An Advantageous Time for Small Cap Investing

So far we are pleased with the market reaction to the 2016 election. We have been fortunate to navigate our way through the election season by sticking to our decade old process for evaluating and investing in individual securities.

YTD through November 30th, on a gross basis, the Small Cap Opportunities Strategy returned **21.03%** while the Russell 2000 (R2) returned **18.00%.** Over the past 12 months Small Cap Opportunities has returned **13.66%** on a gross basis vs. the Russell 2000 return of **12.08%.** Finally, to emphasize the longevity and success of our strategy, for over 10 years our Small Cap Opportunities strategy has an annualized gross return of **10.32%** vs. the Russell 2000 10 year annualized return of only **6.81%.**

While individual stock picking will remain our focus, the new political and economic environment is expected to bring with it benefits and challenges to specific sectors. A host of pledges on deregulation, tax reform, health care reform, energy independence, and a series of administration appointments that are consistent with these pledges, indicate that times are indeed changing. These changes will cut across sectors from financials to energy, industrials, and technology.

Couple this with steepening yield curve, global monetary easing, respectable economic data in the U.S. and abroad – it is not surprising that certain sectors of the U.S. equity markets experienced an aggressive November bump in the anticipation of growth in 2017 and 2018. Since the election and through December 8th, U.S. small cap stocks have risen the most. We think the 2017 environment sets up nicely for smaller companies that have the quality characteristics (good balance sheet, solid revenue and earnings growth, realistic pricing) that define our investment process.

Since the election, a few investment managers who stuck to their knitting, adhered to their process and focused on quality companies in specific industries made a lot of money. The key question, as always, is "where do we go from here?" Our take is positive but mixed and we see promising small cap investing opportunities in sectors that we feel will be advantaged with new policy.

Anticipated Policies

As we see it, Trump laid out an agenda and followed up with appointments of people who philosophically support his agenda. Policies he articulated over the last several months that could influence equity markets are:

- Corporate Tax Rate Reduction - including a one-time 10% repatriation tax opportunity which would "absolutely get cash back" into US according to Secretary of the Treasury Nominee Steven Mnuchin.

- Regulatory Rollback - In the same CNBC interview Mnuchin stressed that regulatory rollback would be Mnuchin's second priority, starting with a reevaluation of Dodd-Frank. "There [are] many aspects of it that prevent banks from lending and we need to make sure that banks lend. We want to see huge growth in this economy in small- and medium-sized businesses," he stated.

- Infrastructure Spend - On election night the President-Elect doubled down on his promise to make America's infrastructure and defense "great again".

- Energy Renaissance – With his selections of Exxon Mobil CEO Rex Tillerson to be Secretary of State, Oklahoma A.G. Scott Pruitt for EPA and potentially former Texas Gov. Rick Perry for Energy, the President-Elect signaled a commitment to oil and natural gas and to less regulation.

- Affordable Care Act Restructuring – Not an easy task, the repeal and replacement of the ACA will have varied and considerable implications for different segments within the Health Care Industry. Bottom line - the repeal and restructuring process will be a slow go.

With respect to the Federal Reserve, we anticipate:

- Increased Interest Rates and a steeper yield curve that should benefit net interest margins for banks, leading to upward earnings revisions for future years.

- Regulatory easing should provide relief from some regulatory burdens and capital requirements and should lower expenses and improve cash flow for the financial industry.

2017 Fiscal Stimulus

We do not expect much from fiscal stimulus in 2017. Firstly, corporate tax reform passed in 2017 probably will not be retroactive. The 2001 Bush cuts were passed in a recessionary environment, which this is not. Secondly, it appears that the imperative to change the tax code is aimed at making America's future tax rate competitive again. Engineering for the future will probably trump near term stimulus.

Not since Reagan has comprehensive tax reform been implemented. Our expectation is that the extremely complicated task of re-engineering the tax code gets completed in 2017 and gets rolled out in 2018.

Our view is that the 2017 the traditional fiscal policy expansion bump to growth and inflation may be weaker than expected. However, the impact of tax cuts and spending during 2018 to 2021 should significantly boost GDP growth from 2018 onward.

Deregulation and earnings repatriation hold more promise for faster stimulus, with large cap technology companies benefiting from repatriation while banks and energy firms benefit from regulatory easing.

Sector Implications

Implications for Small Cap Banks – Small Cap Banks have experienced large gains since the election. In our view, the market is anticipating a steeper yield curve, relief from some of the regulatory burdens of Dodd-Frank for small and regional banks (although we don't see Dodd-Frank repeal owing to 60 vote requirement), lower tax rates, and stronger economic growth.

We have been covering small banks for over 25 years. The past 5 years have been challenging and banks have taken it on the chin with rock-bottom interest rates, Dodd Frank regulations, and a struggling economy. Indeed, banks have experienced generational lows in bank net interest margins and revenue growth, while returns on equity are substantially below pre-crisis levels. If the past few weeks are indicative, we may have reached an inflexion point. If true, we see much hope for small cap banks through:

- **Steeper Yield Curve** - A compressed yield curve has hurt net interest margins for years. A rising yield curve may allow for net interest margins to rise.
- **Regulatory Changes** – There is potential for a more significantly relaxed regulatory environment and capital requirements for small banks. The impact of Dodd-Frank on non-interest expenses have been high. With new policy and regulatory easing, the growth in these expenses may abate, freeing up cash flow on bank balance sheets
- **Lower Tax Rates** – Lower tax rates would benefit smaller banks. Right now, community banks pay close to the full corporate tax rate. The new administration's and Speaker Ryan's tax reform plans are largely aligned (the devil is in the details). Under either plan community banks would be large beneficiaries of a lower corporate tax rate.
- **Pro-Business Administration** – A Pro-business administration should spur loan growth. Borrowing for capital equipment has been weak. Economic stimulus could lead to increased demand for capital equipment and borrowing.

