The Opportunity in Small and Mid Cap Stocks

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Amy Zhang recently provided a portfolio update for clients in the Alger Small Cap Focus and Alger Mid Cap Focus strategies. To kick off the call, Alger's Market Strategist Brad Neuman, CFA, shared his insights on the markets and economy. The call was hosted by Matt Goldberg, a senior vice president and divisional manager in our distribution organization.

Please note, this transcript is from a call on July 8, 2020 and it has been edited for clarity and brevity.

Matt Goldberg: Welcome to today's call with Alger on the topic of small and mid cap investing with Amy Zhang, who is the portfolio manager of both the Alger Small Cap Focus and the Alger Mid Cap Focus strategies. And in addition to Amy and myself, we're also joined by Alger's Director of Market Strategy Brad Neuman. He's instrumental in helping to create our intellectual capital and he works extensively with our portfolio managers and analysts.

Brad Neuman: Thanks, Matt. I'm going to give a brief update about where we are in the economic outlook and why we're excited about small and mid cap stocks. So the U.S. economy is obviously in a deep hole right now. But we believe it is recovering albeit not as fast as some Asian countries like China. U.S. GDP was down 5% in the first quarter. And it's estimated to decline about 30% here in the second quarter.

However, I believe in May, we technically exited the recession that we now know began this past February. Retail sales grew 18% in May month over month. The unemployment rate declined in May and June from 15% to 11%. And manufacturing grew in May and likely grew further in June. Additionally, housing has been improving with a large homebuilder just this morning reporting record sales for June up stunning 94% year over year.

Now, I know that a lot of investors are concerned with the resurgence and new virus case growth and what it may mean for the economic outlook. The interesting thing is that we're seeing new cases well correlated with mask use. Early adopters of mask policy, such as Delaware, Maryland, New Jersey, New York and Pennsylvania, had fared better than others that have not mandated mask policies.

In fact, new cases per million people were recently reported to be only 65 in states where patrons and employees were required to wear masks in certain businesses and more than double that, or 149 new cases per million, in states where masks were not mandatory. More recently, California, Nevada and Texas have instituted mandatory mask policies as well as areas of Arizona and Florida providing some hope that cases will flatten out.

For a broad market perspective, it does look expensive on traditional metrics. But we believe that when factoring in low interest rates and a higher free cash flow generation of companies today relative to earnings, that makes stocks look much more reasonable.
But we're not here to talk about the broad stock market. We're here to talk about the outlook for small and mid cap stocks and of course Amy Zhang's portfolios specifically. But let me give you some highlights.

Brad Neuman (continued): It's worth noting how smaller cap stocks have performed coming out of recessions. When we look at the average for the past three recessions, we see that small cap stocks have outperformed in recoveries. In fact, in the 12 months after the trough of the past three recessions, the Russell 2000 increased 38% as compared to only 22% for the S&P 500.

And finally, I like to note about valuations for small or mid cap stocks. They're actually trading at a discount when we look at last 12-month P/E multiples when they normally traded at a premium. Small or mid cap stocks are trading at more than a 20% discount versus the S&P 500, which compares to their historical premium over the past decade.

And if you look further and look at growth stocks in particular, small and mid cap growth stocks look attractively valued as well with the S&P SmallCap 600 Growth Index the cheapest compared to the S&P 500 in nearly 20 years and the S&P MidCap 400 Growth Index close to the cheapest in a decade relative to the S&P 500 using the price to earnings multiples in last 12 months estimates.

Matt Goldberg: Thanks, Brad. I'd like to pivot now to Amy, who has a really diverse investment background. For example, she worked at Citicorp early on in her career building credit derivatives. I find this adventurous because it provides Amy with a unique perspective on the importance of downside protection. Amy's background is also unique in that she attended a value business school at Columbia, started her buy side career at Franklin Templeton, a value shop, and can now bring all that perspective as she's managing growth equities now.

Amy, again, welcome to the call. Really appreciate you being on the line. And as we kick off this portion of the Q&A, can you talk about the type of companies that you broadly look to own in your portfolios?

Amy Zhang: Thank you, Matt. And thank you all for being so supportive and being on the call.

At the core of what we do is identify and invest in what we believe are exceptional small and mid cap companies that have the potential to become exceptional large companies. We invest in companies that can save time, life, money and headaches. And as many of you know, a common theme of what we invest in is really innovation. We really look for companies that can disrupt or transform a market. And that dovetails well in our philosophy of Positive Dynamic Change. And we always want to be on the right side of the change. The growth for small, mid cap companies can be really exponential. It's not linear so that's why we take a very long-term perspective. We seek small, high-quality companies exhibiting sustainable and growing revenue streams. We invest in companies with defensible competitive positions and high financial quality, such as solid balance sheets and strong cash flow generation, which typically provide better downside protection.

Usually for us, we're looking for the winners that can go up 2, 3, 4, 5, 10 times or 20 times. A recent example is Shopify, which was more than 20 times. And we have numerous examples of such. But on the downside, we could have companies that go down 20%, 30%, 50%. But a common characteristic for our companies is that they generally have high financial quality. So even those companies, because they have a strong balance sheet, they do have strong cash flow generating capabilities. At the end of day, it is about having a portfolio of companies with idiosyncratic drivers and not correlated with each other.

Matt Goldberg: Thanks, Amy. To continue the thought there, how does the universe of stocks you're looking at – how would you describe it in the current landscape?

Amy Zhang: Change is a constant in small companies, and we believe innovation is really the best way to outgrow the economy. And that would transcend different economic cycles. With COVID, unfortunately it just accelerated that digital transformation.

Amy Zhang (continued): We invest in companies, whether in the technology sector or not, that can turn data into actionable information. And that's really very important because for AI to increase productivity, reduce cost, you need to have that data.

