INVESTMENT

As Recovery Strengthens, Look for Opportunities in Global Small Caps

American Century Investments Senior Portfolio Manager, Trevor Gurwich, discusses the opportunities the pandemic, and ensuing recession, has created for global small-cap investors

It has been said that the one constant is change. Change may be inevitable, but I don't think anyone anticipated the speed or severity of change global markets have experienced so far this year. While the coronavirus pandemic and resulting recession have pressured economies and investment markets alike, they have also created opportunities for global small-cap investors who can adapt quickly to shifting conditions.

As we continue to navigate the uncertainty around the current health crisis, we believe our bottom-up investment approach helps us identify opportunities in companies whose earnings are inflecting positively despite current volatility.

While we note that small-cap stocks have historically underperformed large caps during risk-off periods like we saw at the peak of the pandemic, they have also led during recoveries, as seen during the past two recessionary environments. Because it's difficult to time such moves, we believe it's important to maintain a long-term allocation to global small caps. While the length and scope of this crisis remains uncertain, we think small caps may now be able to lead markets higher following their underperformance in this downturn.

The Importance of Staying Nimble

We believe our investment process helps keep us nimble, allowing us to capitalize on persistent inefficiencies and recent market dislocations in the global small-cap universe. Our process seeks to identify early fundamental inflection points that lead to sustainable acceleration in earnings growth. Small caps tend to experience higher frequency of inflection points and greater share price volatility than their large-cap peers. For example, when a large global company like Nestlé launches a new product or expands into a new geography, it is less likely to translate into a positive fundamental inflection point than for a comparable small-cap company.

Global small-cap markets also tend to be slow to recognize inflection points in growth trends. We focus on exploiting such inefficiencies by identifying companies in the early stages of a growth cycle. Capturing an inflection point and reacting quickly in an effort to take advantage of potential earnings acceleration are key to our process and particularly important in global small-cap investing.

Recent stock market volatility, changes in consumer patterns and higher earnings variability have translated to a broad array of compelling investment opportunities, including companies that are inflecting positively and with shares we believe are mispriced. We believe the key to success in such an environment is the ability to quickly source and research new ideas, capitalize on market dislocations, and objectively incorporate both upside and downside risks. An additional key benefit to this approach is a broad opportunity set. We seek sustainable improvement and don't limit ourselves to companies delivering above an absolute level of growth. We are finding such earnings improvement in a wide range of companies, including those benefiting from secular growth trends, cyclical recovery and evolving consumer behavior trends.

Advantages of a Global Approach
In our view, investing globally delivers more compelling risk-adjusted returns compared to a regional small-cap approach. We believe our global approach can offer diversification and performance potential through exposure to a greater opportunity set, while helping to offset any home country bias. We believe active managers can avail of the best opportunities and highest conviction ideas regardless of region, sector, industry or domicile. A universe of more than 6,000 names provides access to 'best-of-breed' companies on a global basis and, importantly, to those companies that represent good process fits.

We view environmental, social and governance (ESG) factors as an important input into our fundamental research, which could potentially help decrease downside risk or increase exposure to upside potential. Our integrated ESG approach focuses on issues that may materially impact a company's business fundamentals, notably a company's earnings visibility and growth trajectory.

Selectivity Is Key as the Outlook for Earnings Remains Unclear
The impact of COVID-19 on earnings has been large and notable. Visibility for future earnings remains murky, with many companies withdrawing or declining to give guidance. The range of potential earnings scenarios underscores the importance of selectivity. We seek to differentiate between businesses facing cancellations and longer-term demand hits versus those that may only experience delays in revenues. For example, travel-related companies such as airlines, hotels and cruise lines have taken dramatic hits to revenue, as business and recreational travel has all but ceased during the pandemic. However, companies exposed to outdoor recreational activities, such as boating and recreational vehicle makers, saw sharp drop-offs in revenue as the pandemic worsened, but rebounded strongly as consumers turned to outdoor recreation and vacation activities closer to home.

Pivoting to Take Advantage of Opportunities as Economic Recovery Evolves
Early in the COVID-19 crisis, our bottom-up focus on companies with accelerating and sustainable earnings growth helped us identify companies that were beneficiaries of shelter-in-place measures. Examples included online education, video gaming, and data center companies. We are now keenly observing the recovery in global markets. Signs of improvement or stabilization in multiple countries are further supported by substantial fiscal stimulus measures. As a result, our process is now finding companies that may have suffered during the crisis but are likely beneficiaries as economies begin to reopen.

An example has been a low-cost gym operator in Benelux, France and Spain, whose share price declined by nearly 70% earlier in the year. Its revenues were severely impacted in the short-term due to lockdowns and stay-at-home measures, but we believe the company will benefit as economies continue to reopen. Revenues could decline by 15% in 2020, but we forecast accelerating revenue and earnings growth in the latter half of 2020 and into 2021. Additionally, the company recently raised extra funding that we believe will support future revenue growth and market share gains versus its weaker competitors, many of which lack scale and are struggling. ■

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