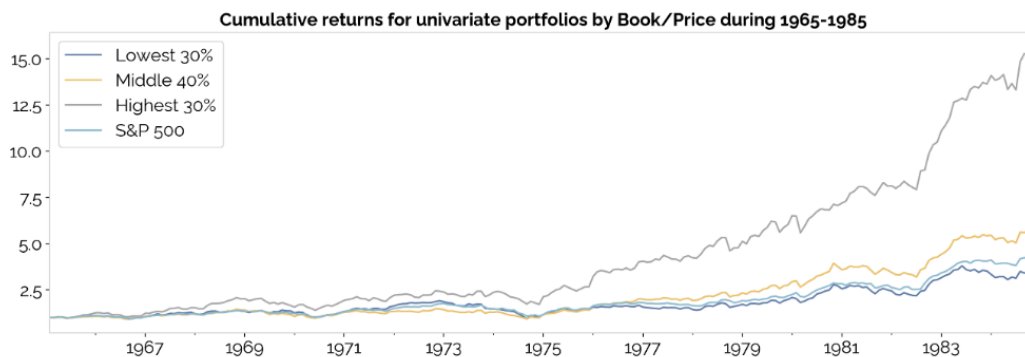
WHAT IS REWARDED?

While intuitively one might expect larger companies to be in better position to pass through cost increases, our analysis of the high inflation period in the US (Jan 1965 – Dec 1984) shows that smaller capitalization stocks generally did better compared to the broad market. Companies representing the smallest 30% of the market returned 13.5% (ann.) during the period compared to the S&P 500 return of 7.5% (ann.) and the largest 30% of the market, which returned 7.2% (ann.) during this period. Smaller cap companies are typically domestically focused, more nimble, less levered, cheaper relative to larger companies and tend to focus on a niche, which can be an advantage.



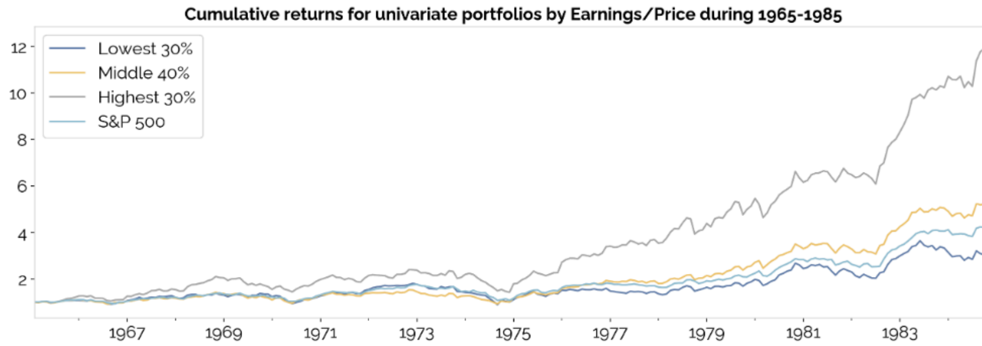
Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

As longer duration equities perform poorly and investors demand higher returns on their invested capital, tangible assets are preferred to intangible ones, and therefore, 'value' companies typically perform better during inflationary periods. For example, during 1965-1985, the top 30% of companies ranked by book/price ratio returned 14.82% (ann.), while the lowest 30% returned 6.3% (ann.).



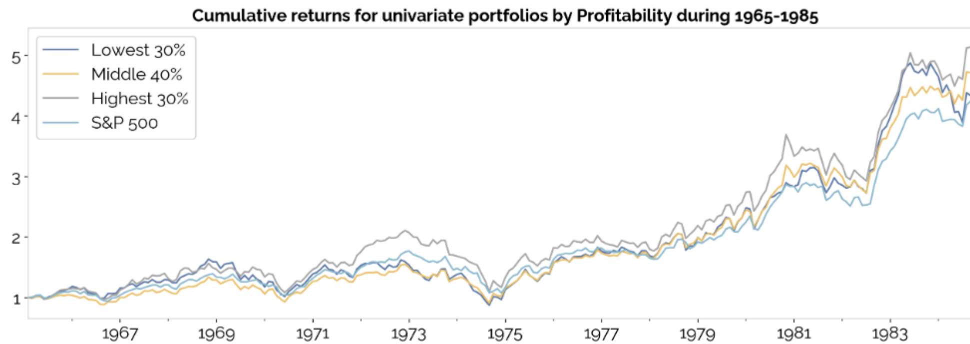
Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

Similarly, the top 30% of stocks ranked by earnings/price ratio delivered 13.4% (ann.), compared to 5.7% (ann.) for the lowest 30% of earnings/price stocks.



