RADIANT

When Loss Makers are Winners

A case for stock picking within smaller capitalization Loss Makers

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While Loss Makers within the US smid cap universe are deeply unattractive as a group, we believe there is a strong argument for stock picking within the category, as it can be a source of both excess return and diversification that benefits an active equity strategy.

Overview

- Loss Makers are a significant part of the US smid cap universe
- As a group, their fundamentals and return profile are deeply unattractive
- We argue for stock picking *within* the Loss Makers group as a way to add alpha to an active US smaller companies strategy…
- …in a way that brings valuable diversification benefits

Defining Earnings Contexts

To better understand the drivers of risk and return in the US smid cap universe[1], it is helpful to divide all companies into three mutually exclusive earnings 'contexts':

Earners – companies with positive trailing 12-month earnings, often deploying earnings as internal capital to grow the business.

Payers – companies with positive trailing 12-month earnings that pay dividends. These tend to be more mature companies.

Loss Makers – companies with zero or negative 12-month earnings. Importantly, this includes two types of companies, those with temporarily negative earnings and those in permanent decline.

Within the Radiant investment process, we believe that this contextual view of companies allows for a more nuanced understanding of their fundamentals and their competitiveness relative to companies at a similar level of maturity. Further, investors seem to have varying preference for each of the Contexts during different points of the earnings cycle. For the purposes of this paper, these Contexts allow for a tidy segmentation of the US smid cap market that facilitates analysis of three very different types of companies.

[1] In this paper the US smid cap universe is proxied by the Russell 2500 Index. On June 2024, the capitalization range of the Index was approximately USD 10M – 48B. The time period used in all exhibits is January 2007 – June 2024 as this is the longest history we have for our analysis.

Characteristics of Loss Makers

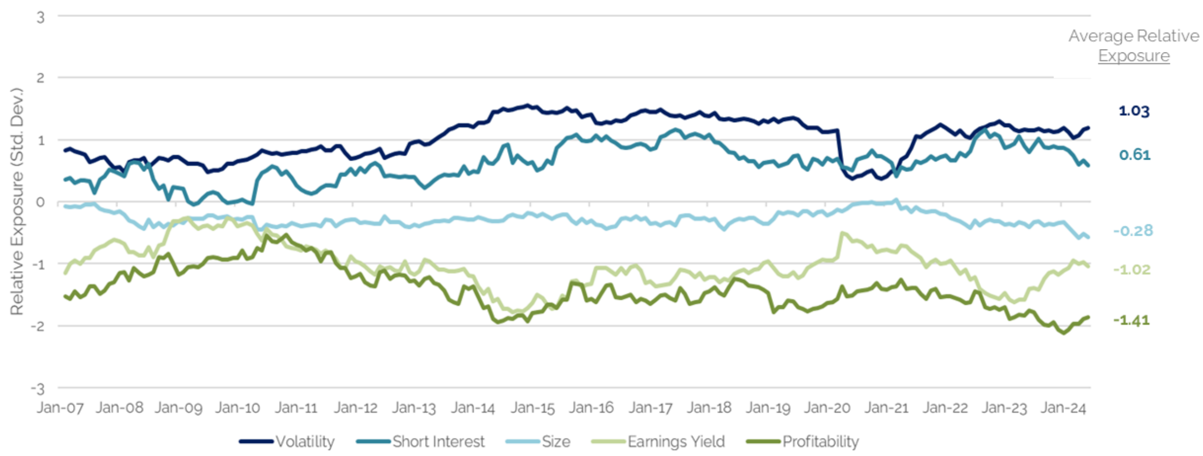
The weight of US smid cap stocks represented by Loss Makers varies over time, as does the actual number of names, but they have consistently been a meaningful part of the US equity market. The smid universe has historically been dominated by Payers; in recent years, Loss Makers have overtaken Earners in terms of number of stocks and are largely on par with Earners when it comes to percent of market capitalization. On 30 June 2024, the 786 names in the Loss Makers segment of the US smid cap universe represented just under 15% of universe cap.

Exhibit 1: Earnings Context Representation by Cap and Count

Source: S&P Global, FTSE Russell. Count and capitalization are observed monthly over the period January 2007 – June 2024. US smid universe is proxied by the Russell 2500 Index. Earnings Context categories (Loss Makers, Earners, Payers) are defined by Radiant Global Investors. Membership in these categories is observed monthly.

