Market Update—Small Cap Growth

A Good Time to Consider Active Management for Small Cap Growth

At Renaissance, we manage our Small Cap Growth Strategy with an exclusive focus on high quality, growth companies. Broadly speaking, this means finding and investing in companies that are growing revenue and profitability at a rapid and sustainable rate combined with very attractive gross profit and operating margins.

The constituents of the Russell 2000 Growth Index includes many such companies. We continuously own investments in 50 to 60 of those that we believe offer the most compelling opportunities within this group.

The index also includes the stocks of many companies that we would characterize as low quality. In our process, which begins with all Russell 2000 Growth constituents, we exclude companies that account for just north of one-fourth of the index, by index weight, from consideration for investment. We exclude approximately 1.0% of the index, because the very low trading volumes of the stocks render them very difficult to buy and sell. Another 3.9% are excluded due to lack of any research coverage by sell-side analysts. These two groups have historically performed poorly as a group. There is, after all, a reason they lack trading volume and/or research coverage.

The third group of companies that we exclude from consideration are those that are not profitable and comprise approximately 22.0% of the index. Most of these are development-stage biotech (DSBs) and pharmaceutical companies. Individually, the stocks of these non-profitable companies are extraordinarily volatile. Even as a group, they offer a rollercoaster ride for investors. During the last three years, the non-profitable companies have performed very well, up 20.4% annualized, easily outpacing the return of the Health Care sector of the broad Russell 2000 Growth Index and that of the Renaissance Small Cap Growth universe, up 19.0% and 18.8%, respectively. However, longer term, the numbers don't look as compelling. Even after the recent "rocket run", these stocks have lagged their more conservative, profitable peer group. These unprofitable Health Care companies were up 13.8% annualized over the last ten years. While, this sounds impressive, it comes up short when compared to Health Care stocks in the Renaissance Small Cap Growth universe, which were up 17.1% annualized. In addition, when one considers the level of volatility inherent in these stocks, the case against them becomes more pronounced. In the third quarter of 2015, unprofitable Russell 2000 Growth Health Care sector stocks were down 24.5%. In the fourth quarter of 2018, they were down 32.3%. See Charts I, II and III for the Risk & Returns of the Health Care sector of the Russell 2000 Growth Index and Sub-Universes.

HEALTH CARE SECTOR RISK & RETURNS
Russell 2000 Growth Index and Sub-Universes

Chart I — 10-Year Risk & Returns

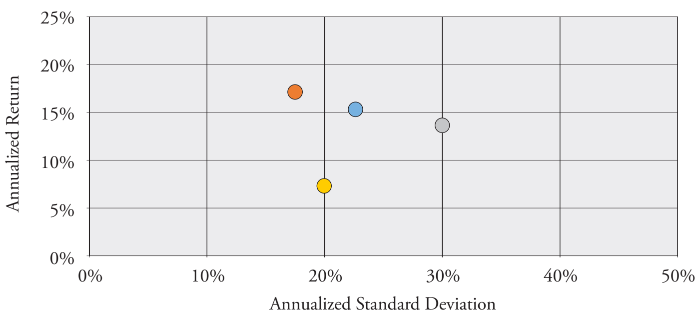


Chart II — 12/31/17–12/31/19 Risk & Returns

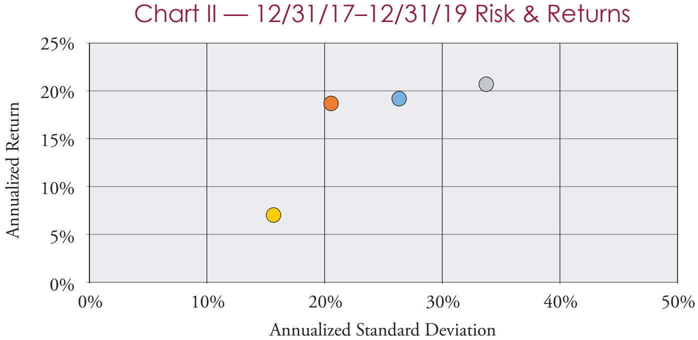
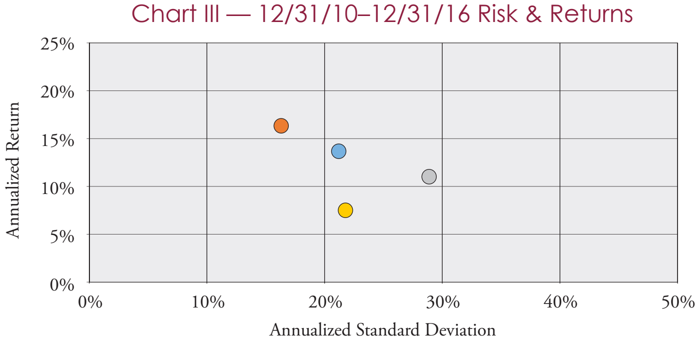


