The Great Unwind

The pandemic of 2020 will be read about in history books for many generations to come. Hopefully, it will be in the context of the world uniting to defeat COVID-19 before it could do greater harm than claiming the millions of victims already lost and before it could destroy the global economy. We believe that is the way it will be remembered.

For most professionals, one lasting remembrance will be the "work-from-home" economy that the pandemic created and the lasting effects of the massive investment made into technology to enable it. Of course, some companies were well prepared for such a world and business went on as usual, except that meetings were largely held on Zoom instead of in person. Thanks to our Chief Operations Officer and his supporting staff at Renaissance, our operations continued fairly seamlessly when the decision was made to shut down the office.

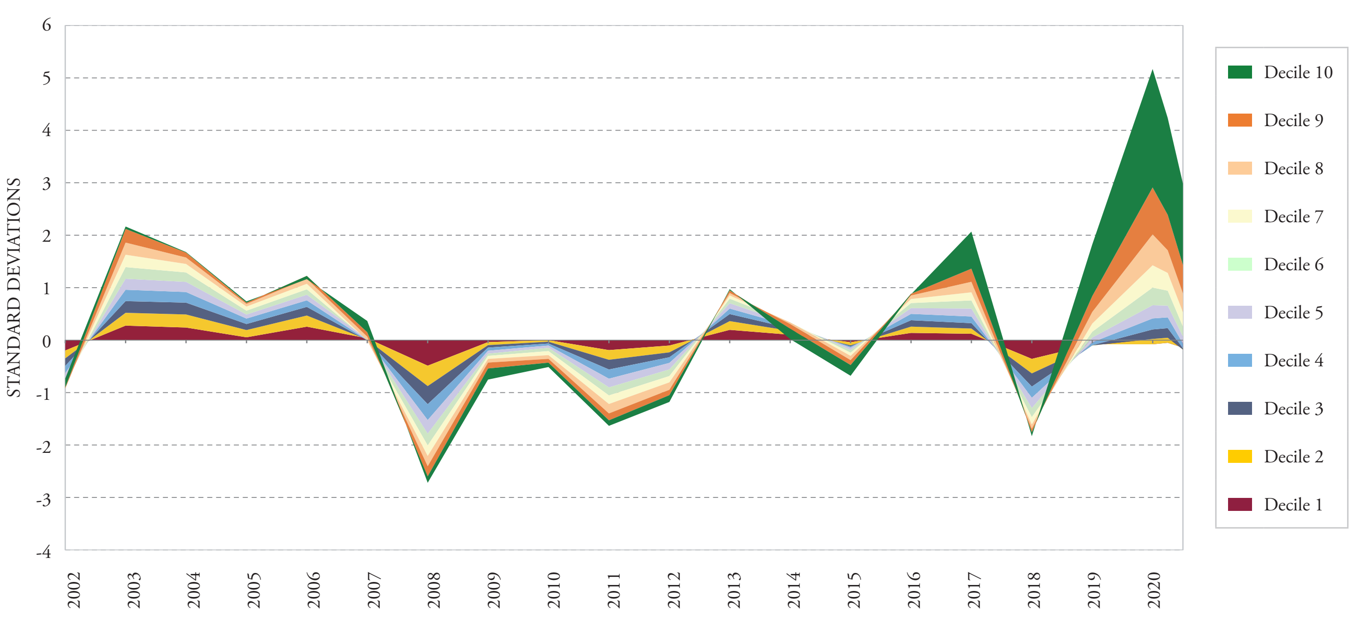
Most companies in the U.S. were not as fortunate and, in many cases, it took massive overtime by IT and other departments to deal with the challenges presented by the lockdown that began in March of 2020. With the lockdown came an unprecedented and urgent spend on technology to enable companies, in some cases, to simply keep the doors open.

This massive capital expenditure has long-term consequences. Many companies are now operating at a higher efficiency level relative to the pre-COVID era, and they will continue to do so after the world's economies have fully re-opened. We see this reflected in the profit margins of many of the companies in which we are invested—reduced travel expenditures, reduced office space requirements, and greater efficiency relative to labor costs.

