ANCHOR CAPITAL ADVISORS LLC

ANCHOR PERSPECTIVES | **07.16.2019**

DIG DEEPER:
QUALITY IN THE SMALL CAP WORLD

The views expressed below are those of Anchor Capital Advisors, LLC ("Anchor") as of the date written on the last page of disclosures and are subject to change at any time. They are based on our proprietary research and general knowledge of said topic. The below content and applicable data are in support of our views on said topic. Please see additional disclosures at the end of this publication.

In the past few years, Anchor Capital has observed that the quality of many companies in the Russell 2000 Value Index has weakened. We view the decline in quality as a result of companies with negative earnings, flat to declining profitability ratios, and higher leverage. This decrease in quality increases the risk of investing in the passive index.

We believe actively managed portfolios are better suited to handle specific company and market risks associated with investing in small caps. We also think active portfolios are more able to manage downturns in the markets due to their disciplined focus on positive and growing earnings, stable and improving profitability ratios, and strong balance sheets and cash flow.

The bottom line: an investment should compensate for its risk. By neglecting to look under the hood and passively investing in an index, an investor may be exposed to a greater level of risk than one is suited to.

NEGATIVE EARNERS AND VALUATION

As depicted in Exhibit 1, the percentage of non-earning companies in the Russell 2000 Value Index is approximately 30%. History indicates that small, unprofitable companies skew towards high volatility, higher risk, and potentially greater underperformance.[i]

Therefore, in our opinion, it is more likely that an actively managed portfolio which values earnings should exhibit lower risk and potentially outperform a passive investment over the long term.

EXHIBIT 1

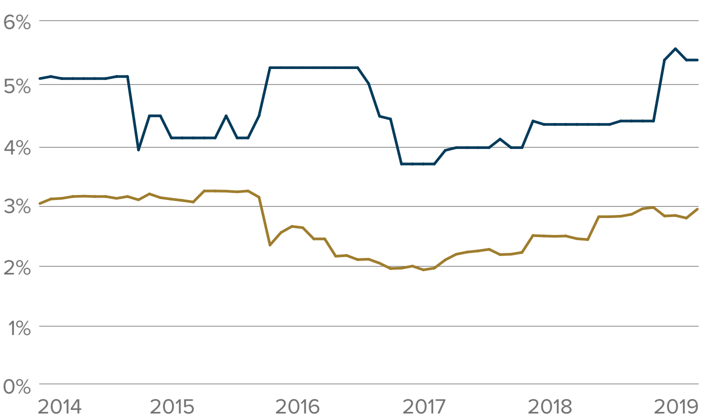
RETURN ON ASSETS AND NEGATIVE EARNERS IN THE INDEX AND IN ANCHOR CAPITAL SMALL CAP VALUE

Quality Characteristics of Anchor SCV vs. Russell 2000 Value

KEY TAKEAWAY

- The quality of names in the Anchor Small Cap Value strategy, as measured by return on assets (ROA), is consistently higher than those of the Russell 2000 Value.

Strategy vs. Benchmark:
Return on Assets (Weighted Median)



Strategy vs. Benchmark:
Percentage of Companies with Negative Earnings Per Share

ACA: Strategy/SCV/Quality Profile (Managed Accounts). Source: FactSet

When valuation metrics are reported by the indices and other financial reporting companies, negative earners are often removed from calculations of certain metrics. For example, the Russell 2000 Value Factsheet reports "Price to Earnings (P/E) Ex-Neg Earnings" as 15.8x in its characteristics section, as of March 31, 2019.

Vincent Deluard, head of global macro strategy at INTL FCStone, suggests summing the market caps of all companies in the index and summing the earnings all companies in the index to incorporate negative earners and get a more realistic P/E.[ii] By this calculation, the index was trading at 49.7x earnings on March 31, 2019.

By this same adjusted P/E of 49.7x, the earnings on yield on the index (the inverse of the P/E ratio, or 1 divided by 49.7) was 2.0% compared to 2.42% for the ten-year U.S. treasury as of March 31, 2019.[iii] In theory investors prefer a higher yield than the risk-free rate (the U.S. treasury) when they invest in riskier assets, such as small cap stocks.[iv]

PROFITABILITY RATIOS

Low profitability measures for the index, such as Return on Assets (ROA) in Exhibit 1, are further indicators of weaker quality companies, in our opinion. Profitability ratios such as ROA can show how well a company is utilizing its assets to generate earnings.[v] Although a low ROA can stem from many things, a low or declining ratio may be a negative sign for a company.