Chart III — 12/31/10–12/31/16 Risk & Returns



Russell 2000 Growth Index
Small Cap Growth Universe
Unprofitable Companies
No Coverage & Low Volume

Sources: Renaissance Research, Bloomberg

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We do not believe that DSBs are necessarily bad companies. However, as a group, we think the odds are stacked against them. Currently, there are 291 Health Care companies in the Russell 2000 Growth Index that we exclude from our universe—257 of them because they are unprofitable, 30 because of a lack of research coverage and 4 due to their low trading volumes. The vast majority of these companies are trying to come up with a cure for cancer or some other disease or condition that plagues us. The staggering number of companies chasing similar pursuits make for some difficulty in identifying the winners. It also virtually ensures that the reward for success within this group will be diluted due to the sheer amount of competition among them. Importantly, their business models are inherently challenging. Assuming a company gains approval from the Food and Drug Administration (FDA) for a drug, the company then must convert from a research organization to an operating company, complete with hiring a new sales force to distribute the drug to the American public, but only after first negotiating approval and reimbursement rates from health insurance companies. After navigating this transformation, the company then needs to start thinking about its third stage – life after the expiration of its patents on the approved drug. What's their next trick?

To quote one Health Care analyst: "So, basically, if you 'rolled the dice' on a small cap biotech investment during the last 20 years, you've had a 60% chance of negative annual returns, another 17% where you modestly beat the market, and about 23% of outcomes that are meaningfully positive." Most would not play blackjack in Vegas with these odds.

The last three years have been an ideal environment for the stocks of DSBs. These companies are heavily dependent upon investor funding for their research efforts. A healthy mergers and acquisitions backdrop also helps to prop up these stocks. Large pharmaceutical companies that were looking for new avenues of growth acquired 16 of these companies in 2019, which was easily a record year. Low interest rates also helped to fuel this phenomenon. However, what happens when the market turns south and funding for speculative investments that offer binary results dries up? There are political risks for drug companies too. Lowering drug prices is one of the very few agenda items on which both Republicans and Democrats agree.

Just as the last three years offered outsized gains for these stocks, we expect a reversion to the mean over the next three years (or worse).

We don't completely shun the biotech and pharmaceutical industries. We typically have a few investments within these industries that fit the profile of the type of companies we like – high quality, consistent and predictable growth, solid earnings momentum and a reasonable stock valuation.

One can enjoy the rewards of investing in exciting, smaller high-quality growth companies without the exposure to the risks inherent in the DSB industry. However, it requires active, fundamentally-oriented stock selection. Buying an indexed ETF or mutual fund won't get you there.

DISCLOSURES

The opinions stated in this presentation are those of the authors as of the date listed on this presentation and are subject to change at any time due to changes in market or economic conditions.

HEALTH CARE SECTOR RISK & RETURNS

For the three charts included in this marketing update, we have calculated returns representing four index-weighted portfolios for the Health Care sector of the Russell 2000 Growth Index. One is for the whole Health Care Sector of the Russell 2000 Growth Index, and the other three represent subsections of the Health Care sector of the index – 1) stocks that were included in our Universe, 2) stocks that were excluded from our Universe because they were expected to be unprofitable in the current year and 3) stocks that were excluded from our Universe because they either lacked sell-side analyst coverage or because their average daily trading volume over the last 200 days was below $2 million per day. Each stock in the Health Care Sector of the Russell 2000 Growth Index was placed into one of these three latter portfolios. These portfolios were created starting on 12/31/2009 and re-balanced quarterly. The quarterly returns were then geometrically linked to calculate the annualized returns.

This return information is provided for informational purposes only regarding the return characteristics of securities constituting the Russell 2000 Growth Index. This information is not meant to be, nor is it representative of, the performance of Renaissance Investment Management or any portfolio managed by Renaissance Investment Management. The returns achieved by Renaissance Investment Management or any portfolio managed by Renaissance Investment Management may vary widely from the information presented above. In addition, the return information provided above does not include fees, expenses and other costs likely to be incurred by an investor and, therefore, are not representative of a rate of return that would generally be available to an investor. All investing entails risk, including the possible loss of the principal amount invested.

Continued

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RUSSELL DATA

REFERENCED INDICES

(Indices are unmanaged and are not available for direct investment.)

Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.

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