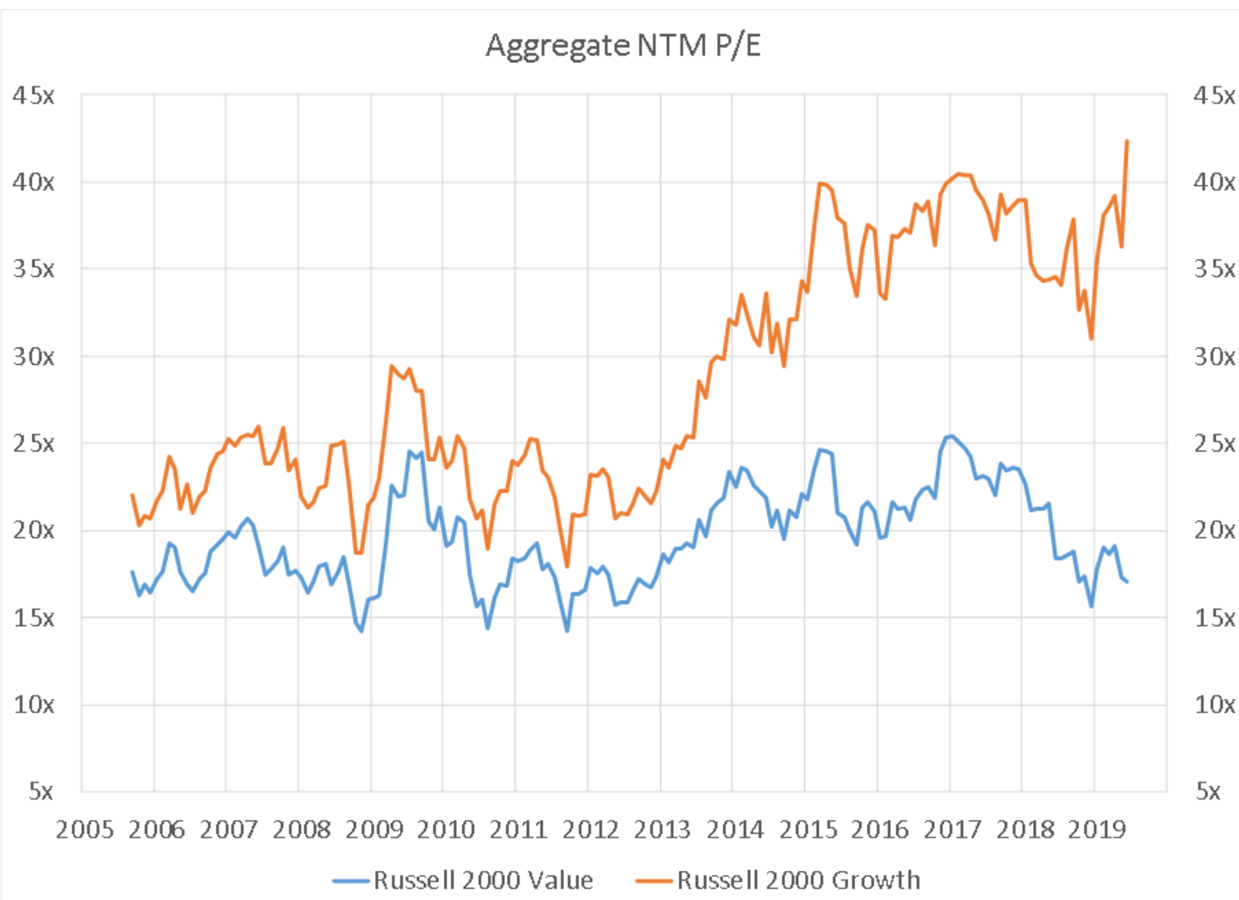
LISANTI CAPITAL GROWTH

IS SMALL CAP GROWTH TOO EXPENSIVE?

One of the negative comments we hear consistently about small cap growth stocks is that they are “too expensive”. Investors making this statement usually point to price/earnings ratios, or the market capitalization of a company relative to its level of revenues in the last year. Indeed, if one looks at the chart below of small cap growth (represented by the Russell 2000 Growth index) versus small cap value (represented by the Russell 2000 Value Index), the relative valuation appears to be much higher than at any time in the past 14 years. Frustrated Value investors have been eagerly awaiting a “reversion to the mean” trade (which would mean that relative valuations come more in line with historical levels); in that scenario, small cap growth stocks would underperform small cap value stocks. . Our concern is this sounds less fundamental to us and more like the rookie roulette player thinking “it’s come up Red so many times in a row, I have to bet Black.” (Of course we know each new spin has the same statistically even probability of landing on either color.)

NEXT TWELVE MONTHS’ (NTM) PRICE/EARNINGS RATIO COMPARISON



Source: Furey Research Partners, FactSet . Data as of June 30, 2019

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Why has small cap growth so outperformed small cap value? While we believe the current macroeconomic backdrop, of GDP around 2% and inflation under 2%, is an environment that is especially favorable to small cap growth companies, since their higher growth rates would typically stand out from the crowd of general smaller companies, we also think more than the general macroeconomic backdrop is influencing this divergence.

Let's examine that premise that small cap growth stocks are too expensive, first. As classically trained research analysts, we were taught to look at P/E (price/earnings) ratios as a measure of valuation, for those companies that make money, and to look at market capitalization to sales ratios for those companies that are not profitable.