As a group, Loss Makers have very distinctive style characteristics: they are much more volatile than their smid cap peers, more often shorted, and have inferior earnings yields and profitability, as shown in Exhibit 2. Perhaps surprisingly, they are, as a group, only a little smaller in capitalization, on average. It is tempting to think of them as only micro-cap companies, but this is not the case for many.

Exhibit 2: Relative Style Characteristics of Loss Makers



Source: Wolfe Research, FTSE Russell. Loss Makers are companies with negative trailing 12-month earnings, observed monthly. Active exposure to common factors is expressed in standard deviation relative to the Russell 2500 Index. Exposures are observed monthly over the period January 2007 – June 2024.

But Loss Makers' defining attribute is their poor performance. Over the period studied here (Jan 2007 – June 2024), Loss Makers underperformed the broader US smid universe by more than 3% on an annualized basis, at a higher level of risk, resulting in a far inferior Sharpe Ratio (Exhibit 3).

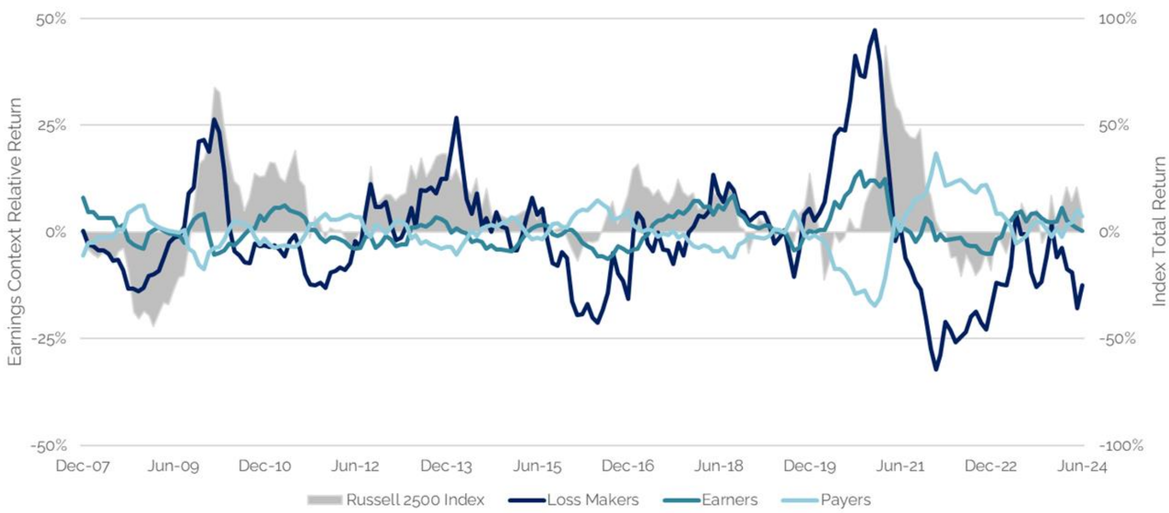
Exhibit 3: Earnings Contexts' Summary Performance

	Russell 2500 Index	Loss Makers	Earners	Payers
Return (annlzd.)	7.71%	4.65%	8.54%	8.08%
Volatility (annlzd.)	19.53%	25.88%	20.46%	18.42%
Sharpe Ratio	0.395	0.180	0.417	0.439
Beta vs. Market	1.00	1.24	1.03	0.92
Count (avg.)	2457	624	721	1112
Percent Capitalization (avg.)	100.00%	13.69%	29.95%	56.09%

Source: S&P Global, FTSE Russell. The US smid universe, proxied by the Russell 2500 Index, is approximately 2500 of the smallest stocks in the US. All returns are gross of fee. All figures calculated over the period January 2007 – June 2024. Returns and volatility are annualized. Loss Makers, Earners, and Payers are Radiant's proprietary, mutually exclusive Earnings Contexts used to categorize stocks according to their earnings profiles.

Their pattern of performance is instructive in explaining their high Beta: as implied by Exhibit 4 below, if Loss Makers are going to outperform, they appear to need an up-market environment. Critically, though, it is not the case that they outperform in *every* up-market. For example, over the trailing year, they have performed poorly even though US smaller stocks have rallied[2]. It is tempting to think that they will disproportionally benefit from an up-market environment, given the category's high Beta and volatility profile, but that's only true half of the time[3].

