DIVERSIFYING TO BUILD RESILIENCE

At Templeton, we have long argued that markets were more fragile than they appeared. Templeton's small-capitalization (small-cap) stock team has been acting on this conviction in recent quarters. In anticipation of an eventual late-cycle dislocation, we reduced and consolidated energy holdings at the end of last year to shed commodity price risk. We also sold companies that had high financial leverage or whose prospects were excessively dependent on restructuring success. In short, our strategies were not fully committed to the deepest value stocks ahead of the collapse because we were concerned about the cycle and had constructed more balanced exposures. Our focus in recent quarters has been diversification and resilience, which resulted in a material quality upgrade. Indeed, Templeton's small-cap strategies are generally showing improved gross profitability and better free cash flow margin growth while maintaining roughly the same leverage profile and a consistent valuation discount to benchmarks.

These moves provided some shelter from the severe headwinds facing small-cap value stocks in the early months of 2020. Not since the height of the technology, media and telecommunications (TMT) bubble in 1999 had international small caps underperformed international large caps—or international value underperformed international growth—by such a wide margin. There were few places for small cap investors to hide during the market's flight to safety. Anything small, leveraged or economically sensitive was punished. While we concede that losses were virtually unavoidable for small-cap value strategies in this environment, we are deeply unhappy with absolute losses and admit that this was a painful period. That said, we are pleased that our proactive efforts to increase resilience at least partially mitigated the severe style drawdown impacting small-cap value investors during this challenging period.
RAISING PRODUCTIVITY AND CAPTURING QUALITY

Ultimately, we believe that what we’ve been doing since volatility spiked in mid-February will be more important for long-term performance than anything we did beforehand. One development that gives us confidence is the frenetic pace of activity in recent months. Since volatility resurfaced, the small-cap team has had to replace its regularly scheduled weekly research call with ad-hoc meetings to keep up with the influx of new investment ideas. We are now meeting several times a week and are seeing a number of new ideas make their way into the strategies. As a global team accustomed to communicating across time zones and continents, the remote working arrangement the coronavirus protocol has necessitated seems to us like business as usual. In recent years, we’ve invested consciously in technology and logistics to help us capitalize on our global footprint via effective coordination. That’s helped not only with internal communications, but with management meetings as well. Much of our time during March and April has been spent web conferencing with portfolio companies and prospective investments, which has given us firsthand insight into conditions on the ground in Europe and Asia. Having a global presence and unfettered access are unique advantages in the inefficient small-cap space, and technology solutions are currently allowing us to maintain these advantages in a remote working environment.

Since a company’s stock price tends to fluctuate well in excess of its fundamental value, periods of excessive fear or euphoria create investable dislocations. Our goal is to take advantage of these dislocations to create alpha for our clients. The extreme investor panic experienced in the first quarter represented just such an opportunity. Our approach to investing in this environment has been to search for bargains among quality stocks. Our definition of quality includes, but is not limited to, the following characteristics:

- Entrenched sales leadership in a growing market
- Technological leadership in a field dependent on innovation
- Strong management with a proven track record of value creation
- Well-capitalized, early entrant into a promising new market
- Trusted and recognized brand in a high-margin consumer product segment

For many years now, investors have struggled to find reasonably priced exposure to high-quality companies. That’s resulted in many value portfolios being overexposed to low-quality cycicals that looked cheap but weren’t well-prepared for an economic downturn. Finding quality at bargain prices is no easy task, but we believe the potential in small-cap stocks is relatively better than large caps given the underfollowed and regionalized nature of the former. As such opportunities became more frequent in the first quarter, we are excited about the caliber of companies we were able to increase exposure to at a reasonable price.

CONSUMER STRATEGY: NUANCE AND BALANCE

The consumer sector offers a good example of this strategy in action. To begin with, we’ve brought down our consumer exposure across the board in anticipation of an economic downturn and more austere consumer behavior. Our reductions have primarily focused on mass-market consumer brands selling high-ticket items that can easily be deferred by cash-strapped consumers. Our current holdings—several of which were initiated during the period—represent a much higher-conviction, better-balanced opportunity set in this environment. On the one hand, we’ve increased exposure to a number of discounters and
budget retailers selling a mixture of essential and discretionary items at affordable prices. These companies are likely to survive and even prosper in a muted consumption environment. On the other side of the spectrum, we have exposure to a handful of premium brands that are likely to retain their cachet and desirability even through a downturn. Unique prestige brands with competitive moats and economically resilient customers typically command a valuation premium, though a combination of stock-specific issues and broad market volatility have recently created opportunities to invest in these companies at affordable prices.