In order to make a decision about valuation, therefore, it logically follows that one needs to make an accurate determination of the rate of growth in sales and earnings. . .and this, we believe, is where the "too expensive" argument fails. We believe there is a secular inefficiency in the smaller cap growth stocks, which is that *the risks and opportunities of growth are routinely misunderstood and therefore mispriced*. This is particularly true of companies that fit into three buckets:

Secular Growth Companies---these are companies that are changing the way society lives and works. They are at the forefront of the transformative changes going on in the economy. They are growing because their value proposition is so compelling to their customers. We believe these kinds of companies are relatively indifferent to GDP growth, unless we experience a severe global economic downturn accompanied by a credit crisis (such as what occurred in 2008-2009). Indeed, one could argue that in periods of slower economic growth, they might see growth accelerate, due to their value proposition. These companies have products and/or services that are "must haves" in their customers' eyes, and we believe that makes their growth potentially more sustainable. They also are usually early in the "change curve", and that means, to us, that the rate of growth in sales and earnings they can produce is routinely underestimated.

Structural Growth Companies—these companies "self -help" their way to growth. Many tend to grow faster than their industries or sectors due to internal drivers, such as a well- executed acquisition strategy; a rapid innovation engine that drives new product growth; a marketing approach that makes them a "trusted supplier" to their customers. . . they may not be as exciting as the Secular Growth Companies, but they appear likely to deliver consistently above average growth in earnings and revenues.

Transformational Growth Companies—like the phoenix rising from the ashes, these companies are transformed through new management and a sharpening of executional capabilities that take them from middling performers, in terms of sales and earnings growth, to strong growth companies.

What do all three of these types of companies have in common? Investors routinely underestimate their ability to grow sales and earnings, and the length of time they can sustain that growth, in our opinion. When we examine most earnings and sales forecasts closely, we find that oftentimes the assumption is that growth slows to some "sustainable" rate, because the assumption is made that as these companies get bigger, they cannot possibly sustain the current rate of growth. While that may be true, our research indicates it is significantly less true today than in prior periods. Why? Several reasons:

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Companies can use technology to scale—they are not limited by how many people they can add. Thus, they can grow “big” in terms of sales and earnings with much more operating leverage than prior business models. They also tend to have business models that “layer on” (such as subscription models) which lower the cost of taking the service for the customer but increase the likelihood that the customer will retain the service over time, and therefore easier for the company to layer on growth and thus sustain a higher rate of growth.

When investors discuss valuation, oftentimes they have a bias towards growth slowing as the company grows. That slowdown in growth does not always occur. We believe this is why many fast growing companies, in retrospect, look “inexpensive”. We realize that this is not true for all companies—to be able to sustain an extremely high growth rate, companies need experienced management teams and almost flawless execution—but those companies are out there and our research process focuses on uncovering them.

While we would not argue that valuations relative to historical levels are high, we maintain there are sectors and individual companies that are exceptions…and exceptional. If anything, it points to the wisdom of active management versus buying the basket of Russell 2000 Growth. As the old saw goes, “it’s not a market, it’s a market of stocks.” What’s more, our work indicates that our economy is in a period of rapid change and indeed transformation. Many of these companies are beneficiaries of that transformative change. If they can continue to execute on their growth strategies, our research indicates that many of these companies have the potential to grow at rates higher than forecasted, for longer than forecasted. . . which might, in retrospect, make them “inexpensive” at current valuations.

Price to earnings (P/E) ratio is the valuation of a company’s current share price relative to company earnings. Next twelve months (NTM) refers to a measure being forecasted for the immediate next twelve months from the current date.

LISANTI CAPITAL GROWTH
Investing in growth

About Us

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About Lisanti Capital Growth:
Lisanti Capital Growth, LLC (Lisanti), founded by Mary Lisanti, is a certified woman-owned and managed SEC registered investment advisor specializing in U.S. small- and small/mid-cap (SMID) equity growth investing. In September 2017, Dinosaur Group Holdings, LLC, the parent company of DCM Advisors, LLC (DCM), an affiliated registered investment advisor, acquired a minority interest in Lisanti. Lisanti manages separately managed accounts and is the investment adviser to the Lisanti Small Cap Growth Fund (ASCGX). DCM is an SEC registered investment advisory firm providing asset management and wealth advisory services to institutions, registered investment advisors, family offices and high net worth individuals.

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Justin Keating
Research Analyst

Kit Yee Martin
Chief Administrative Officer

** Years of experience*

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An investment in the Fund is subject to risk, including the possible loss of principal amount invested. The Fund invests in smaller companies, which carry greater risk than is associated with larger companies for various reasons such as narrower markets, limited financial resources and less liquid stock. Investments in technology companies are vulnerable to factors affecting that sector, such as dependency on consumer and business acceptance as new technology evolves. The Industrial sector can be significantly affected by business cycle fluctuations, worldwide economy growth, government and corporate spending and others.

The views expressed reflect those of the portfolio manager as of the date noted. The portfolio manager’s views are subject to change at any time based on market and other various conditions.

Before investing, you should carefully consider the Lisanti Small Cap Growth Fund’s investment objectives, risks, charges, and expenses. This and other information is in the prospectus, a copy of which may be obtained by calling (800) 441-7031. Please read the prospectus carefully before you invest.

Foreside Fund Services, LLC is the distributor for the Lisanti Small Cap Growth Fund.

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