EXHIBIT 2

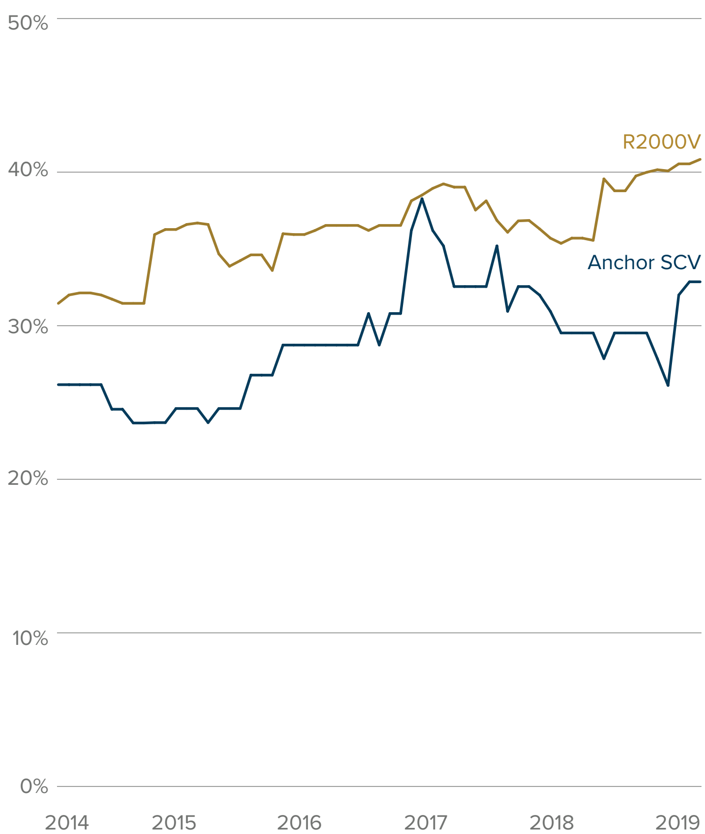
DEBT LEVELS IN THE INDEX AND ANCHOR CAPITAL SMALL CAP VALUE

Debt Levels Have Been On The Rise; Pay Down Has Begun

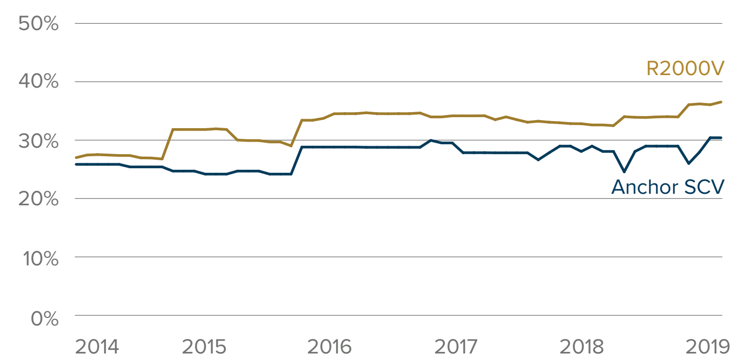
KEY TAKEAWAYS

- Debt to Capital for the Russell 2000 Value has been near peaks in recent years due to an escalation of debt.
- Long-term debt has been on the rise, while short-term debt has remained stable.

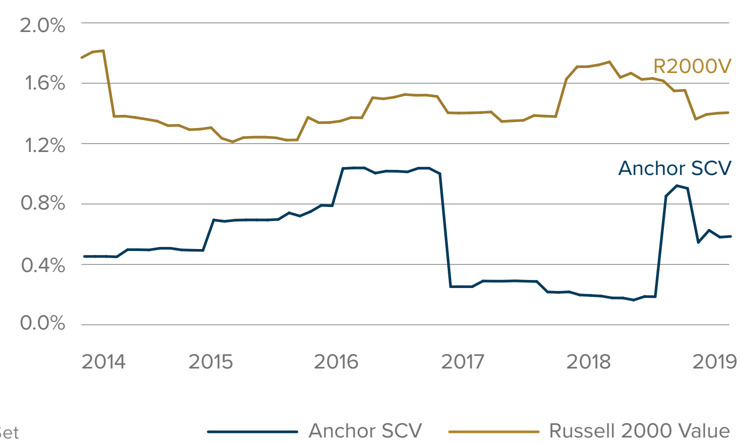
Total Debt to Capital
Weighted Median, Ex. Financials



Long-Term Debt to Capital
Weighted Median, Ex. Financials



Short-Term Debt to Capital
Weighted Median, Ex. Financials



ACA: Strategy/SCV/Debt Profile with Benchmark (Managed Accounts). Source: FactSet

LEVERAGE

We have also noticed that in this prolonged low interest rate environment, leverage for companies in the index has trended up. We believe that growing debt on a balance sheet increases the chance of risk, especially in market downturns. Avoiding excessive leverage is a form of risk control for us.

