



A Potentially Attractive Entry Point for US Smaller Companies

A long-term allocation to this dynamic market segment makes sense.

Curt Organt, Portfolio Manager, T. Rowe Price US Smaller Companies Equity Strategy

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Key insights

- Value stocks have come under pressure as economic uncertainty prompts investors to shorten their time horizon, pile into secular winners, and avoid cyclicals.
- We believe our rigorous fundamental research gives us an edge in identifying where the market's misunderstanding of secular risks could create opportunity.
- We are looking for the most compellingly valued stocks relative to their long-term prospects.

The strong rebound in US equities in recent months, thanks in large part to substantial fiscal and monetary stimulus, has been encouraging to see. However, there is still much that remains uncertain, and we anticipate increased market volatility over the coming months and quarters.

For US smaller companies, this landscape is a potentially challenging one and a likely headwind to near-term performance. That said, we continue to believe that investors should maintain a strategic, long-term allocation to US smaller companies as part of a broader US equity allocation. As such, any near-term volatility could

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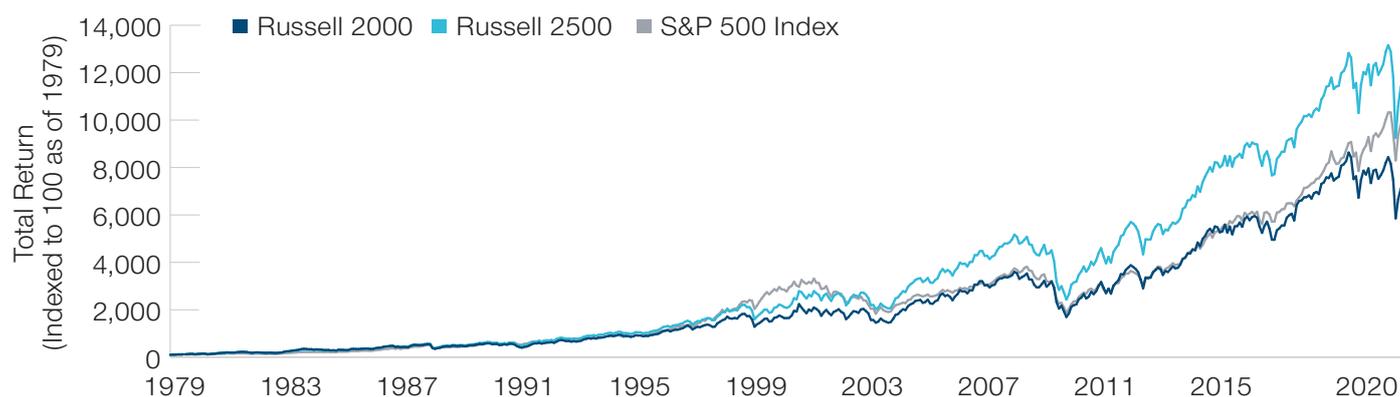
provide attractive entry points for investors to add exposure to the dynamic US smaller companies segment.

Ongoing Support Despite a Challenging Near-Term Landscape

The current market recovery is unusual in that it has been led by large, high-valuation companies and in the absence of any visible improvement in the economy. Historically, smaller companies have typically led the market rebound following a period of economic weakness or recession. More agile and less burdened by layers of management, smaller companies are generally quicker to respond to change than larger counterparts. And with a larger proportion of earnings generated domestically, smaller companies are likely to be the earliest beneficiaries as the US economy begins to improve. Meanwhile, the potential for globalization to be wound back in favor of domestic reshoring could also provide a significant boost for smaller companies over a long-term horizon.

Divergent Fundamentals

(Fig. 1) Free cash flow growth for large-cap growth and value stocks



As of July 31, 2020.

Past performance is not a reliable indicator of future performance.

Sources: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved, and S&P 500 (see Additional Disclosure).

During Difficult Times, Access and Regular Dialogue Are Key

In 2019, T. Rowe Price had more than 11,000 separate meetings or conversations with company management teams globally. And despite the more challenging circumstances in 2020, we have been able to maintain a similar cadence of conversations with company management teams. This has a lot to do with the strong relationships established over time with the companies that we invest in, some of which stretch back over several decades.

Importantly, this has meant that we have generally been able to continue with a regular schedule of one-on-one conversations with management teams throughout the coronavirus crisis. We have been able to ask the kind of specific, often difficult, questions that are crucial in helping us to understand how individual companies are positioned during this unprecedented time—which businesses are vulnerable and which could potentially emerge from the crisis even stronger. This kind of direct interaction and access to key personnel is not afforded to many in the industry.

