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The Opportunity in Small-Cap Value

By Robert Huebscher
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Bill Hench is head of the small-cap team at First Eagle Investments and portfolio manager of its small-cap strategy. The First Eagle Small Cap Opportunity Fund (FESCX) was established April 27, 2021 and is managed by Bill and his team.

Prior to joining First Eagle in April 2021, Bill was a portfolio manager of the Small Cap Opportunistic Value strategy at Royce Investment Partners, where he worked for 18 years. Before that, he spent 10 years in the institutional equity business in Boston and New York, most recently with JP Morgan. He began his professional career as a CPA with Coopers and Lybrand. Bill earned a bachelor's degree from Adelphi University.

I spoke with Bill on February 9.

Bob: What are the benefits of investing in small-cap stocks?

Bill: If you look historically over long periods of time, there are risks to the small-cap market that you don't have with large-cap or mid-cap, like liquidity, financial dangers and depth of management. Historically, investors have been compensated for that risk. That means that you could potentially get more attractive returns than the S&P over time. Also, it's more of a domestic play than bigger names. You tend not to have as many big, multinational companies in this part of the market. If you were to look at some of the small-cap indexes like the Russell 2000, about 80-plus percent of its revenues in small companies are generated domestically. In my view, it's a great way to play the U.S.

Bob: What is your distinctive approach to small-cap investing? Explain your opportunistic strategy.

Bill: In the interest of full disclosure, I was fortunate to work with a pioneer in small-cap investing, Buzz Zaino, who had started this process more than 40 years ago at what was then Lehman Brothers. I worked with him for 18 years at my prior firm. Much of what I learned and how to implement our distinctive approach, as you call it, was through him.

It's a strategy that seeks to take advantage of short-term weakness in companies that happens in the normal course of business. Nothing grows forever in a straight line. We all learned that in the financial crisis. What this process and approach does is take advantage of that. When things are not going well for otherwise solid companies, we tend to invest in them on the theory that they're doing something that's potentially going to make it better or make it get back to normal. That's simply all that we're doing.

My experience at my prior firm taught me that if you can catch that change, you may be able to capture most of the improved performance as the company normalizes.

Bob: What do you look for in a potential investment? Does the process of identifying opportunities in the small-cap space differ from large-caps? How does your team stay on top of a large opportunity set off several thousand stocks?

Bill: The first thing we look at is valuation. We are a value fund, so we look for things that are cheap. By cheap, we use metrics that have historically been looked at as ways to value stocks: price to book and price to sales. We don't use price to earnings because most of what we invest in are either underearning, or perhaps not earning anything at all in the short term.

Then we want to ask, "Is there anything that's going to happen, or can anything happen—whether it be the company doing something or the end market—that's going to change, to make it get better?"

Is it different than with large caps? It differs in that you must take into consideration financing and liquidity, which as you move up in market cap are less of a concern.

How do we stay on top of this? As a former colleague used to say, we subscribe to and read lots of trade journals—everything from Engineering News to Autoweek to Women's Wear Daily. That gives us a good, solid background in what's happening in sectors and in parts of the economy where we invest. It's not something that's digested and then regurgitated like a research report. Research reports are great. It's just that we want more primary source material. It allows us to stay on top. We meet with between 300 and 400 companies and listen to close to 1,000 conference calls a year. That's how we keep up.

But it is a labor of love. You have to love doing this, because it is a large amount of work. But you get to do most of it yourself. There's not a lot of research coverage on a good portion of what we invest in. Where there is coverage, we love it and we might use it, but you don't always have that luxury.

Bob: Do you consider microcap stocks?

Bill: Yes, but everybody's definition of microcap is different. We've settled over the years on a billion dollars. At any given point, somewhere between probably 35% to 55%, even 60% of our names are going to be under a billion dollars. What are the differences there? Usually it's a little less liquidity, a little less analyst coverage, and a little less-seasoned companies. But in my view, it is a great source of investment opportunities because of the lack of eyeballs on it. The ability to be nimble makes it easier to turn around a billion or a $500 million company if it has its financing in order than something much bigger.

Bob: In the research I did for this interview, one of the things I noticed is that you look for catalysts to unlock value. What are examples of those catalysts?

Bill: We're looking for anything that'll get something back to normal. Sometimes it's a change of management, sometimes it's cutting costs, sometimes it's a company that is in three end markets and they're not big enough to handle that. Maybe they'll divest something, or it could just be that their end market is getting better. It could be that their customers are spending versus a period versus where they weren't spending.

Think of the recent mergers that took place in the wireless business. When those mergers were going on, capital expenditures tended to be cut back and you saw disappointing earnings in a lot of the equipment providers to telecom.

It wasn't because those companies were bad; they weren't poorly managed. It's just that there are only so many large wireless companies, and if there was a pause in spending, earnings were going to go down. The catalyst there would be a return to normal capex. It can be many different things, but often it's a new management coming to an existing base of business, or an action to improve margins. Whether that's through cost cutting or new products, those are the things that stand out.

Bob: How do you manage portfolio risk? How many names do you typically hold? How do you manage allocations across sectors or industries?

