KNOW WHAT YOU OWN: THE BENEFITS OF PROFITABILITY FOR SMALL AND MID CAP STOCKS

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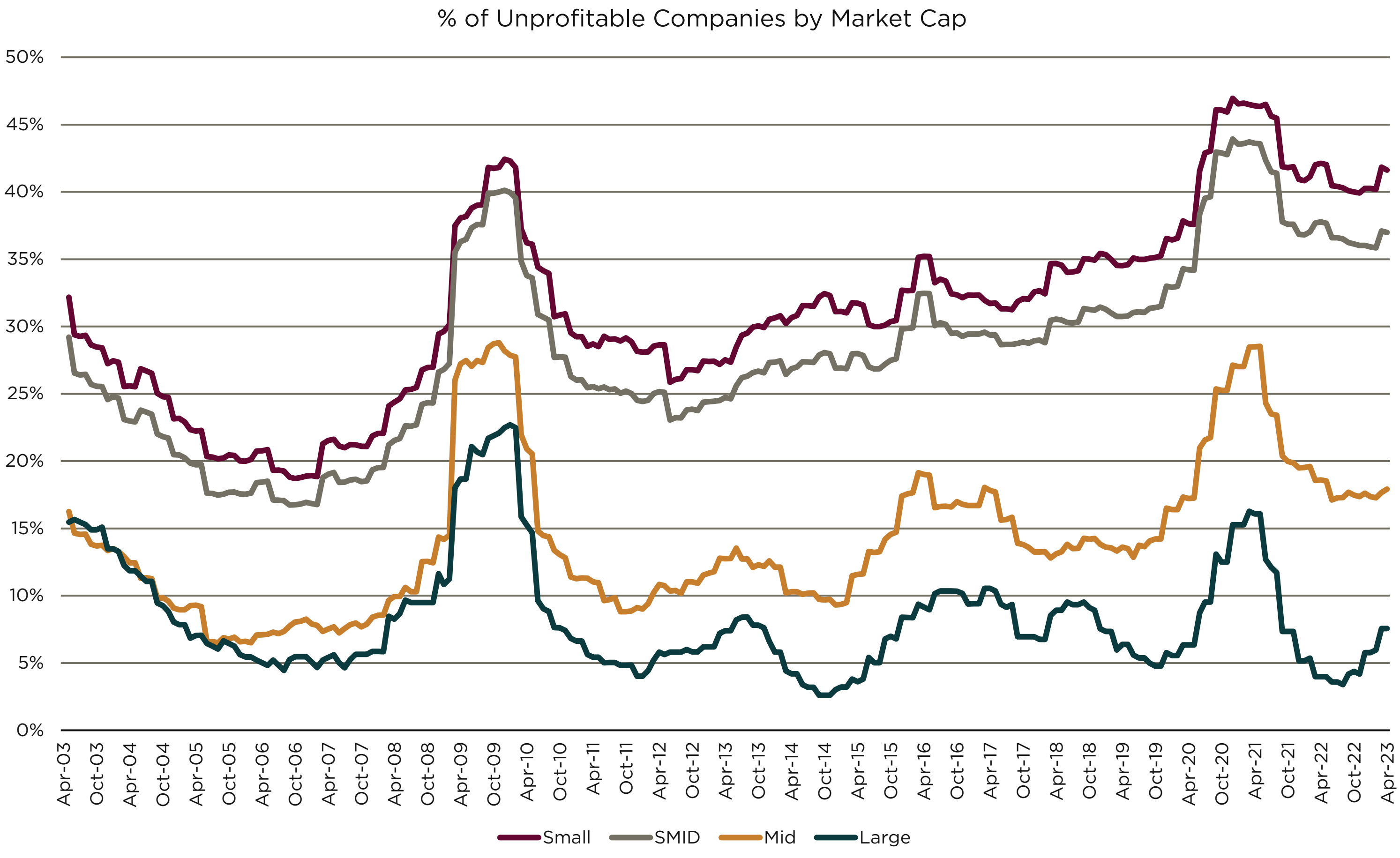
A Growing Percentage of Small and Mid Cap Companies Are Operating in the Red

As public companies operate with the intention of delivering profits to their shareholders, long-term return generation depends on growing those profits over time. However, a growing percentage of companies fail to achieve the goal of positive net profit. The chart below illustrates that as you move lower in market cap unprofitable companies make up a larger percentage of their respective universe. Over the past 15+ years, we have seen an increase in the percentage of unprofitable companies among the smaller cap ranges – a trend that cannot simply be explained by cyclical spikes of profit losses that occur during recessions. Alarmingly, over 40% of small cap stocks are now unprofitable.



