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Small Cap Value Equity strategy review

In Kurt Vonnegut's Cat's Cradle, he tells an abbreviated story of man's creation. In it, God created every living creature and man alone could speak. God leaned close as man spoke. "What is the purpose of all this?" man asked politely. "Everything must have a purpose?" asked God. "Certainly," said man. "Then I leave it to you to think of one for all this,". Since antiquity, investors have labored to extract signal from noise and ascertain order from chaos in an attempt to find purpose. However, there are so many "unprecedented" aspects of the current market environment that long-held conventional wisdom is rendered relatively ineffective. Accordingly, investors may need to prepare new approaches to bring lucidity to increasingly uncertain market outcomes.

There is no doubt that both the market environment and economic activity have vastly improved since the onset of the COVID-induced recession in mid-March. The secondary impacts of "stay-at-home" orders that were quickly transmitted into the real economy have abated to a major degree. In addition, risky assets have quickly recovered (in some cases fully) as over $6T in stimulus from the Federal Reserve (FED) and Congress acted as an income bridge for workers displaced by the pandemic. The aggressive monetary and fiscal response also created a liquidity-induced buying binge which caused asset prices to increase much faster than actual fundamentals. However, inconsistent safety policies related to COVID have allowed new cases to remain elevated while the initial rapid trajectory of improvement in economic activity has slowed, meaningfully, creating more ambiguity regarding the pace and duration of recovery to pre-COVID levels.

Equity markets also seemed to struggle with the level of opacity during the third quarter of 2020. After the sharp rebound of equity prices in the second quarter, markets initially moved meaningfully higher in the third quarter driven by continued economic momentum. However, the latter phase of the quarter experienced a broad retracement in prices partially driven by uncertainty regarding new fiscal initiatives to support wage and employment losses. As a result, the Russell 2000 Value Index finished the quarter with a modest return of 2.6%. Cyclical sectors continued to lead the market as the Consumer Discretionary was by far the best performing group followed by Basic Materials. However, performance was still somewhat balanced as defensive sectors, Consumer Staples and Healthcare, also outperformed the market. On the opposite end of the spectrum, Energy and Financial Services materially underperformed the overall market despite better economic activity and reduced credit fears.

Economic activity continued on an upward path as employment formation and spending was aided by stimulus packages and financial safeguards such as the Paycheck Protection Program (PPP) and the CARES Act. The unemployment rate which peaked at nearly 15% improved to just under 8% while high-frequency economic data and surveys such as PMI rebounded from recessionary levels both in the U.S. and globally. In addition, housing activity has remained strong throughout the crisis and early cycle consumer-oriented areas of the economy most impacted by the pandemic and subsequent shutdowns have witnessed broad-based recoveries as states have re-opened.

The actions taken by the FED and Congress to quickly infuse fiscal and monetary stimulus into the economy has produced the intended results to mitigate financial risks, ensure rational liquid markets, and serve as an income bridge for displaced workers. However, the rapid recovery in equity prices may have already discounted most of this improvement creating increased trepidation as investors wait for a clearer path of economic recovery to pre-COVID levels. The upcoming election is becoming a bigger factor in determining how investors position their portfolios as the presidential and congressional races create uncertainty in how the next administration will be structured. Furthermore, there is a concern that incremental economic improvement will occur much more slowly over the next six months which coupled with increasing COVID fears during the flu season could further dampen market expectations. While markets and the economy are certainly on better footing, the pace and magnitude of the recovery will be the key driver of future fundamentals and self-sustaining improvement.

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