NOV
23
2020

Around the Curve

Banking on a Small-Cap Rebound

Gregory P. Manley, CFA |

The U.S. election is over, and a COVID-19 vaccine is in sight. Given the potential for a decrease in the prevailing uncertainty, a number of investors may be looking to add risk to their portfolios. However, with the S&P 500 up over 11% and Nasdaq Composite just past 31% this year through mid-November, many are wondering if it is too late (see Chart 1). While many larger-cap companies have performed well, there is one group of stocks that has been left out from this recovery: small-cap value.

1 U.S. Equity Index Year-to-Date

%, As of 11/12/2020

Portfolio	YTD
NASDAQ Composite	31.59%
Russell 1000	12.39%
Russell 1000 Growth	28.84%
Russell 1000 Value	(4.62%)
Russell 2000	3.58%
Russell 2000 Growth	16.00%
Russell 2000 Value	(9.47%)
S&P 500	11.25%

Source: Bloomberg (© 2020, Bloomberg Finance LP)

Many have been turned off from investing in value strategies due to the significant underperformance since the Global Financial Crisis (GFC). We get it—it has been painful. But if we dare say the phrase, this time really is different.

Prior to the pandemic, businesses were doing well. Some described the economic conditions at the time as the best they had seen in decades: unemployment was low; interest rates were low; government regulatory bodies were not throwing wrenches in growth engines; and we were expecting growth in capital investments. Cyclical businesses—mainly banks, industrials, consumer stocks, and energy companies—were expecting a strong 2020.

Well, we know what happened next.

Three Categories of Small-Cap Survivors

When the world went into quarantine, these cyclical businesses fell the hardest in the market. The abrupt shutdown was particularly damaging to small businesses, which had to rely on Paycheck Protection Program (PPP) loans to pay wages and rent. By the end of August, the small-cap market was segmented into three broad categories: those that survived and thrived during quarantine, including online retailers like Etsy, Wayfair, and Purple Mattress; those that survived but are still needing an economic recovery to thrive, e.g., banks and industrials; and those that may survive but will not thrive in any environment, e.g., brick and mortar retail, small mall REITs, etc.

Not All Value is Equal

The Russell 2000 Value Index has largely recovered from its lows earlier in 2020 but remains down more than -9% for the year. Here in lies the opportunity. Over 69% of the stocks in this index are still negative for the year. How can this be? Of those three categories we mentioned before, the small-cap value index is heavily weighted in the latter two: those businesses needing an economic recovery and those businesses that will likely struggle in any environment due to secular changes. Now more than ever, it is important to understand that not all value is equal. Going forward, it will be imperative to distinguish between the two categories of underperformers, recognizing that some situations may not really be cheap, such as a mall REIT with JCPenney as an anchor store trading at 5x earnings. We believe stocks that fall into this category are not so much attractively valued but efficiently priced. The way we make these assessments is by using multiple valuation methodologies to determine intrinsic value. We then compare this estimate against the prospects for future value creation by using situation-specific variables, such as an assessment of the business cycle, cash flows, owner earnings, capital needs, and reinvestment opportunities.

Assuming a Biden administration takes over in 2021, we believe they will provide the fiscal support necessary for small businesses to continue to survive until enough of the population is protected from the coronavirus and economic growth resumes. For investors in these companies, it is largely a waiting game. While it may take a couple of years for fundamentals to fully recover, we expect the market to react quickly to good news just as we saw on November 9, 2020, when Pfizer announced a preliminary efficacy rate of 90% for its COVID-19 vaccine trial. Small-cap value shares that day increased nearly 7%, outpacing all other asset classes.

Still Room for Recovery

One particularly large opportunity set to watch is the banking industry. This industry alone makes up 30% of the Russell 2000 Value and accounts for over half of the negative contribution to the index this year. In the early stages of the market decline, many traders consulted their playbooks from the GFC, when undercapitalized bank shares traded lower, and sold banks down to similar valuation levels. This was the wrong trade as banks today are well-capitalized, and as we have seen with the distribution of PPP loans, have greatly aided in helping the economy during this pandemic.

While many share prices of banks have improved off their lows, there is still a lot of recovery left to return to pre-COVID levels. One large reason banks have lagged is due to an untimely change in how reserves against loan losses are accounted for on income statements. On January 1, 2020, most banks implemented what is called Current Expected Credit Loss (CECL) accounting. Historically, banks graded all their individual credits and placed reserves against loans for which payments had become questionable. CECL scraps this way of reserving and instead requires bank management to pull out their crystal balls and become economic forecasters. Credit officers are now required to look forward and estimate what the economy, unemployment, and dozens of other economic variables will look like over the life of their respective loan books.

A simple way to think about it is the longer the life of a loan, the larger the loan loss provision will be since it is more likely an economic slowdown will occur. When a bank takes a provision, it is charged against net interest income on the income statement, reducing today’s earnings. When the U.S. entered lockdown, unemployment and economic growth plummeted, causing these new provisioning models to dramatically increase reserves and decrease current earnings. What is important to understand about provisioning is that it can move up and down. As the country begins to recover, this charge against earnings will at first stop growing and then will begin to reverse should the economy move nearer to full recovery. Just as earnings today are artificially low, these provision charges could reverse in the future, artificially increasing earnings. Bank valuations are very tied to their returns on equity (ROE). As earnings rise, ROE will rise, and valuations will improve materially. Those banks that took advantage of this down period to buy back shares should see even better results.

How much can earnings increase? The financial services firm Stephens recently looked at this question and determined that in a scenario where the economy approaches full normalization, earnings can improve, on average, by 28% at many of the smaller regional banks. Should this occur, we would expect valuations of bank stocks to exceed their 2019 levels. For small-cap banks, this rebound would mean a re-rating from around 1x tangible book value (TBV) today to somewhere higher than 1.5x TBV, on average.

Clear Catalysts Ahead

The example of smaller banks is just one reason why we feel this time is different. With a large part of the universe yet to recover, and with clear catalysts ahead, we believe the timing is right for small-cap value stocks.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.