Small-Cap Value Stocks

SMALL-CAP VALUE STOCKS STILL ATTRACTIVE DESPITE STRONG 2016 RUNUP

KEY POINTS

- Mr. Wagner expects that small-caps are only a year into a bull market that could last three to six years.
- However, small-caps are inherently more volatile than large-caps. Current overall market risks include the need for increased earnings to support higher valuations, the uncertain prospects for proposed tax reforms, and interest rates rising too sharply.
- He looks for companies that aren’t just inexpensive but that the fund can own for a long time—durable, defensible businesses with competitive advantages and strong free cash flows.

At the end of 2016, Bloomberg named J. David Wagner its “top stock picker” for the year. Mr. Wagner started with T. Rowe Price in 2000 as an analyst covering financial services and has managed the Small-Cap Value Fund since the middle of 2014. In this interview, Mr. Wagner discusses his approach to picking stocks and managing the fund as well as the sector’s opportunities and risks.

Q. Small-cap stocks significantly outperformed large-caps last year, and small-cap value stocks led the way. What drove this strong performance?

A. In the early part of 2016, there was a mini-bear market for small-caps, but, after February, a lot of factors accumulated that led to a classic new small-cap bull market. Riskier bonds’ yield differences against Treasuries fell, the economy started to do better, and earnings headwinds—particularly in the industrial and energy sectors—started to abate. Then the Republican sweep in last fall’s election, with its promise of coordinated leadership in Washington, was like throwing gasoline on a fire, raising consumer and business confidence.

A lot of small-caps’ moves last year really can just be explained by an improving backdrop plus expectation that the new administration will push through corporate tax
relief. Also, financial stocks—the largest small-cap value sector, which in turn is dominated by regional bank stocks—have benefited from the expectations of rising interest rates and less regulation.

**Q.** After this big runup, what’s the current environment for small-cap stocks?

**A.** All signs point to a continued stable or improving economy in the United States, where small-caps’ revenue is mainly sourced. Small-caps often pay the full U.S. tax rate—so if that’s lowered, it would really benefit them. In the first couple years of a new bull market, small-caps typically have done well. We’re just a year in now, so I wouldn’t be surprised to see continued strong performance for small-caps. Valuations are not out of line historically. It’s not unusual for small-cap bull markets to run three to six years. However, if the overall market starts to sell-off and valuations start to compress, then you typically would do better in large-caps.

**Q.** What’s your overall approach to managing the fund, including managing risks?

**A.** Overall, we have a very contrarian approach. We’re trying to find great companies that, for whatever reason, are out of favor. Maybe their industry is out of favor or they have company-specific problems. We like companies that we can own for a long time, that are defensible, durable businesses with competitive advantages. We’re always monitoring for stocks that have gotten ahead of themselves, and we tend to trim stocks that look too expensive. We’re not just setting out to buy cheap stocks, but we’re always careful about finding stocks that are fairly valued or cheap that present good risk/reward profiles.

As for risks, any time you have a big surge in the market, you need the earnings to come through to support the new higher valuations, and so we’re keeping a close eye on that—along with the progress of tax reform efforts and whether there’s a sharp rise in interest rates. The small-cap sector is inherently more volatile than large-caps. We dampen that volatility by being well diversified with about 300 stocks in the portfolio and by being disciplined about buying particular stocks when they’re cheap and a margin of safety is built in.

The policy-change expectations generated by the new administration also can be viewed as a general market risk if they don’t come to pass. But when investing, we’re generally neutral on that. We own some stocks that would benefit disproportionately from tax reform. But that’s never our main thesis. We’re focused on unique companies with specific competitive advantages and very shareholder-oriented managements.

**Q.** Given that, how do you find stocks for the fund?

**A.** We rely on the firm’s platform of 50 equity analysts, who are covering all sectors of the global equity market across market caps and styles. It’s a competitive advantage. For example, in studying small-cap suppliers to Apple, our large-cap tech analyst covering Apple can provide us with a better sense of whether these firms have durable points of differentiation. Imagine if you owned a company whose future is linked to Apple but you had no overall insights into Apple?

The main metric we study for most companies is free cash flow, the cash generated after operating and capital expenses. It tells you how much real cash they’re making, money that is available to shareholders. But it can vary by industry: For financials particularly, we focus on price/earnings and price/book ratios. In any case, we seek quality stocks—companies that can generate good risk-adjusted returns for shareholders without excessive leverage.
Q. After a period of such strong performance, where are you finding attractive opportunities?
A. Because we are bottom-up analysts, we don’t do a lot of thematic investing—our sector overweights and underweights tend to be small bets—but there are a couple areas to which we’ve been adding, including consumer staples, banks, and some real estate services firms (see Figure 1).

In consumer staples, for example, we’ve been buying Nomad Foods, a European company. It is Europe’s largest producer of branded frozen foods. It’s not sexy. It’s not a potential U.S. tax reform beneficiary. It’s not a company that benefits from an improving U.S. economy. It’s not in the U.S. small-cap indexes. But it’s a growing, well-managed market leader that has fallen off many investors’ radar.

Our largest sector is financials, but relative to benchmarks, we’re actually a bit underweight in this sector, mainly as a result of holding no mortgage REITs (real estate investment trusts), an area in which companies don’t have much differentiation.

(These types of REITs are not part of the new real estate sector in stock indices, remaining in the financials sector.)

We own regional banks, generally chosen because of their managements and their specific market positions. For example, late last year, we were aggressively buying shares of Bank United, a well-capitalized bank whose valuation had cratered far too much because of a small exposure to loans for New York City taxi medallions, whose prices have plummeted.

Q. Last word: In individual investors’ portfolios, what do small-cap value stocks offer?
A. Historically, small-cap value stocks have tended to outperform larger growth stocks over time. They typically have traded at a small premium to large-caps because there’s more opportunity for them to be acquired and their earnings tend to grow a little bit faster. It’s a very dynamic part of the market with a lot of innovation, a lot of great undiscovered companies, and a tremendous amount of value.

At the same time, lots of big Wall Street investment houses have been reducing their focus on small companies. It’s been common recently for as much as 20% of the stocks in our fund not to be covered by Wall Street analysts—so the case for active management in this area has really never been better.
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Stocks of small companies are subject to more erratic price movements than larger-company stocks, and the value approach carries the risk that the market will not recognize a security’s intrinsic worth for a long time or that a stock judged to be undervalued may actually be appropriately priced.

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