BARRANTAGH Investment Management | 1995 | 2020 25 Years

Q3 2022

TRADING ACTIVITY

BARRANTAGH INVESTMENT MANAGEMENT

Canadian Small Cap Equities

The risk off tone prevailed during the period with large intra-quarter swings for many stocks. The prevailing narrative is that inflation remains sticky and the Fed remains steadfast in taking near-term rates higher, resulting in a strong U.S. dollar, ramping volatility, and risk assets under pressure. We have written previously that in periods of heightened volatility and negative sentiment small-caps can bear an oversized share of the burden. It has felt to us that this year seems especially volatile, so we went back to look at the data.

In 2022, almost 60% of all trading days for the S&P/TSX Small Cap index have seen swings of greater than plus/minus 1%. Going back to 2000, there has never been a year as volatile for Canadian small-caps, with other notable risk-off periods including the credit crisis (2008-2009: ~50%), the COVID crash (2020: ~45%), European debt crisis (2011: ~40%), and tech bubble (2000: ~35%) all trailing. To put this further in context, over the two decade-plus history of the study one can expect roughly a quarter of all trading days on average to reach this volatility threshold, while a "goldilocks" low-vol year such as 2019 was as low as 6%. With ~10x the volatility this year it is no wonder that bearish sentiment currently prevails.

We don't raise this point to signal doom and gloom; on the contrary this is evidence that we are currently in an "emotionally" lead market versus a "fundamentally" lead market, which can lead to dislocations that plant the seeds for attractive future returns. Looking back at the data for Canadian small caps, when volatility spikes (we define as periods where >50% of trading days over the trailing three months have swings +/-1%) forward average one- and two-year annualized returns of over 25% were substantially higher than the benchmark averages over the study (~5%). Further, after these periods of heightened volatility the probability of positive price appreciation was over 75% on the forward one-year and over 85% on the two-year compared to base rate expectations of only ~55% probability of positive returns over all periods. This important dynamic also held true across the larger cap S&P/TSX Composite and S&P 500 indices: after periods of excess volatility, (1) future returns were considerably higher, and (2) the probability of seeing positive future returns increased.

Markets are a discounting mechanism. It doesn't matter how things "feel" at any given time, it matters what is being priced into stocks. Like a pendulum, investors rarely experience an "average" environment and when the pendulum swings to fear and volatility markets can often overshoot. Though its never pleasant to endure these periods, it is precisely this pain that paves the way for higher expected future returns.

BUYS

None.

SELLS

Aecon (ARE) was sold during the quarter on concerns of fixed-rate contract pricing and the company's ability to pass through inflation.

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