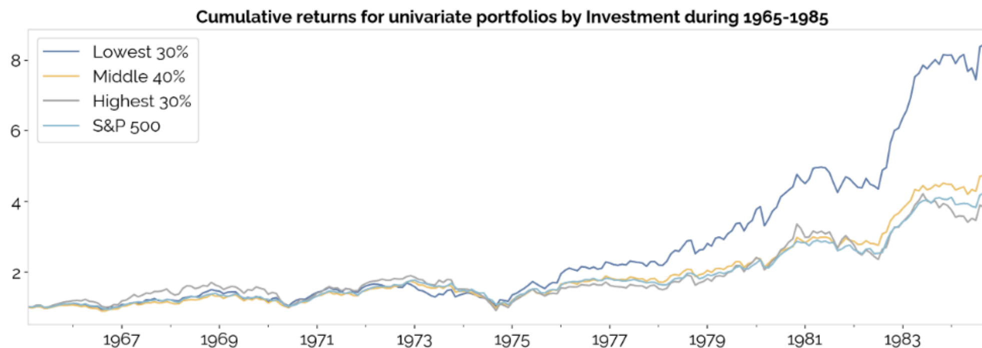
Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

Quality (proxied by cashflow return on equity) also worked well during this period, but its performance was not as spectacular as value. While quality is a necessary ingredient, it may be less discriminating in selecting winners over losers on its own.



Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

However, companies that invest more conservatively as measured by asset growth (often a component of 'quality' investing), have historically performed better than those that invest aggressively (11.3% versus 6.9% annualized).



Source: French's data library, Robert Shiller' Econ data, Federal Reserve Economic Data (FRED)

The Radiant Smaller Companies strategy invests exclusively in mid- and small cap equities – using history as a guide, these segments of the cap spectrum should have an advantage relative to larger cap peers during this period of inflation. All Radiant strategies invest in companies that score well on both fundamentals and environmental, social and governance ("ESG") criteria. Our strategies anchor on our proprietary definition of quality which goes well beyond profitability to include measures of earnings stability and earnings sustainability (including asset growth) which should work to improve performance during periods in which investors are seeking 'known quantities'. The linkage between quality and lower volatility coupled with avoiding speculative growth companies and poor-quality stocks should also benefit our portfolios. In terms of style exposure, it is important to recognize that while quality does well during inflation periods, it will likely need further support from valuation to deliver alpha. Further, as the market swings to find its footing, we see benefit from further complementing quality with a sentiment signal to help us better navigate turbulent markets ahead.

When it comes to ESG, we don't have a historical perspective to point to directly, as modern ESG integration simply did not exist during the last inflationary environment. We can, however, point to what we know to be generally true about strong ESG companies. As a group, companies with stronger 'G' profiles are less likely to be extremely leveraged or use accounting gimmicks to boost earnings. From an 'E' perspective, as western economies wean themselves from Russian oil, we expect companies that provide and use renewable energy to be generally rewarded by investors – this does not mean that we won't continue to see Oil & Gas rally periodically, but our belief is that the best long-run positioning is away from fossil fuel-exclusive energy and toward companies that will be part of the transformation of the energy grid. Finally, companies with better diversity and inclusion have been shown to attract and retain workers, boast stronger (and more consistent) financial metrics, and there is even evidence that diverse teams innovate more quickly. All told, we expect companies that use resources more efficiently – whether those resources are physical, human capital, brand, etc. – are better positioned to weather the inflation storm better than those that do not.

There is no way of knowing how long this period of inflation will last, in part because many external forces (war, wage pressures from lower labor participation rates, global supply chain woes) are contributing to the problem. Marry this with the fact that most investors have only a theoretical understanding of inflation and we begin to appreciate the true challenge of positioning a portfolio in today's environment.

At Radiant, we are firmly committed to investing at the intersection of proven fundamentals and ESG,

---

The information presented herein is intended to reflect Radiant's present thoughts and should not be construed as investment research, advice or a recommendation to purchase or sell specific securities, or to adopt any particular investment strategy. While the data is from sources Radiant believes to be reliable, Radiant makes no representation as to the completeness or accuracy of the data. Investment views, opinions, and/or analysis expressed constitute judgments as of the date of this material and are subject to change at any time without notice. Different views may be expressed based on different investment styles, objectives, opinions or philosophies. This material may contain statements that are not historical facts, referred to as forward-looking statements. Future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions. Radiant disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of May 31, 2022.

Individual investors are advised to carefully consider the risks associated with investments in equities, particularly in small cap and micro-cap securities, as they are inherently more volatile and therefore, considered more risky than larger capitalization companies. This research report does not take into account the investment objectives, financial needs and risk parameters of individual investors. Individual investors are advised by to discuss their particular financial situation with their investment representative and/or other professional advisors, prior to acting upon any recommendations in this report

Past performance is not necessarily an indication of future results. We do not assure future performance.