What Company Management Teams Are Saying

Perhaps the most significant observation from our company meetings in recent months has been the shift in management focus. Prior to the emergence of the coronavirus, a lot of time would be spent discussing the longer-term business strategy—from the pipeline of new products or services to the potential industry trends expected to underpin long-term growth. More recently, however, the focus of management teams has clearly shifted, with all attention now on the near-term environment and simply getting through the difficult 12-months ahead.

Similarly, our conversations with management teams have focused on factors essential to their ability to navigate the near-term landscape—things like flexibility within their cost structures, fixed versus flexible costs, cash on balance sheets, debt positions, and access to capital markets. These are some of the key questions that could ultimately determine whether a smaller company can survive the current crisis—or potentially emerge from it in an even stronger position.

Company management teams are also conveying their dismay at the nearly total lack of clarity on the near-term outlook. Many have told us that they believe economic recovery in the US is entirely dependent on progress made in combating the coronavirus pandemic. Yet, with some states still effectively in lockdown and businesses shuttered, there is a great deal of ongoing uncertainty on this front, making it almost impossible to get a clear picture of what future business demand will look like. As such, we have seen a lot of US companies, both small and large, not only retracting their earlier full-year guidance but scrapping guidance on 2020 earnings altogether, given the extreme lack of visibility.

An Acceleration of Existing Market Trends

One of the notable impacts of the coronavirus pandemic has been the forced acceleration of some of the secular trends already evident in the US economy. The shift toward technology and digital solutions, for example, has accelerated as people are having to stay at home and so need to work, communicate, and even consume via technology. Companies in the software space, for example, have been resilient performers, as people utilize remote communication tools, while gaming, TV streaming, and content delivery firms have also performed well. E-commerce businesses have also benefited, given the surge in online purchasing and the need for home delivery.

Elsewhere, an increasingly evident trend in recent years—of stronger companies within an industry or sector getting stronger and growing their market share—has been made more apparent by the pandemic. This is evident in hard hit areas like bricks-and-mortar retail and the travel and leisure industries, where businesses are failing, leaving the stronger, remaining companies with a larger share of the market.

We are not looking for the cheapest stocks; we are looking for the most compellingly valued names relative to their long-term prospects.

Opportunities to Add Exposure at Good Prices

While the uncertainty and dislocation caused by the pandemic has been unsettling, especially for smaller company investors, we have not shied away from being contrarian, adding exposure in certain areas that have been hit particularly hard. We took advantage of this weakness to add some high-quality cyclical names in the financials, industrial, and energy sectors. Valuations in these sectors compressed significantly in March and April, when uncertainty was extreme and the immediate focus for many investors was to simply reduce risk, regardless of price.

We were particularly active in the portfolio during this time. The breadth of the pullback in the smaller companies segment in March and April meant there was little discrimination shown at a company-specific level. This provided good opportunities to add new holdings, or increase existing positions, at valuation discounts that, in some cases, had not been seen in years.

What We're Watching Next

A new generation of winners are emerging—companies with a strong online presence and also less capital intensive. Brand saturation and wide distribution networks are not the essential attributes they once were, and as industries evolve, barriers to entry will fall and innovation will progress more rapidly. This environment will potentially create greater opportunities for smaller companies. Accordingly, we continue to look for high-quality small- and mid-cap businesses where the growth potential is not yet fully appreciated, but which we believe can compound value over a long-term horizon.

More Potential to Add Value

For active investors, the less efficient nature of the smaller companies segment is particularly appealing as it provides greater opportunities to add value. Less coverage by analysts and institutional investors as you progress down the market capitalization scale, inevitably means there is a higher mispricing potential among smaller company stocks. The uncertainty created by the coronavirus pandemic, which has seen smaller companies particularly impacted, has only increased this potential.

Certainly, the near-term environment for US smaller companies is likely to remain cloudy given the ongoing uncertainty created by the coronavirus pandemic. However, there are compelling reasons for maintaining a long-term, strategic allocation to smaller companies as part of a broader US equity allocation. As such, any potential near-term volatility could present a good entry point into the dynamic US smaller companies segment. Relative valuations are attractive versus history, creating potential opportunities for experienced smaller company investors to find quality businesses in niche growth areas that often fly under the radar of most industry research analysts.

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