Additionally, there is potential for sector re-rating and sector rotation. Paradoxically, the impact on some sectors from lower taxes and higher earnings may be offset by lower valuations if rates continue to rise**.** Historically low rates lifted US equity valuations to near-record highs but have hurt small bank earnings. Our current overweight in financials reflects our optimism that small banks in particular will benefit from higher rates, less regulation, economic growth and lower taxes. We believe these trends are positive while we are mindful that higher interest rates could present mark to market issues with specific financial firms on the one hand and rates could stay low for longer.

Implications for Energy/Industrials - Less regulation on the energy industry has been a consistent Trump talking point. Appointments at State, EPA and Energy suggest a fertile environment for extractors. New policy should support service firms catering to the oil and gas industry as well as spurring investment in the sector.

- **Coal** - The coal mining industry is expected to receive a reprieve although they remain deep in the woods.
- **Oil & Gas** – E&P companies should benefit from opening up of Federal lands, the Gulf of Mexico and the Arctic to further oil and gas development.
- **Regulations** – We expect friendlier regulatory environment re: fracking and pipelines and faster approvals for leases on public lands.
  Utilities – We expect a gradually rising rate environment which will not be advantageous for yield proxies such as REITS and Utilities.

Implications for Health Care - Although we generally expect a "lighter hand" for healthcare under the Trump administration, relying more on market competition and innovation, we would anticipate some uncertainty as Republicans determine how best to repeal and replace the ACA. A full repeal would be difficult to implement from a practical standpoint, not to mention the disruptive impact it would have on access, and Republicans have already hinted at keeping parts of Obamacare while replacing others. We do expect near-term volatility as the finer points are ironed out which could lead to shorter term investment opportunities. With that said, our basic view of healthcare is unchanged and we will be monitoring certain aspects of the industry with a watchful eye.

- **Costs** - will remain a problem, and we continue to be hesitant to invest in business models dependent entirely on government reimbursement.
- **Homogeneous Products** - We believe undifferentiated products and services ("me too") will struggle to maintain share.
- **Economies of Scale** - We believe economies of scale will increasingly matter as cost/competitive pressures continue to ramp, underpinning a robust M&A environment.
- **Drug Pricing** - We would characterize pricing as a bipartisan, populist issue, so our view on therapeutics is to continue to find novel, differentiated therapies with limited competition.

Implications for Technology – Positive momentum should be derived from:

- **Tax Reform -** Tax reform likely will help those companies with a higher mix of domestic revenue vs international. Repatriation is huge for specific companies.
- **Higher Infrastructure Spend** – This will be a positive for names more focused on industrial/construction markets. Specific semi-conductor and component suppliers should benefit.
- **Net Neutrality –** We see a potential reversal of net neutrality as a positive for telecom/cable operators as it potentially gives them greater pricing power and control of content distribution. Also tied into this could be higher levels of capex spend for communication related technology companies as operators are incentivized to invest in their networks.
- **Regulations** – A more relaxed regulatory environment will help M&A Activity. This will be beneficial for M&A deal closures. The TMT space is consolidating with many smaller cap names in the crosshairs. This will benefit M&A deal closures in telecom/cable as we see a convergence of wired and wireless networks. We could also see a higher probability of operator/content M&A as operators seek content to prioritize on deregulated networks.
- **Defense Spend –** The jury is mixed here. Again, higher defense spending will benefit large and small companies that support the Military-Industrial Complex supply supply-chain. This includes specialized semi-conductor firms and select information technology service providers. On the other hand, Trump has railed about the embedded Pentagon bureaucracy and high cost of delivering a high quality national defense regime. Shots fired over the bough of Lockheed and Boeing indicate that sharper pencils are on their way.

Implications for Infrastructure/Industrials/Durables – While $1 Trillion in infrastructure investments over the next decade may prove to be optimistic (per the Ross-Navarro Plan), we do expect an increased level of infrastructure spending during a Trump administration that would benefit engineering, construction equipment, and industrial equipment suppliers.

- **Higher GDP Growth** - should benefit logistics companies, including truckers, rail, intermodal, and their suppliers, along with distributors of industrial goods.
- **Increased Demand** - Energy-levered industrials and distributors could see increased demand due to new investment based on longer term commodity reflation.

- **Lower Tax Rates -** Commercial services, including consulting firms, should benefit from lower corporate tax rates through higher levels of M&A activity and potentially more cross border transactions.
- **Small Cap Industrials -** Domestically focused small cap industrials typically pay a higher tax rate than international, and would benefit more from lower tax rates as well.

<u>What does this all this mean?</u>

Small cap stocks have done well. We think that small cap equities are positioned to continue to do well with expected tail winds coming from tax reform, regulatory easing, and targeted fiscal government spending. Monetary policy has been accommodative to date.

Over time, a small cap core style focused on quality companies that have good balance sheets, real earnings and earnings growth, can produce superior risk-return characteristics. Further, the notion that the small cap equity market is inefficient and lends itself to an active security selection and portfolio construction approach, is supported by our YTD, 1,2,3,5, 10 year returns, certainly versus the Russell Small Cap Indices.

We believe that AlphaOne' s approach to small cap investing is positioned well to take advantage of both current and anticipated market environments.

As always thank you for your support of our AlphaOne Portfolio Management team.

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