DISTORTIONS

When money flows into ETFs, it distorts the markets by rewarding lower quality companies, ignoring valuations, and increasing stock correlations.[vi]

As Michael Kretschmer, CFA, Chief Investment Officer at Dutch investment firm Pelargos Capital put it in an interview: “Price discovery is to capitalism what free speech is to democracy… buying equity ETFs indiscriminately rewards public companies regardless of corporate performance. Capital market participants would then need to question whether there is still truth in price.”[vii]

Given the issues we’ve highlighted with the index, we believe that over the long term a higher quality, lower beta, active strategy will outperform a passive investment in the index while reducing investment risk.

ANCHOR’S APPROACH

At Anchor Capital, we are aware of the benchmark holdings and weights, but we are not beholden to them. We do not take benchmark weights into consideration in building our portfolios – unlike the investments of passive ETFs.

Anchor employs a fundamental bottom-up investment process seeking to invest in quality companies at attractive valuations. We conduct thorough research to attempt to identify quality companies with stable earnings, high returns, and low debt levels. Historical price performance indicates that these types of companies outperform over the long run. Our portfolio construction process strives to provide consistent relative outperformance with less downside risk over a full market cycle, which is more than we can say for passive investing.

Valuation is of utmost importance when balancing risk and reward. As University of Rochester’s Robert Novy-Marx said, “One common recurring theme is the strong relation between quality and value. The two are quite similar, philosophically. Quality can even be viewed as an alternative implementation of value—buying high quality assets without paying premium prices is just as much value investing as buying average quality assets at a discount.”

Anchor believes that by adhering to strict valuation discipline, we can add a measure of risk control that the index is currently neglecting. In our opinion, our actively managed portfolios, due to their disciplined focus on positive and growing earnings, stable and improving profitability ratios, and strong balance sheets and cash flows, are better suited to handle company and market risks, as well as to manage downturns in the markets.

Index and Definitions

ROA: Return on Assets. Used as a low profitability measure for the Russell 2000 Value index.
ROE: Return on Equity. Used as a low profitability measure for the Russell 2000 Value index.
ROIC: Return on Invested Capital. Used as a low profitability measure for the Russell 2000 Value index.

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[i] Robert Novy-Marx, Simon Graduate School of Business, University of Rochester. "Understanding defensive equity." http://rnm.simon.rochester.edu/research/UDE.pdf. Updated March 2016

[ii] MarketWatch. "Here's the shocking truth about the Russell 2000's P/E ratio," 8.18.2017. https://www.marketwatch.com/story/heres-the-shocking-truth-about-the-russell-2000s-pe-ratio-2017-08-18

[iii] FactSet Financial Data and Analytics

[iv] Investopedia, "Earnings Yield," https://www.investopedia.com/terms/e/earningsyield.asp

[v] https://www.investopedia.com/terms/p/profitabilityratios.asp

[vi] Rodney N. Sullivan, CFA, and James X. Xiong, CFA. "How Index Trading Increases Market Vulnerability." Financial Analysts Journal. Vol 68, Number 2, 2012

[vii] John Rubino. "Archimedes in the Bathtub." CFA Institute Magazine. March 2017

[viii] Robert Novy-Marx, Simon Graduate School of Business, University of Rochester. "Quality Investing." http://rnm.simon.rochester.edu/research/QDoVI.pdf, December 2012 (Updated May 2014)

FIRM DEFINITION: Anchor Capital Advisors LLC is a Registered Investment Advisor (registration with the SEC does not imply any level of skill or training) and operates through three divisions: Anchor Managed Accounts division, Anchor Institutional division and the Anchor Private Client division. The Anchor Capital Managed Account division also serves as an investment sub-advisor to Unified Managed Account (UMA) Programs sponsored by brokerage firms, banks and other organizations. Through the UMA program, Anchor Capital provides a model portfolio for each discipline which has been chosen by the UMA sponsor. For GIPS® purposes, the firm is defined as the Institutional and Private Client Investment Management divisions of Anchor Capital. On June 1, 2006 Boston Private Financial Holdings, a holding company, purchased an 80% equity interest in Anchor Capital Advisors LLC. The company's employees continue to retain a 20% interest. On March 30, 2018 Anchor Capital Advisors purchased majority ownership from Boston Private Financial Holdings. Anchor now owns 70% interest and Lincoln Peak Capital owns 30% interest in the firm.

