Updated September 2021

Perception Versus Reality

Why Interest Rate Concerns Frequently Drive Unnecessary Rotations Among Equity Market Capitalization Categories

By: Eric Kuby, Chief Investment Officer & James (Jim) Lane, Senior Analyst

Summary

Investment idioms and sayings like “Sell in May and Go Away” and “The Trend is Your Friend” are only a couple of many sayings that some investors accept as truisms. As small cap investment specialists, we like to investigate whether similar small cap-related beliefs are valid or not. In this white paper, we analyze whether historical data supports the belief that it is prudent to sell stocks, and especially small cap stocks, when interest rates are likely to increase for some sustainable period. North Star analyzed the three periods in the last 30 years when interest rates increased for a sustained period of more than 12 months. Our conclusions are:

I. Broad equity indices, <u>both</u> small cap and large cap, can and sometimes do rise during rising interest rate periods, but not always; in our view, this supports idiosyncratic, active management through bottoms-up stock picking in all market capitalization categories.
II. Small cap equities <u>can</u>, but <u>do not always</u>, outperform large cap equities during rising interest rate periods, such as from August 31, 2011, to December 31, 2013; in our view, this supports idiosyncratic, active management through bottoms-up stock picking.
III. Other than <u>Technology</u> and <u>Health Care</u> equities consistent outperformance and <u>Utilities</u> equities consistent underperformance during lengthy rising interest rate periods, there is no clear quantitative evidence that other sectors perform in a consistent declining or consistent increasing manner during rising interest rate environments; in our view, this supports limited sector-exposure management when active managers have high conviction that interest rate outlooks are changing from “stable” to 'likely to rise'.

Context

Given recent increases in news reports and Federal Reserve officials comments that the economy may require tapering of the current level of quantitative easing bond purchases, which would likely precede increases in targeted Fed Funds Rates, we are updating our comments on the historical quantitative relationship between U.S. Treasury yields and the performance of small cap and micro cap stocks. We are adding some analysis of how small cap stocks perform versus large cap stocks during such rising interest rate periods, by both looking at broad market indices, as well as the limited sector-specific data from the past 30 years. Notwithstanding short-term market-to-market fluctuations associated with interest rate fluctuations and speculation, historical data suggests that our small cap and micro cap strategies may assist investors in meeting their investment return needs, regardless of interest rate trajectories.

We believe that there is a common misperception that small and micro cap stocks may provide less attractive relative returns during periods of rising interest rates, and that such misperceptions can unnecessarily drive rotation away from small and micro cap stocks. This can be costly from a tax perspective and foregone opportunity perspective. The possible underlying logic for such rotation among market capitalization categories is that borrowing costs may rise more rapidly for companies with less revenue and earnings power than borrowing cost increases for companies with much larger revenues and earnings.

Looking back at data over the last 30 years, there have been three periods when interest rate increases have persisted for more than one year. It is useful to analyze these longer periods because (during these periods) companies reported several quarters of earnings, allowing us potentially to separate sentiment-related index and stock performance from performance tied to underlying earnings and business performance trends. We may be entering a fourth such period given meaningfully higher recent inflation data; during such times, monetary policy may become significantly less accommodative, and the benchmark U.S. 10-year Treasury yield may increase toward historical averages in the mid-single digits.

	Period One			Period Two			Period Three		
	09/30/1998	01/31/2000	% Change	08/31/2011	12/31/2013	% Change	07/31/2016	10/31/2018	% Change
U.S. 10-Year Treasury Yield (%)	4.44	6.68	-	2.23	3.04	-	1.46	3.15	-
Broad Indices									
Wilshire 5000 Index **(WINDX)**	10.0	11.6	**16%**	12.60	16.0	**27%**	19.3	21.3	**11%**
Wilshire Small Company – Value **(WSMVX)**	13.1	11.3	**-14%**	17.44	24.7	**42%**	23.4	22.8	**-3%**
Wilshire Small Company – Growth **(WSMGX)**	10.8	15.7	**45%**	19.23	26.7	**39%**	26.7	27.8	**4%**
Russell 2000 **(IWM)**	46.1	61.9	**34%**	71.52	114.7	**60%**	122.3	154.0	**26%**
S&P 500 **(SPY)**	98.5	142.6	**45%**	147.24	181.0	**23%**	218.2	270.6	**24%**
Dow Jones Industrial Average **(DJIA)**	8,416.8	10,963.8	**30%**	13,306.64	16,020.2	**20%**	18,543.5	25,115.8	**35%**

Analysis

The table above shows the performance several indices during three periods of 12-months-or-more during which the U.S. Ten Yield Treasury yield rose.