Bill: Having done this for a long period, we've found that there are two ways manage risk. One is to be diverse. We've always owned a lot of names. If you invest with us, you'll probably see 250 to 260 names in the portfolio. Concentration is wonderful when it works, but when it doesn't, especially in small-cap, it'll ruin your numbers. Diversity is key.

The second thing is to keep the portfolio cheap. We try to keep the portfolio cheaper than the market in general. It gives us a little bit of downside mitigation, but the key is the diversity. No matter how smart you think you are, no matter how much work you do, no matter how great you think a company's management team is, you're going to get surprises.

Sometimes it's the company's fault, sometimes it's not. If you own 5% or 6% or 7% position in that company, it is tough to recover in small-cap. We love the diversity. Sector-wise, it's just a result of our stock picking. Traditionally, we tend to have a lot in industrials and technology; we tend to be light versus the index on things like financials.

Bob: What is your sell discipline? What triggers the point at which you'll take gains and move on from a stock? How long will you wait for an investment thesis to play out?

Bill: Sometimes we sell if the stock is a good thing and reaches what we think is fair value. As things approach what we would consider a fair value based on the metrics of that company, we're going to slowly work out of it.

Or, as happened today, we had a takeover for a premium. We're going to sell. Also, when we're wrong, we sell. If we're buying something and suddenly what we thought was going to happen is not going to happen, or it's going to be worse or take longer, we're generally quick to cut bait.

Bob: What role do environmental, social and governance (ESG) issues play in your stock analysis?

Bill: A couple of years ago, before we moved from Royce to First Eagle, we incorporated a process into our analysis where we looked at factors that could affect ESG. For the most part, those things were done in our regular due diligence.

But I don't think there's yet a set of data that could help us judge the effectiveness of ESG. We look at it, but it's not the driving force. We have a fiduciary duty to get as good a return as we can for our investors, and that's still first and foremost in our process.

Bob: A number of the First Eagle equity strategies are known for holding cash counter-cyclically and gold as a potential hedge. Is that part of your process?

Bill: No, this is a process where we try to remain fully invested. We'll probably have somewhere between 3% and 5% cash. If investors want to participate in small cap, they want to get as much exposure as they possibly can. Therefore, we generally remain fully invested. If investors don't want to hold small cap, usually they'll sell.

Bob: What differentiates your fund from its peers?

Bill: We've got experience. We've performed. We tend to be a true small-cap fund, which means we're probably 30 to 40% smaller on average than our competitors and the index. We've owned more than 1,000 companies in the past. In my view, we're good at acquiring positions and very good at disposing of them, whether for good or bad reasons. We've lived through these cycles.

But perhaps what differentiates us most is our long track record of strong results managing a large pool of money at our prior firm. That remains our job on behalf of clients today.

Bob: Many advisors will allocate to small- and small-cap value through a quantitative or factor-based approach. What guidance would you offer to them vis-a-vis the active approach that you employ?

Bill: If you're going to go active, you should have your expectations aligned with the managers. We always tell people that over the cycle, we try to outperform the indexes. But there are going to be fallow periods. In nasty markets, we don't do well. But we don't get defensive; we strive to be aggressive. In the short term, you have to realize that when you invest with us, if you see that the indexes are down a lot in our area, we are probably going to do as poorly or more poorly on the downside. But our performance at our prior firm showed that our upside coming out of that fallow period more than made up for the downside during it. If you're going to go active, you have to be aware of how the managers are positioned and how they've performed in the past under both good and bad economic times.

Bob: Small-cap value has significantly outperformed growth over the past year. What do you attribute that to? Do you expect that trend to continue given the market environment?

Bill: Value was underperforming for so long versus growth. It was just a matter of time before that changed. But from a fundamental point, what happened was that growth had done well. There was a feeling that higher interest rates and inflation, two things that we had not seen in a long time, would slow that down. Combine that with the fact that value stocks were very, very cheap. You could call it a reversion to the mean, or just that the fundamentals had improved for value. There's a little truth to both of those explanations. But you're dealing with a world where if you're a small-value name, its multiple is very low; its balance sheet has gotten a lot better in the last couple of years because it had these wonderfully low rates where it could refinance and get its house in order and live to see a better day where it could raise prices, which is where we are now.

Bob: We're facing 7% CPI inflation. How has that impacted the small-cap market? Has it prompted you to make any changes in how you evaluate stocks?

Bill: It's in our face every day. We can't ignore it. We're going through earning season, and it's a topic that we hear from every company in terms of how much it costs and how difficult it is to employ people, and some input costs going up dramatically. If you look at some of the better strategists or market observers, they'll tell you that everything is up a lot. It has a profound effect.

We're not doing anything differently. Inflation is a factor that's there and can't be ignored. Traditionally, if you look at a lot of the literature, you'll see that small value was one of the places that's been best able to cope with inflation. The people who have been around for a long time are saying, "Oh, back when inflation was a thing, it was actually a fairly good time for relative performance."