After an initial breathtaking sell-off, the stock market as a whole reacted extremely well to the unprecedented stimulus injected into the economy by governments around the world. Investors quickly identified the winners of the COVID-19 sweepstakes and bid their stocks up in response. However, as happens from time to time, the response of stocks may have overshot in certain pockets.

Chart 1 shows the price-to-earnings (P/E) of stocks in our Small Cap Growth Universe broken down by P/E deciles over the last 20 years. Decile 1 represents cheap stocks, while Decile 10 represents expensive stocks. The lines indicate how many standard deviations above

CHART 1: RUSSELL 2000 GROWTH STOCKS BY P/E DECILE[1]



Data from 12/31/2002–6/30/2021
[1] Please refer to the disclosure entitled "Construction of P/E by Decile" in the Disclosures Section.
Source: FactSet

or below normal the average P/E is for the group relative to its 16-year history from year-end 2002 to 2018. As can be seen in the chart, stocks have tended to fluctuate significantly between under- and over-valuation during the course of this 20-year time frame. After all, we have had five bear markets in the Russell 2000 Growth Index since the beginning of 2003.

In 2001, Cisco posted revenues of roughly $22 billion, up over ten-fold from 1995. It represented the peak of investment growth in routers and other equipment that enabled the build out of the Internet. Since then, revenues for the company have grown a meager 120% cumulatively over the subsequent 20-year period. Its stock peaked in 2000 at $77. On July 30, it closed near a 52-week high of $55, down 29% from the high posted over two decades ago. When investors bought CSCO in the $70s back in the year 2000, they surely expected to see more than 4% annualized revenue growth over the subsequent two decades.

Many stocks today in the Russell 2000 Growth Index are priced with the expectation that the companies they represent will continue to experience outsized growth for years to come. While some companies may actually enjoy such an experience, Cisco is a reminder that today's leading-edge technology will eventually run out of greenfield opportunities once it enjoys widespread adoption. After all, who today doesn't have WiFi in their home, a smart phone in their pocket, or a secure connection to their virtual office desktop in the cloud?

As can be seen in Chart 1, the most expensive stocks (Decile 10) got far ahead of themselves during 2020, yet during 2021 they began to normalize in terms of their P/E on Fiscal Year Two expected earnings. However, by our math, the normalization process for Decile 10 is only 31% complete. As can be seen in the chart, the market rarely trends back to normal and flattens out there. It usually goes south of normal before rallying back up. In more emotional terms, this phenomenon is most aptly expressed as "greed and fear". Fear has just started to creep into the mindset of investors who were overexposed to Decile 10 during the three months from February through April, and they received some false hope during the last two months of the second quarter.

For those investors who remain broadly committed to the most expensive stocks, we believe the recent pain they've experienced will likely continue. In most cases, the recent pullback probably reduced gains, but further price erosion will cause actual losses for many, which may transform pain into fear and fear into a loss of conviction.

DISCLOSURES

This Market Update reflects the thoughts of Renaissance as of July 30, 2021. This information has been provided by Renaissance Investment Management. All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision, nor should it be considered a recommendation. The views and opinions expressed are those of the Portfolio Manager at the time of publication and are subject to change. There is no guarantee that these views will come to pass. As with all investments, there are associated inherent risks. Please obtain and review all financial material carefully before investing.

CONSTRUCTION OF P/E BY DECILE

Each P/E decile represents the universe of profitable companies in the Russell 2000 Growth Index as of 12/31/2002 broken down into ten buckets of companies with an equal number of companies in each bucket. The companies were placed in their respective buckets based upon their price-to-earnings ratio on estimated earnings-per-share for fiscal year two. The deciles were then recalculated the next year-end and each year thereafter through 12/31/2020 and for 6/30/2021. For each decile, the average P/E was calculated using a trigonometric mean, throwing out 20% of the outliers.

PERFORMANCE

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Small Cap Growth Market Update

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REFERENCED INDEX

(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.