Exhibit 4: Earnings Contexts' Rolling 12-Month Relative Performance



Source: S&P Global, FTSE Russell. The exhibit shows rolling 12-month relative returns for the three Radiant Earnings Contexts versus the Russell 2500 Index, our proxy for the US smid cap universe, as well as the Index total return. All returns are gross of fees. Period is January 2007 – June 2024.

Given the outperformance periods for Loss Makers are few and far between, and their longer-term risk/reward profile is not compelling, why not simply throw away all Loss Makers? Even with ~20% of the market cap gone, there would still be plenty to choose from within the US smid cap universe. Many active managers reject them out of hand for this reason, assuming a straight-line relationship between their 'loss making' status and their poor performance results. At Radiant, we believe that this is a large cap mentality inappropriately applied to small caps. While Loss Makers do indeed have negative earnings (by definition), we understand that there are other ways to gauge 'economic traction', and that by doing so, we can effectively identify the Loss Makers that may only be temporary Loss Makers, rather than those in permanent business decline. But is there a good investment reason to identify the subset of Loss Makers that are improving their fundamentals? Put differently, is there a return incentive to identify loss-making companies that are generating 'economic traction'?

[2] This total return of the Russell 2500 Index was 10.47% over the year ending June 30, 2024.
[3] Of the 199 rolling 12-month return observations (December 2007 – June 2024), the total return to the US smid cap universe (proxied by the Russell 2500 Index) was positive in 138 periods. Of those, Loss Markets outperformed the Market in 70 periods, or in approximately 51% of up-market environments. Using calendar years as observations (instead of rolling 12-month periods), this number drops to 33%.

Identifying the 'Winning Losers'

It is Radiant's overarching, fundamental thesis that smaller companies experiencing 'economic traction' will outperform other smaller stocks over a full economic cycle. Applying this principle to Loss Makers should, in theory, help with stock picking intra-category, as it could be a way to isolate companies that are on their way to becoming Earners or even Payers. In Exhibit 5 below, we use a portion of Radiant's alpha model that seeks a combination of strong company fundamentals[4] and positive analyst sentiment to segment the Universe into high/mid/low alpha groups. This experiment is very basic in that it does not consider risk control, turnover, trading costs, or other very important criteria like ESG, impact, or tail risk, so it is in no way a proper simulation of a Radiant implemented strategy. This simple experiment does, however, make clear that it is possible to apply a fundamentals-led lens to Loss Makers to identify a subset that meet with above-market returns.

Exhibit 5: Loss Makers' Performance by Alpha Group

	Russell 2500 Index	Low Alpha Loss Makers	Mid Alpha Loss Makers	High Alpha Loss Makers
Return (annlzd.)	7.71%	-0.22%	4.52%	12.74%
Volatility (annlzd.)	19.53%	23.27%	21.15%	21.01%
Sharpe Ratio	0.395	-0.009	0.214	0.606
Beta vs. Market	1.00	1.12	1.02	0.97

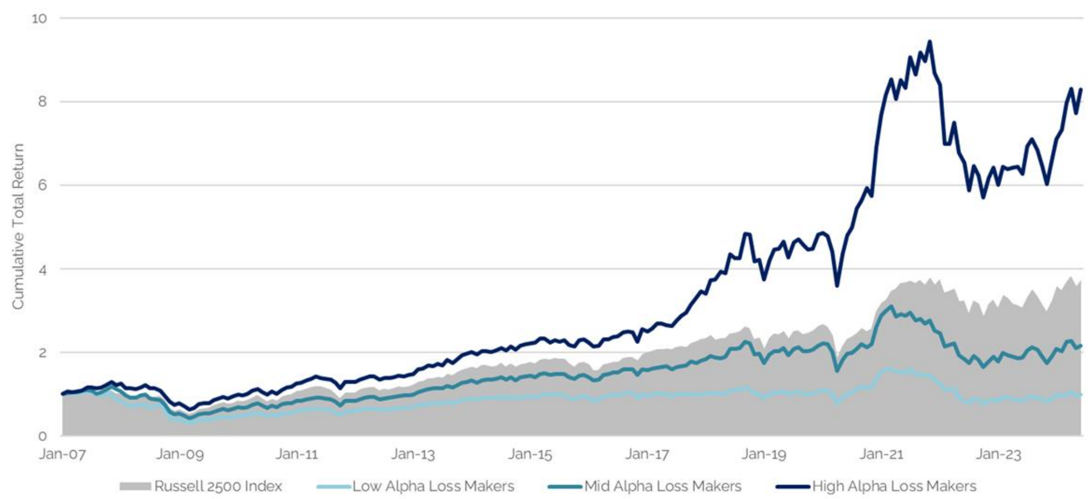
Source: S&P Global, FTSE Russell. The Russell 2500 Index is approximately 2500 of the smallest stocks in the US. All returns are gross of fee. All figures calculated over the period January 2007 – June 2024. Returns and volatility are annualized. On a monthly basis, Loss Makers are divided into Low, Mid, and High cap-weighted Alpha groups using a 30%/40%/30% weighting scheme, according to Radiant's proprietary fundamental alpha assessment. The groups are rebalanced monthly. The High Alpha Loss Maker group, therefore, contains the 30% of Loss Makers scoring highest on Radiant's proprietary fundamental alpha signal, at any point in time.