Period One (September 30, 1998-January 31, 2000) – Mixed Trends

The broad market S&P 500 Index increased 45%, as did the Wilshire Small Company – Growth index, while the small cap Russell 2000 returned 34% and the Wilshire 5000 Index returned just 16% and the Wilshire Small Company – Value index returned a negative 14%.

Period Two (August 31, 2011-December 31, 2012) – Small Cap Outperformance

The broad market S&P 500 Index increased 23%, the Wilshire Small Company – Growth index increased 39%, and the Wilshire Small Company – Value index returned 42%. Therefore, in this rising interest rate period, investors in small company stocks would have outperformed the same investment in large cap stocks.

Period Three (July 31, 2016-October 31, 2018) – Mixed Trends

The broad market S&P 500 Index increased 24%, the Wilshire Small Company – Growth index increased 4%, the small cap Russell 2000 returned 26% and the Wilshire 5000 Index returned 11%, while the Wilshire Small Company – Value index returned a negative 3%.

North Star's Thesis

If we are at the early stages of a prolonged period of rising rates, it is likely not too late for investors to dip their toes into the small and micro cap pool. Moreover, not all small and micro cap stocks are the same, as many companies have low or no levels of debt. Portfolios can be constructed to focus on small and micro cap companies with lower leverage levels. In fact, as of 8/31/2021 the median debt/equity ratio for the North Star Dividend Fund (NSDVX) is 0.70 and for the North Star Micro Cap Fund (NSMVX) is 0.29. As such, we believe that the earnings power of the companies in these portfolios would be less impacted by rising interest rates than portfolios with higher debt/equity ratios.

Annualized Performance as of 06/30/2021

	Q2 2021	1Y	3Y	5Y	10Y	SI
North Star Micro Cap Fund **(NSMVX)**	7.56%	76.25%	19.36%	18.15%	13.22%	11.80%
North Star Dividend Fund **(NSDVX)**	3.50%	47.95%	6.31%	9.66%	10.00%	11.52%
Morningstar Small Value Index **(MSVL)**	4.95%	72.08%	5.63%	8.08%	7.70%	9.11%
Russell 2000 **(RTY)**	4.06%	60.30%	12.01%	14.98%	10.81%	7.31%
Russell 2000 Value **(RUJ)**	4.19%	70.29%	8.01%	11.36%	8.59%	6.62%
S&P 500 **(SPX)**	8.17%	38.62%	16.46%	15.40%	12.51%	6.53%

NSMVX Inception 12/31/1997 | Expense Ratio 1.40%
NSDVX Inception 02/01/2010 | Expense Ratio 1.50%

The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. For performance information current to the most recent month-end, please call toll-free 855-580-0900.

Since the end of Q2 2021, small and micro cap stocks have underperformed the S&P 500 by almost 7%. This may be due to investor concerns regarding the potential interest rate increases looming if inflation data remains elevated or accelerates. Regarding North Star's small cap equity funds, during this quarter-to-date period when interest rate increase concerns have been rising, North Star Micro Cap Fund declined 3.33% and the North Star Dividend Fund declined 1.45%. With just a few exceptions, the companies in these funds reported excellent trends in profitability for Q2 2021 (mostly reported in August 2021) with similarly positive outlooks for upcoming quarters. As such, we maintain strong conviction in our existing portfolio positions.

