SAPIENCE
INVESTMENTS

Quality is Cheap

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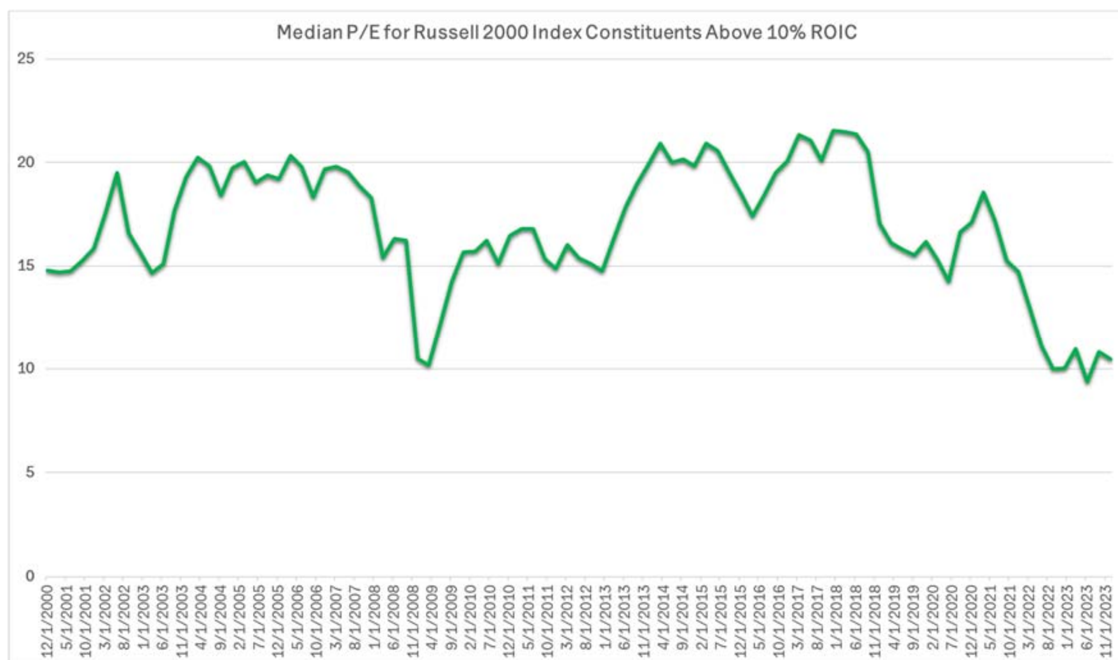
"You can't be a good value investor without being an independent thinker – you're seeing valuations that the market is not appreciating. But it's critical that you understand why the market isn't seeing the value you do."
~Joel Greenblatt

The last white paper we wrote was in November 2021—in hindsight, it just about coincided with the latest peak of small-cap stocks. Here is a quote from that paper:

"Looking out over the near to medium term, we remain constructive but more cautious, as the reduction of fiscal and monetary stimulus should lead to a less favorable backdrop for equities. On the other hand, consumer balance sheets remain sturdy and transitory supply shocks should abate over the next few quarters. The economy should post a strong recovery over the next 12-18 months. A significant turning point in U.S. monetary policy is at hand. However, the consensus view among market participants is still that the FOMC won't be able to lift rates as postulated and if they do, it would be a policy mistake. In last few weeks, the elevated inflation levels is causing a rethink of this consensus view."

From a macro perspective, in this post-pandemic environment, it is difficult to gauge where we are at present in the economic cycle—towards the end or the middle? The general rules of thumb are not apt for the current environment. While most investors expected the U.S. economy to have suffered a mild recession, if not a hard landing by now, we are still waiting for one to arrive. A year ago, most economists and market strategists expected that the U.S. would suffer a recession as inflation would remain stubbornly high, bond yields would remain elevated, and stocks would remain weak after declining in 2022. Frustratingly, the markets pretty much did the exact opposite. Today, it's the inverse of last year. Looking at 2024, about three-quarters of the market strategists expect a soft landing—falling inflation, below trend economic growth, and an accommodative monetary regime. A more bullish scenario would be that economic growth accelerates due to the easing of financial conditions, as has been the case since November. In this scenario, rates don't decline as much but the economy is on a better footing. Currently, only about one-fourth of market participants expect a hard landing (i.e. a real recession). In this scenario, rates decline more than currently factored, but the economy would be much weaker.



Source: Bloomberg.

We have no edge in forecasting or assigning probabilities that would be more accurate than the market to the above macro outcomes. Even after the bounce in the last two months of 2023, since the peak in November 2021, small caps were down approximately 21% through the end of January—they clearly did not benefit as much as large-cap growth stocks post Covid in 2020-2021 and in 2023. Today, quality stocks within small/SMID caps are cheap on an absolute basis and more so on a relative basis versus the large cap quality/growth stocks. The graph above shows the median PE for quality stocks (defined as companies with ROIC>10%) in the Russell 2000 Index, for the time period, 2000-present. In the last 24 years, the only other time when PE multiples were this low (as now) for quality stocks was during the GFC. More recently, since the end of 2021, SMID stocks as a group have been derated due to the fear of an impending rise in interest rates and the associated falloff in the economy. The correlations have risen within this group and even higher-quality stocks are trading at historically low multiples. At Sapience, we did well from 2020-2022 as our focus on buying quality companies at lower absolute valuation during the Covid weakness helped us outperform the benchmark and peers who are more relative-return oriented. In 2023, we underperformed as we were more defensive and it became evident that the economy was not going into a recession, thus cyclicals recovered. At the end of 2023, as markets began factoring in cuts as early as March by the FOMC, smaller caps and lower quality companies within SMID caps bounced (some of that rally reversed in January). As we are entering a more normal macro regime, SMID stocks, especially value, should recover with the expectations of moderating inflation and declining rates. The higher-quality stocks within this group should rerate more as we believe these stocks have been undeservedly punished—their earnings are more stable and their ROIC are higher, thus compounding the book value and intrinsic value at a higher clip in the medium to longer term.