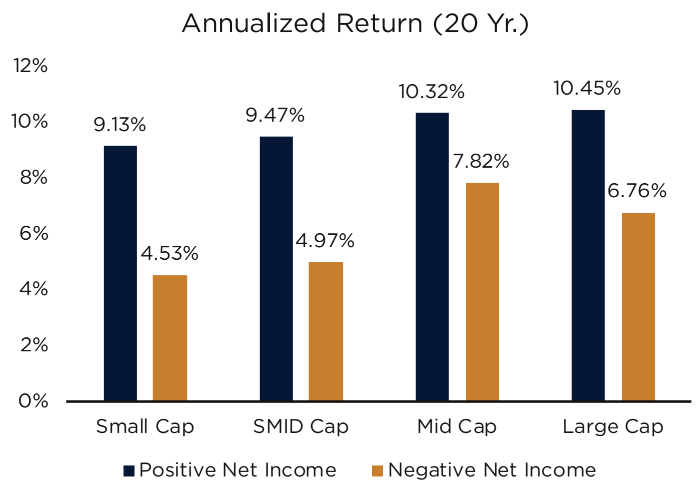
Note: Large Cap = Russell 1000, Mid Cap = Russell Mid Cap, SMID Cap = Russell 2500, Small Cap = Russell 2000

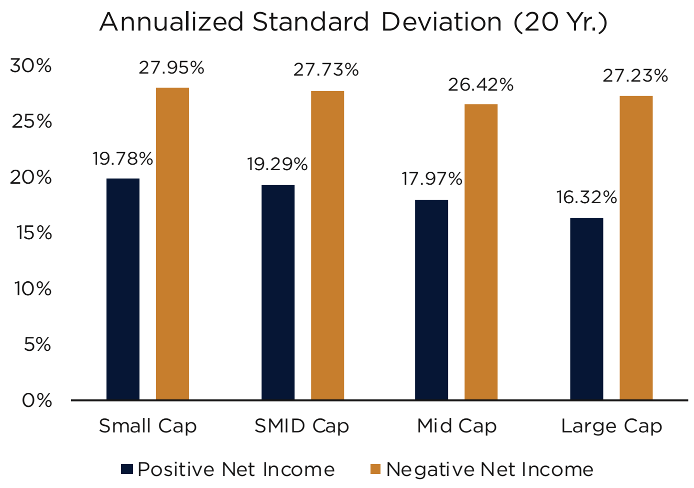
Source: Johnson Asset Management, FactSet, As of 4/30/2023

Why has this percentage been increasing? We point to a few key reasons for this trend: First, there are practical factors such as the mix of businesses that make up small and mid cap companies shifting more towards industries with increasing spend on intangible assets, such as R&D and trademarks, which are expensed immediately rather than amortized. This leads to decreased profitability now as companies invest in what they hope will lead to future revenues. Second, over the past decade plus, lower costs of capital have enticed smaller companies to be more aggressive in capital investment and acquisition. Finally, in recent years, the dynamic global environment has forced management teams to navigate global trade disruption, manage inflationary pressures, find qualified workers, and prioritize technological advancement, all while continuing to develop new products and execute well on current initiatives. Some management teams have navigated these challenges well and boast healthy profit margins, however an increasing number of small and mid cap companies have struggled to remain profitable.

Removing Unprofitable Companies Improves Risk AND Return

Historically, unprofitable companies have underperformed profitable companies over time. Active management offers the chance to remove these unprofitable companies from an allocation. In fact, eliminating unprofitable companies both reduces the risk and enhances the return across market cap ranges. For small and mid cap stocks, over the past 20 years, the returns of companies with positive net income have beaten those of companies with negative net income by more than 400 bps annually. At the same time, companies with positive net income also reduce risk, exhibiting 70% of the risk of companies with negative net income, as measured by the monthly standard deviation of small and mid cap stocks.





Methodology: The study covers the 20-year period ending 5/31/23. The statistics referenced are based on an equal-weighted, monthly rebalanced return series across a variety of market capitalization benchmarks. They are not directly comparable to the market-cap weighted indices, but the return series was constructed from the historical constituent data of the Russell 2000 (Small), Russell 2500 (SMID), Russell Midcap (Mid), and S&P 500 (Large).
Source: Johnson Asset Management, FactSet, As of 5/31/2023

Both the growing proportion of unprofitable companies within the small and mid cap space, as well as the superior risk and return characteristics of profitable names over time suggest that it has become increasingly important to know what you own within your small and mid cap allocations.