Finally, there are the “away from home” stocks that have been hit hard by coronavirus concerns. Examples include a Belgium-domiciled movie theatre chain and a restaurant food distributor in Italy. These businesses can be thought of as the “cleanest dirty shirts in the laundry.” It takes rigorous credit analysis, deep industry knowledge and highly selective investment criteria—not to mention emotional fortitude—to initiate positions in these types of stocks, but a modest allocation can actually improve risk dynamics by increasing exposure to upside volatility. Overall, within our reduced consumer sector allocation, these moves leave us with a diverse collection of higher quality companies offering idiosyncratic risk-return profiles.

EASTWARD TO OPPORTUNITY

We’ve made similar moves in our regional allocations. In Europe, our focus has been on “best of breed” companies whose reputations and competitive advantages will likely sustain them through a crisis that will permanently impair equity in weaker firms. We’ve been finding more abundant opportunities outside of Europe, however. Reflecting the evolving fundamental opportunity set, we’ve shifted exposure to Asia, and especially Japan, which now makes up more than a quarter of regional exposure in our small cap strategies. We are finding a number of Japanese firms with strong balance sheets and domestically focused revenue models operating in a society that appears relatively well-equipped to manage coronavirus challenges.

Following the Nikkei bubble of the late 1980s, Japanese companies that had previously pursued global leadership at all costs turned inward, becoming more pragmatic and conservative, strengthening balance sheets and focusing on improvements in efficiency and productivity. More recently, corporate Japan has been the subject of significant structural reforms designed to improve corporate governance, shareholder returns and business competitiveness. As a result, firms that already had solid balance sheets, leading technological capabilities and premier global brands are now undergoing deep structural reforms designed to improve returns on equity and shareholder value. While companies in many other parts of the world are entering this crisis with excessive leverage and/or expensive valuations, Japanese stocks look comparatively cheap and the country appears well positioned to begin reaping the benefits of historical prudence and ongoing reform.

SMALL IS BEAUTIFUL: STOCK-PICKER’S PARADISE?

At Templeton, we made a number of strategic adjustments over the course of the past year that allowed us to enter this crisis with a more resilient and defensive small-cap positioning. Since February, as volatility rapidly escalated and opportunities that were previously unattainable to value-oriented investors began to emerge in an array of different companies, we’ve continued to rebalance accordingly. The February/March drawdown highlighted the importance of risk management for small-cap investors, particularly those with a value bent. Understanding financing needs is especially critical as many companies of this
size are non-investment grade, and we do not want to own firms whose fates depend on the “goodwill of strangers” in convulsive credit markets. While that dynamic will likely sustain volatility in the small-cap space, other macro headwinds could actually benefit small caps, such as declining oil and commodity prices, given that smaller companies tend to be commodity consumers instead of producers.

Though small-cap stocks sold off indiscriminately in the first wave of this crisis, smaller companies tend to behave more idiosyncratically over time, and fundamental investors can take advantage of the market’s excessive moves. Indeed, international small-cap stocks in April 2020 traded at multi-year valuation lows relative to large caps on measures like price-to-sales, price-to-book, price-to-earnings and price-to-free cash flow. The macro outlook remains gloomy despite the high likelihood of more effective COVID-19 treatments and an eventual vaccine that will thankfully ease the toll of human suffering. The small-cap universe is a place where fundamental stock-pickers may be able to sidestep some of the macro challenges that lay ahead and find those rare diamonds in the rough—selective, bottom-up values capable of producing unique and uncorrelated returns over time. We will continue working hard to capitalize on this attractive opportunity set for our clients.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. Investments in smaller-company stocks carry special risks as such stocks have historically exhibited greater price volatility than larger-company stocks, particularly over the short term. Value securities may not increase in price as anticipated or may decline further in value. Additionally, smaller companies often have relatively small revenues, limited product lines and a small market share.
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