And health care is another very important theme. Especially in the pandemic, a lot of our companies are providing solutions for COVID, whether it's in health care or consumer or in technology.

I think that's the reason why we have done well both in up and down markets. But even in the new normal, I think we're well positioned because we believe the strong companies fueled by innovation are going to become stronger.

Matt Goldberg: Amy, are there some specific themes that you can elaborate on in health care, technology or the consumer space?

Amy Zhang: Yes. You know digital transformation is really universal and that applies to health care as well. Our companies in health care are very diversified in terms of different subsectors. But they're really in the cutting edge of technology, such as DexCom, which is a leader in continuous glucose monitoring. But we also invest in companies that produce insulin pumps, such as Insulet and Tandem.

There are other examples, such as companies that are leaders in liquid biopsy or kidney transplant test diagnostics. Also, Quidel, which is a leader in antigen tests for COVID. But they've been a leader in infectious disease for flu testing for many years. But for them to do point of care, you can get results in 15 minutes, it's a breakthrough situation in our current environment. But again Rome was not built in a day. It is really about the underlying needs of the population. And our companies really address those unmet medical needs.

On the other hand, there are areas such as e-commerce that have been a very important trend. That is why we were early investors of Shopify and we hold it in both of our strategies. Clearly, you could see how it's really about platform – from one product to a whole platform to address every single need of customers where they want.

And then there is cloud computing. Most of our companies in the tech area are the leaders in SaaS and cloud computing in our opinion. And there's a significant secular trend about shifting to cloud. And then there's remote work. It's not just work from home. And we have many companies in that area and then cybersecurity.

And last but not least, in consumer, we look for companies that can provide consumers with a very compelling value proposition. A good bang for their buck. But those are the companies that intend to be very innovative. For example, Wingstop. I feel like they're really a technology company that sells chicken wings. Going forward, a key driver for them is the digital strategy of delivery and pickup, so we believe they can do well not just in the COVID situation but going forward in the new normal too.

Matt Goldberg: Let's shift gears and discuss the Mid Cap Focus portfolio. Can you share with us what led to the launch of the portfolio, as well as your thoughts on the asset category?

Amy Zhang: Yes. We believe mid cap as an asset class is extremely attractive on a risk/reward basis because they may have the growth of small caps but they also may be higher quality like large caps. So it can possibly be the best of both worlds.

Many of these companies are ones we have known for a long time. I think of it like having a child. My son is now 10 years old, so knowing him for these past 10 years provides me with a lot of insight into his development. When he becomes a teenager, I think I'm definitely in a better position to understand him than if I'd never known him as a kid.

Same with companies. I think knowing the history and the kind of company that I followed, whether investing in them or following them as competitors, those are the companies that have stood the test of time.

Amy Zhang (continued): I have been managing small and mid cap stocks for 18 years, so I think to have that history is very important.

Also, we see this portfolio as a natural extension of Small Cap Focus, with an overlap that is very small. Right now, the overlap is less than 18%.

Matt Goldberg: Thanks, Amy. It really is this natural extension of the research and the work you've done with your team. And it does make sense that it would be a byproduct of all the experience that you already have.

What are the additional distinctions you might draw between the two strategies? Are there any additional differences or similarities that you think worth highlighting?

Amy Zhang: Yes. They both invest in what we believe are exceptional growth companies, and they both have a low debt-to-capital ratio. But what differentiates them is the initial point of investment. In Small Cap Focus, we look for companies with revenue under $500 million and in Mid Cap Focus, we look to invest in companies that have revenue over $500 million.

Also, they are investing at different stages of a company's lifecycle. If we look at our Positive Dynamic Change investing philosophy, we invest on the left side, which is high unit volume growth. But then on the other hand, there is the other side, which is lifecycle change and that is more suitable for mid cap companies. And knowing the history of them allow us to capture those changes earlier probably than our peers.

And also there's a sector weighting difference. As many of you know, Small Cap Focus is very heavily exposed to health care and technology. They are still about 80% of the portfolio. However, it's different for Mid Cap Focus. Currently, our largest overweight is consumer discretionary. But that shows you there are so many interesting consumer discretionary companies that are investible, such as Chipotle, Lululemon, DraftKing, and Burlington to name a few. I liked these mid cap names when they were smaller, but it was just extremely volatile. But now, they have different idiosyncratic drivers that make their moats much wider and stronger. So that's a very important distinction. And that's why the two portfolios are very different.

And tech, we're actually underweight. The reason is I think a lot of tech has gone up a lot, especially mid caps. Large cap is more expensive than mid cap, and midcap I think is more expensive than small cap tech. So, it's a deliberate attempt and we're actually 10% underweight.

Matt Goldberg: Great. Amy, in the past, I think you've said fundamentals are more important than valuation multiples. Is that pretty accurate? Is that a good way to look at the companies in your market cap ranges?

Amy Zhang: Actually, Brad and I just coauthored a paper on that. The shorthand of valuation multiples is really not applicable to small and mid cap companies just because there's a lot of different reasons. But one of the key reasons is that the growth is really exponential. It's really a step function, so not linear.

To that extent, to understand if a company could go from an exceptional small company to an exceptional large company, they're going to be an exceptional mid-sized company. And then it's really very powerful. There's nothing more powerful than compounding growth. To that extent, nobody could have accurately used any multiple to predict Shopify, for example.

Matt Goldberg: On behalf of Brad and Amy and myself, we'd like to thank everyone for taking the time to join us today. We value our relationship with each of you. And we are here for you during these extraordinary times. Please reach out to your local Alger representative with any questions, concerns that you or your clients may have. Thank you.

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