Given the performance of the Magnificent 7 stocks since the beginning of 2023, Sapience, like many others in the investment world, are expecting better relative returns for small and mid (SMID) value stocks in the near to medium term. The bounce in SMID stocks that we witnessed in November and December aroused some faint excitement among allocators and consultants, however, after January's tepid performance, there is a question mark—can the trend from November and December continue? There is a possibility that in the near term the momentum might shift from the Magnificent 7 to SMID technology stocks. While we think SMID stocks should perform better in 2024, we have much higher conviction that the current dislocation in high-quality stocks within the SMID universe offers an uncommon opportunity.

The economy's uncertainty caused even the high-quality businesses within cyclical sectors like Consumer Discretionary and Financials to become cheap. The SVB banking crisis was another factor that further pressured multiples within regional banks in 2023. More recent worries for regional banks are due to their exposure to commercial real estate (CRE), irrespective of the types of real estate and the quality of the underlying credit. In addition to the derating in the cyclical sectors (e.g., Financials and Consumer Discretionary companies), which is somewhat understandable, last year the two sectors that are traditionally defensive—Health Care and Consumer Staples—were also derated. Within Health Care, several industries and companies have come under pressure due to the potential long-term benefits of weight loss and related ailments due to GLP-1s. The Health Care sector has also been experiencing a lull since last year—resulting from a slowdown in spending within life sciences. These two issues coupled with economic uncertainty for discretionary types of healthcare businesses has led to valuations that we believe are quite attractive within the sector. In the Consumer Staples sector, companies' multiples have been compressed due to a lack of volume growth and fear of declining volumes in food items and snacks in the future due to the impact of GLP-1s. In our view, it's not an easy task these days to find quality businesses that are trading at reasonable valuations in the Technology sector and to a lesser degree within Industrials. However, through our research, we believe we've found a few. Within Energy, the stocks are trading at a low multiple, generate strong free cash flow, and have attractive dividend yields. As of January 31, 2024, our largest holdings in our Small- and SMID-cap portfolios in these seven sectors are listed below (overlaps between the portfolios are noted in italics). These holdings illustrate our process of investing in what we believe are higher-quality businesses that are undergoing positive change or are out of favor due to macro- or industry-related factors.

Consumer Discretionary: Six Flags Entertainment Corp., Hasbro, Inc.
Consumer Staples: *TreeHouse Foods, Inc.*
Energy: Viper Energy Partners LP, Diamondback Energy, Inc.
Financials: *Webster Financial Corp.*

Health Care: Integra LifeSciences Holdings Corp., Catalent Pharma Solutions, Inc.[1]
Industrials*: Stericycle, Inc.*
Technology: Varonis Systems, Inc.[2], Twilio Inc.
[1] Novo Holdings announced the acquisition of Catalent on Feb 5, 2024.
[2] After the recent run-up, we believe this company is not cheap on an absolute basis.

One of our favorite quotes by Jeremy Grantham is: *"You don't get rewarded for taking risk; you get rewarded for buying cheap assets."* Since the beginning of 2023, the Magnificent 7 stocks have done outstanding. However, excluding Nvidia (being the prime AI beneficiary), the top-performing stock among the remaining six is Meta. Going back to the end of 2022, Meta had the lowest valuation, so it was deep value and high quality. Similarly, today within SMID caps, there are several high-quality stocks that can be classified as deep value. This is an unusual set up because historically deep value stocks are deservedly cheap: more cyclical, highly leveraged, and generally low-quality businesses. Typically, at the bottom of a cycle, the cheapest companies are cheap for good reasons as was the case at the end of 2008. While today we don't know exactly where we are in the economic cycle, it doesn't seem to us that we are at the bottom. In a recessionary scenario, the profitability and margins of small companies can suffer dramatically. Therefore, with high-quality companies at a cheap valuation you are getting the best of both worlds—better downside protection in a recession and equal or greater upside potential in a soft landing than the more cyclical and lower-quality businesses. This kind of free lunch is seldom on offer in the markets.

Is today a re-run of the TMT bubble? Although there is an even greater concentration of total market cap in the largest companies, which is troubling, we do not view the current scenario as being quite that vulnerable. Many of these dominant companies have massive scale, have wide moats, and generate abundant free cash flow. That said, this remains a market extreme, signs of exuberance are everywhere and there is no skepticism about the growth narratives. We like what we own far better than the Large Growth Indexes or even the Small Cap Indexes. We believe in the power of knowing the companies we own well enough to effectively assess their value and to hold them when they might be out of favor and, at times, trade at a significant discount. This includes owning healthy franchises that are misperceived by the markets and investing in select troubled businesses where we are confident in our underwriting assumptions of improving rather than static operating results. The market should not pay us for identifying stocks that are cheaper than average, but we believe it will pay us for our superior insights. With this in mind, we believe that the current dislocation in high-quality stocks within the small and SMID universe offers a compelling opportunity that is infrequent in the markets and has the potential for asymmetric returns.

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