THE DAILY CHECK-IN WITH GOLDMAN SACHS

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Liz Bowyer: Hi Sally.

Sally Pope Davis: Hey Liz.

Liz Bowyer: You're a portfolio manager investing in small cap and value stocks, both of which have posted some of their strongest returns in recent years. Describe the outperformance that you're seeing.

Sally Pope Davis: Well, first, let's define what we're talking about with small cap. In general, we're talking about companies with market caps of $4 - 5 billion and below. And the small caps have been outperforming the broader market for the last three months. After the vaccine news was announced in early November, small caps recorded their best single quarter ever, as measured by the Russell 2000 index. It was up 31 percent versus 12 percent for the S & P 500. And after a long time of underperforming, value outperformed growth. And small cap was up 33 percent during this period. And it's continued into this year with the Russell 2 up 13 percent, whereas the S & P is up 3.5 percent.

And driving some of this growth is fund flows. We've seen almost $19 billion flow into ETFs in the last three months, which is quite a lot for this asset class.

Liz Bowyer: And what are some of the drivers behind this outperformance?

Sally Pope Davis: Well, small companies tend to get harder in a recession. And there are a number of reasons behind that. They're smaller scale. They have higher fixed costs. And they have less operating leverage versus larger companies. And they also tend to be single product or single industry. And they're less diversified than larger cap companies. So, they don't benefit from that diversification that can cushion their earnings or their sales when you get into recession.

The flip side though is the reverse happens and small caps start outperforming large. Earnings and sales estimates are still rising for small cap companies right now, more so than large. And estimates indicate that small cap earnings are being revised up 50 percent and sales are being revised up 7 percent.

Liz Bowyer: And how about the broader macro economic context? How are small caps faring in this environment?

Sally Pope Davis: Well, we have a number of factors that are favorable. You know, something the Fed is keeping short-term rates low. Second, you have the prospect of the economy reopening in the second half as more and more people are vaccinated. And third, you've got potential fiscal stimulus. So, you have an economic outlook that is really quite robust. And that's an environment where small caps tend to outperform. And when you have stronger growth, you tend to have higher rates and a steeper yield curve, which also benefits small caps. So, it's a good setup.

Liz Bowyer: And with the new Biden administration, what does the policy landscape look like for small caps?

Sally Pope Davis: One of the outgrowths of the pandemic may be this concept of reshoring or onshoring where US companies bring back more of their supply chain to the US. And since small cap companies predominantly tend to be domestic, they stand to benefit from that trend.

Liz Bowyer: And are there certain sectors in the small cap space that you expect to continue to outperform in 2021?

Sally Pope Davis: Well, as the yield curve continues to steepen, and if we do have rising rates, that should benefit the financial sector. And the Russell 2000 value is about 25 percent in financial stocks. So, that should be an important contributor this year.

But even with rates rising, they are historically low. And we would expect housing stocks to continue to benefit, as well as building material stocks. And there are many of those in the small cap and spin cap [PH] sectors. And then cyclical stocks: materials and industrials. They're still attractively valued. And they tend to benefit from a stronger GEP and any type of infrastructure spending we may get, as well as the reshoring trend.

Even though I mentioned that many small caps are primarily domestically focused, many do also have foreign sales. And to the extent we continue to have a weaker dollar, that should help their exports. And we expect that the global economy will rebound as well. And continued demand from China. And so, a good set up for foreign sales as well as domestic.

Liz Bowyer: And as we continue to see M & A activity, what kind of investment opportunities do you think that might create around small caps?

Sally Pope Davis: Well, large companies right now are flush with cash. They're looking for growth and scale. And small cap is where they go shopping. And as M & A picks up, historically, small cap companies tend to benefit. And the great part is because they're smaller, they often get taken out at significant premiums relative to market value.

But we also expect to see M & A consolidation within sectors. So, for example, in small cap banks, we expect to see continued consolidation because the banks need to invest more in technology. And they're looking for ways to scale and to create offering, leverage, and benefit from expense savings. And finally, you know, from listening to the capital markets companies who've just reported earnings, their M & A pipelines are full. So, we're pretty optimistic about the M & A prospects this year.

Liz Bowyer: So, overall, it seems like a very favorable environment for small caps. But what do you see as some of the risks?

Sally Pope Davis: Well, as you said, you know, the stocks have had a great run. And they could pause at any time. Although, the near-term outlook certainly is positive. But you know, valuations now are less compelling. The Russell 200 PE is just over 32. Now that's heavily influenced by the Russell 2000 growth, which has a PE of 46.5. But the value PE, it's more reasonable. It's at 21.5.

The interesting thing is that valuation for small caps is at historic lows relative to large cap. Now, that may speak more to the valuations extremes at the larger caps. But it would say that the small cap valuation continues to be attractive. But, you know, when you're speaking about PEs, you have to remember that earnings are being revised upward rather dramatically. So, PEs may not be as high as we think.

You know, the other thing that we're watching from a fundamental standpoint is tax policy. Smaller cap companies being more domestic tend to bear the full brunt of any tax increase. So, to the extent we get an increase in the corporate tax rate later this year or next, we would expect more of an impact on smaller companies versus large.

Liz Bowyer: So, finally Sally, I'd be remiss in not asking you about the recent surge in retail investing, which has driven up the stocks of many small cap names. How broad is this impact on the small cap space?

Sally Pope Davis: Well, retail participation certainly has increased this year, both from long-term investors who are buying ETFs and diversifying their positions, to those who are more actively trading using both stocks as well as options. And retail trading as a percentage of volume is up to 25 percent of volumes this year, relative to 15 to 20 percent just a year ago. As an investor, you know, philosophically, we welcome more market participation. It brings more liquidity and more market activity in the market. But these small cap stocks are less liquid. So, to the extent there's more liquidity, that's generally a positive.

Now recently, you know, we have seen some more volatility around some smaller cap names, particularly some small cap value names that were more structurally disadvantaged. And they attracted some shorts and short squeeze in some retail participation from some empowered retail investors. And that may be a new market dynamic. And you know, we as market participants may need to adapt to that new participation.

Liz Bowyer: And what do you think the impact of this might be on the small caps over the long term?

Sally Pope Davis: Well, time will tell how sustainable it is. I mean, there may be some trends that have been helpful to retail participation. You've had a rising market, which is, frankly, more fun to invest in. You've had more specific opportunities around the pandemic and the pandemic unfolding into work from home stocks or what we would call the reopening trade. And you know, you also have more accessibility. You have retail apps that are easier and, frankly, more fun to use. And you have no commission. So, all of those have, you know, certainly played into the market dynamic. You know, longer term, you know, we'll see what happens when markets become less friendly when, you know, some of the trends that we see are less pronounced. We may see some diminished retail activity. But social media, easy to access trading apps, no commissions, those are things that are here to say. And that may be a more sustainable trend as we go forward. But as we noted, more liquidity, more activity in general is a positive for all market participants.

Liz Bowyer: Thanks Sally.

Sally Pope Davis: Thanks Liz.