With small cap, most companies don't get multiple expansion or compression based on what the bond market is doing or other macro events. Our stocks are much simpler than that. They go up when their earnings are better, and they go down when their earnings are worse. We are in a period where earnings are strong. With inflation, as long as you can pass on those costs, your numbers are probably going to be better. When passing on costs becomes an issue, then the opposite will happen.

Bob: Has the increased market volatility helped or hurt your approach?

Bill: From a mental point of view, it sometimes hurts. But from a practical point of view, it gives us an opportunity to do what we do best, which is to accumulate positions at attractive prices. Oftentimes when you see volatility and the market down severely based on whatever the news of the week is, if you get down into the weeds of the small and microcap names, it's usually worse than what's happening with the headline Dow-type names. Something we seek to take advantage of is mispricing. It can be taxing on investors. But for us, we've traditionally relied on volatility as something that allows us to potentially get good average prices over time., which has driven our performance over time.

Bob: Are you seeing any opportunities in particular sectors, without going into any specific names?

Bill: One thing that we find attractive are the semiconductor capital equipment names. Traditionally, they've been a highly cyclical group of stocks. But the worldwide build out of more production that is being spread to mitigate risk is in our view going to be a long-term potential benefit to those names.

"With small cap, most companies don't get multiple expansion or compression based on what the bond market is doing or other macro events. Our stocks are much simpler than that."

We still like housing names, which we think are trading at incredibly low valuations as the 10-year Treasury approaches 2%. But demographics and a change in where people are living are driving that and lots of consumer businesses that have benefited from cutting costs during this difficult period. Now they are coming back to get more customers and running more business through an existing cost base, which hasn't moved up yet.

Of late, we've found a number of attractive investment opportunities in our part of the equity market. Hopefully, that'll continue.

Bob: The market performed generally poorly in January. Did that create buying opportunities for you?

Bill: We always try to be fully invested and in the beginning of the year, it is potentially a huge opportunity. We had certain things that were down a lot and others which were doing okay. We did add a lot in technology and in some of healthcare names, where there was justified fear that higher wages would have a disproportionate effect on the short-term earnings. Those were the two of the bigger areas where we nibbled away.

Bob: What is the key takeaway you would leave with our audience of advisors about small-cap value and particularly about the approach that you take at First Eagle?

Bill: If you are willing to be patient, you can take advantage of the volatility in the small cap market to potentially get very good capital appreciation over the long term.

We believe it's a good opportunity to invest domestically. Many of our investors in the past had us in either 401(k) or other retirement vehicles, because they were able to not ignore the volatility, but be aware of it and take advantage of it.

Bob: We've covered your fund and your investment process. Tell me a little bit about yourself. What are some of the activities that you like to do when you're not looking at investments? What are some of the sources that you like to go to for reading, for insights? You mentioned trade publications, but beyond that.

Bill: My wife and I like to travel. Fortunately, we've got friends all over country and some overseas. We haven't seen our friends overseas in a while, but hopefully that'll change with the restrictions being lifted.

I try to be a good guitar player, but never seem to get over the hump.

I still read newspapers, believe it or not, hard-copy newspapers: The Journal and The Times. But we read a lot of trade journals. We'll pick up anything that we can—lots of science and even science fiction, just to open our minds up a little bit.

First Eagle Investments

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Average Annual Returns as of 12/31/21:	Since Inception	Inception Date	Expense Ratio Gross*	Expense Ratio Net
First Eagle Small Cap Opportunity Fund Class A (FESAX) w/o load	-2.27%	July 1, 2021	6.82%	1.25%
First Eagle Small Cap Opportunity Fund Class A (FESAX) w/ load	-7.14%	July 1, 2021	6.82%	1.25%
First Eagle Small Cap Opportunity Fund Class I (FESCX)	0.86%	Apr 27, 2021	6.57%	1.00%
First Eagle Small Cap Opportunity Fund Class R6 (FESRX)	-2.08%	July 1, 2021	6.57%	1.00%

*The annual expense ratio is based on expenses incurred by the fund, as stated in the most recent prospectus. These are the actual fund operating expenses prior to the application of fee waivers and/or expense reimbursements. First Eagle Investment Management, LLC ("First Eagle") has contractually agreed to waive and/or reimburse certain fees and expenses of Classes A, I and R6 so that the total annual operating expenses (excluding interest, taxes, brokerage commissions, acquired fund fees and expenses, dividend and interest expenses relating to short sales, and extraordinary expenses, if any) ("annual operating expenses") of each class are limited to 1.25%, 1.00% and 1.00% of average net assets, respectively. Each of these undertakings lasts until February 28, 2023, and may not be terminated during its term without the consent of the Board of Trustees. The Fund has agreed that each of Classes A, I and R6 will repay First Eagle for fees and expenses waived or reimbursed for the class provided that repayment does not cause annual operating expenses (after the repayment is taken into account) to exceed either: (1) 1.25%, 1.00% and 1.00% of the class's average net assets, respectively; or (2) if applicable, the then-current expense limitations. Any such repayment must be made within three years after the year in which First Eagle incurred the expense.

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Russell 2000® Value Index measures the performance of small-cap value segment of the US equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Indices are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index

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