MODEL DISCLOSURES: The model returns do not reflect actual trading. The model transaction history does not reflect all portfolio transaction activity for accounts in the sponsor program. Model transactions correspond with trading activity generated in the course of investment for substantially all accounts in the sponsor program. Model transactions and holdings do not reflect individual portfolio activity for new account investments, or account activity and holdings in various individual portfolios subject to tax considerations or individual client discretion. Model performance may differ materially from individual client portfolio results.

CALCULATION OF RATES OF RETURN: All securities in the model are valued at last sale price, as provided by independent pricing services. The portfolio valuation is reflected on a trade date basis. Model investment returns include the reinvestment of dividends and other earnings. Effective 1/1/2010, dividends (excluding income on money market securities) are credited on an accrual basis. Time-weighted portfolio returns are calculated for each monthly period in the prior quarter. Monthly model results are linked to determine annual returns. Individual client portfolio results may vary from the results presented for the model because of different investment objectives, tax status and other considerations. Returns of individual client accounts will be reduced by advisor fees and other expenses which might be incurred to provide investment management, custody, administrative, actuarial, accounting or other services to the client. The model returns are calculated on a pure gross of fee basis, before the deduction of management fees, custodial fees and transactional costs. For all periods presented, the net of fee returns are presented after debiting the gross or pure gross of fee results by 3%, which represents the highest known annual wrap fee charged by any of the sponsors of the Separately Managed Account program that Anchor participates in. Effective 6/30/2017, the net returns presented are calculated using Style Advisor/Informa Investment Solutions. The monthly net return is compounded to calculate the quarterly, YTD and annual returns. The numbers may be slightly different from net returns published prior to 6/30/2017, which were calculated by simply subtracting 3% from the annual gross return. Additional information regarding policies for calculating and reporting model returns is available upon request.

SMALL CAP VALUE STRATEGY: The Anchor Managed Accounts Small Cap Value (SCV) model was created on 1/1/06. Anchor Capital's Managed Accounts Division created this model for purposes of presenting performance results which approximate those of the Managed Accounts Small Cap sponsor program portfolios in aggregate. The investment objective for the model is to achieve a high rate of return through the purchase of small cap value stocks. The results prior to 1/1/06 presented herein represent those of the Anchor Capital Institutional and Private Client Investment Management Division. The results from 6/30/02 through 1/1/06 for the Institutional and Private Client Investment Management Small Cap strategy were published in the product presentation.

TOTAL DEBT TO CAPITAL: Source: FactSet Portfolio Analytics. Represents total debt as a percent of capital for the period and date(s) requested. This is calculated as total debt divided by total capital.

BENCHMARKS: Russell 2000 Value Index (R2000V): offers investors access to the small-cap value segment of the U.S. equity universe. The Russell 2000 Value is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate small-cap value manager's opportunity set. Russell 2000 Index (R2000): offers investors access to the small-cap segment of the U.S. equity universe. 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. The Russell 2000 includes the smallest 2000 securities in the Russell 3000.
All investments carry a certain degree of risk, including the possible loss of principal. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject to market risk, active management risk, and growth stock risk. Indices are unmanaged and you cannot invest directly in an index. They do not reflect any management, custody, transaction or other expenses, and generally assume reinvestment of dividends, income and capital gains. Performance of indices may be more or less volatile than any investment strategy.

Anchor's standard fee schedule is available on request and can be found in Part 2A of our Form ADV. Investment advisory fees are generally collected quarterly, which produces a compounding effect on the total rate of return net of management fees. The actual fee charged to an individual account may differ from the standard schedule depending on a number of factors including account type and size.
The information provided should not be deemed as a recommendation to buy the securities or sectors presented. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss. The information included herein does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. All material has been obtained from sources believed to be reliable, but its accuracy is not guaranteed.

For a complete listing of all strategies, contact Anchor Capital Advisors LLC at (617) 338-3800.

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