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Marketing Material

RUSSELL 2000: SEARCH IT FOR GROWTH

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IN A NUTSHELL

_ Russell 2000: Avoiding its broad beta and value play.
_ Russell 2000: The profitable are vulnerable, but unprofitable show great promise.
_ Technology was the only Russell 2000 sector with positive earnings growth in the second quarter of 2020.
_ Russell 2000 leverage is rising and concerning at the old & vulnerable sectors.
_ Russell 2000 is more sensitive to U.S. GDP, especially old & vulnerable sectors.

RUSSELL 2000: AVOIDING ITS BROAD BETA AND VALUE PLAY

From a macro perspective, the Russell 2000 is typically treated as a higher beta, more value (financials heavy) and U.S. economy-tilted version of the S&P 500. While small caps carry a connotation of growth, usually growth is a characteristic more associated with sector or industry than size. In this note, we review Russell 2000 earnings and balance sheets after the second quarter of 20202 and the shifting composition of the Russell 2000; as its old & vulnerable sectors struggle in the pandemic, while its young & healthy sectors show promise with many of its tech companies turning profitable for the first time. We see the Russell 2000 more as an attractive universe for growth-stock selection than the index as a macro play.

RUSSELL 2000: THE PROFITABLE ARE VULNERABLE, BUT UNPROFITABLE SHOW GREAT PROMISE

The Russell 2000 lost 99% of its profits in the second quarter of 2020 vs. a year ago. As 1077 companies were profitable vs.1257 last year. Of the profitable companies in the second quarter 2019, profits fell 2/3rds in the second quarter of 2020.

The decline in profits at the profitable Russell 2000 firms in the second quarter of 2019 is the same magnitude suffered in aggregate by the old & vulnerable S&P 500 sectors in the second quarter 2020 (financials, real estate, consumer discretionary ex internet retail, industrials, materials and energy).

In the second quarter of 2019, about 125% of Russell 2000 profits, or about 90% excluding the health-care sector, came from financials, consumer discretionary, energy, materials, industrials, Real Estate Investment Trusts (REITs). These are the sectors vulnerable in this pandemic, which are also mature and generally growth challenged. Whereas, young & healthy sectors (tech, communications, health care, staples and utilities) were small contributors to Russell 2000 profits in 2019. For instance, health care in aggregate has not been profitable at the Russell 2000 for years. Excluding health care, tech was 8% of Russell 2000 profits in the second quarter of 2019, but then surged to 33% in the second quarter of 2020 as its profits increased and other sectors declined. On a more normalized basis or in 2022, we would expect tech and communications to be about 15% of profits.

The overall mix of Russell 2000 profits remains skewed toward old & vulnerable sectors, despite the recent jump in tech earnings and smaller losses at health care. Thus, the Russell 2000 price-to-earnings ratio (P/E) ex. health care or negative earnings firms is a P/E on what are generally old & vulnerable businesses. However, the market-cap composition of the Russell 2000 is now 40% tech and health care. We think these two sectors, despite their high or infinite P/

Es, are the more attractive segments of the Russell 2000 and ripe for stock picking.

TECHNOLOGY WAS THE ONLY RUSSELL 2000 SECTOR WITH POSITIVE EARNINGS GROWTH IN THE SECOND QUARTER OF 2020

The only profitable Russell 2000 sector that had earnings-per-share (EPS) growth in the second quarter of 2020 was tech and the growth mostly came from non-profitable Tech companies turning profitable this year for the first time. Many of these tech companies were able to use pandemic conditions to increase their customer base, scale up their business model and turn profitable. These companies are flourishing, they were pandemic immune and are likely to continue to expand briskly as adoption and demand for their business productivity enhancing services goes mainstream.

RUSSELL 2000 LEVERAGE IS RISING AND CONCERNING AT THE OLD & VULNERABLE SECTORS

Russell 2000 ex. financials Net Debt / Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) is up from 290% a year ago to 330% now on trailing four quarters, mostly owing to the decline in EBITDA. Total debt is only marginally higher at 700 billion dollars now vs. 680billion dollars a year ago. The Net Debt / EBITDA ratio of Russell 2000 ex financials is similar to the old & vulnerable part of S&P 500. However, the old & vulnerable sectors of the Russell 2000 suffered much greater balance-sheet deterioration. Suggesting, Russell 2000 ex. tech and health care has more leverage risk than S&P 500.

RUSSELL 2000 IS MORE SENSITIVE TO U.S. GDP, ESPECIALLY OLD & VULNERABLE SECTORS

The Russell 2000 generates nearly 80% of its revenue in the United States, vs 65% of S&P 500 revenue being domestic. The Russell 2000 is more sensitive to U.S. gross domestic product (GDP) while the S&P 500 is more sensitive to global GDP and better secular growth drivers. After the initial reopening bounce, U.S. GDP is showing signs of sharp slowing and perhaps stalling. Initial jobless claims are still higher than their peak during the financial crisis and election risks could weigh more on small caps. Analyst bottom-up consensus EPS estimates for full 2020 for the Russell 2000 are expected to be down 68% vs. 2019 and consensus 2021 EPS is still 10% below 2019 EPS. It is probably going to take until at least 2022 for the Russell 2000 to recover its pre-pandemic profits. We think economic conditions and overall index composition, which is still higher beta and value tilted vs. S&P 500, will keep Russell 2000 gains vs. the S&P 500, and likely absolutely, limited over the coming year, unless its promising growth stocks at tech and health care deliver strong gains and carry the index.

GLOSSARY

A balance sheet summarizes a company's assets, liabilities and shareholder equity.

Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A Real Estate Investment Trust (REIT) is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

The Russell 2000 Index is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Small cap firms generally have a market capitalization of less than $2 billion.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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