The High Alpha Loss Makers outperform the Universe by approximately 5% on an annualized basis, and significantly outperform other loss-making companies[5].

The results are even more dramatic when viewed on a cumulative basis.

[4] Here, we are purposefully vague, given the proprietary nature of our investment models, but we have used gross margin and changes in gross margin as important fundamental concepts within our evaluation of Loss Makers.
[5] We have satisfied ourselves that the performance spread between High/Mid/Low Alpha Loss Makers was not primarily the result of a capitalization bias. Sorting Loss Makers into High/Mid/Low *capitalization* groups produces only minimal excess return in the High group.

Exhibit 6: Cumulative Performance of Low, Mid, and High Alpha Loss Makers



Source: S&P Global, FTSE Russell. The Russell 2500 Index is approximately 2500 of the smallest stocks in the US. All returns are gross of fee. Here, cumulative total return is shown over the period January 2007 – June 2024. On a monthly basis, Loss Makers are divided into Low, Mid, and High cap-weighted Alpha groups using a 30%/40%/30% weighting scheme, according to Radiant's proprietary fundamental alpha assessment. The groups are rebalanced monthly. The High Alpha Loss Maker group, therefore, contains the 30% of Loss Makers scoring highest on Radiant's proprietary fundamental alpha signal, at any point in time.

The Additional Benefit of Diversification

As mentioned above, Loss Makers have a different cadence of performance as compared to Earners or Payers. This property carries through to active returns. The active returns from our Loss Makers stock selection example above are very lowly correlated – and hence diversifying – with those of High Alpha Earners and High Alpha Payers (the three categories most likely to be held in Radiant's live strategies). While the High Alpha group for each Earnings Context outperforms the Universe over the period of this study, the *timing* of the rewards is different, leading to a diversification benefit.

Exhibit 7: Performance of 'High Alpha' Groups within each Earnings Context

	Russell 2500 Index	**High Alpha Loss Makers**	**High Alpha Earners**	**High Alpha Payers**
Return (annlzd.)	7.71%	12.74%	8.69%	13.71%
Volatility (annlzd.)	19.53%	21.01%	22.10%	20.66%
Sharpe Ratio	0.40	0.61	0.39	0.66
Beta vs. Market	1.00	0.97	1.05	0.96
Correlation with Loss Makers	0.20	1.00	0.16	0.15
Correlation with Earners	0.10	0.16	1.00	-0.27
Correlation with Payers	0.12	0.15	-0.27	1.00

Source: S&P Global, FTSE Russell. The Russell 2500 Index is approximately 2500 of the smallest stocks in the US. All returns are gross of fee. All figures calculated over the period January 2007 – June 2024. Returns and volatility are annualized. On a monthly basis, Loss Makers, Earners, and Payers are divided into Low, Mid, and High cap-weighted Alpha groups using a 30%/40%/30% weighting scheme, according to Radiant's proprietary fundamental alpha assessment. The groups are rebalanced monthly. The High Alpha group for each Context, therefore, contains the 30% of stocks scoring highest on Radiant's proprietary fundamental alpha signal, at any point in time.

Some Loss Makers are Indeed Winners

Given loss-making companies' generally unattractive features we understand the impulse to exclude them from an actively managed portfolio. But what we have found in our research is that it may be possible to identify, ex-ante, the subset of Loss Makers that could go on to not only outperform their peers, but to outperform the Universe by a substantial margin. This group – what we refer to as High Alpha Loss Makers – brings an additional benefit of diversification to our active portfolios.

In short, we truly believe that *some* Loss Makers can indeed be winners, and from an investment point of view, useful in improving the risk-return profile of US smid cap equity portfolios.

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