Given the historical data analyzed above, we believe that when considering existing or possible new investments using small and micro cap stocks, it is best to avoid interest-rate-related urges to rotate away from small cap and micro cap equities. Instead, we believe that small cap and micro cap equities with low financial leverage, resilient business models run by strong managers, and with possible takeout dynamics in consolidating industries may perform very well in rising interest rate environments.

The Russell 2000 Consumer Discretionary Sector *(as of 06/30/2021)*

We believe those attractive characteristics can be found in several companies in the Consumer Discretionary sector, in which the North Star Funds has the highest concentration of holdings (over 46% in the North Star Micro Cap Fund and over 18% in the North Star Dividend Fund). In comparison, the Consumer Discretionary Sector represented 293 out of the Russell 2000's 1,985 members at June 30th, 2021. These companies include retailers and e-tailers, media and entertainment companies, and restaurants.

Over the last ten years, the total return for the Russell 2000 Consumer Discretionary Sector (RGUSDS) has been 277.88% versus 219.79% for the Russell 2000 (RTY), making the RGUSDS the third best performing sector in the index behind Healthcare and Technology. Correspondingly in the first half of 2021, Consumer Discretionary stocks were the second-best performing stocks (+40.89%) behind the Energy sector (+44.01%). Not only have the total returns been compelling in this sector, but we believe the companies in this sector have the characteristics of steady growth and consistent EBITDA margins. From a valuation perspective, the sector has the second smallest median P/E ratio (16.51) and the third smallest EV/Sales ratio (1.78) within the group.

Due to the stable nature of these businesses with their consistent return on equity (8.24%), these Consumer Discretionary companies can deploy a fair amount of leverage as they have the highest total debt to total equity ratio (1.86) of the group with exception to the heavily leveraged Utilities sector.

Digging deeper, we particularly like companies that have been able to adapt to the evolving demand for an omnichannel business. While the Consumer Discretionary sector in general has benefitted from the acceleration in e-commerce demand, the western apparel retail, e-commerce floral and gifting, and aftermarket auto parts industries, have demonstrated particularly robust trends.

In addition to tracking traditional macro-economic series, such as interest rates, the North Star Research Team also tracks more niche indicators. For example, in 2021 country music stations have dominated the radio format with over 2,200 unique stations, or 12.5% of all leading stations in the United States. We view this as a good indicator in the interest of all things Western-themed.[i]

Recently, consumers have looked to comfort themselves and their loved ones through gifting, as evidenced by the 33% increase in Google searches for the term "online gift" from 2016-2021. During the same period, this trend is manifested in the Google search interest over time for the term "flower delivery," which received a score of 65 during Mother's Day 2021 versus 47 during Mother's Day 2016.[ii]

Furthermore, consumers are becoming comfortable with Do-It-Yourself tasks. One vertical that has historically been underrepresented across the e-commerce channel has been replacement auto parts. While the U.S. auto aftermarket e-tail segment recorded $3 billion in sales in FY2013, it is estimated that the segment will record $13 billion in sales in FY2023. Additionally, despite less demand for travel during 2020, the year still recorded over 14 million units in new car sales and 39.3 million units in used car sales versus 11.6 million units and 36.9 million units in 2010, respectively.[iii]

Conclusion

As it has often been noted, the U.S. Economy is a consumer-driven economy. The rising interest rates do not change that dynamic but do create compelling opportunities within the small and micro cap universe, including the Consumer Discretionary sector. In order to identify those small and micro cap stocks most likely to outperform their peers, we continue to seek investments that offer compelling upside return potential based on our DCF-anchored valuation methodologies, growth prospects, M&A opportunities and identification of time-tested management teams.

Contact Information

Please contact us at info@nsinvest.com if you would like to discuss the North Star funds, strategies and investment research.

Key Definitions

Russell 2000 Index: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

Russell 2000 Value Index: The Russell 2000® Value Index measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values.

S&P 500 Index: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Google Search Interest: The scores awarded by Google Trends on the "interest over time" line express the popularity of that term over a specified time range based on absolute search volume relative to the number of searches received by Google.

Discounted Cash Flow (DCF): DCF is a valuation method used to estimate the value of an investment based on its expected future cash flows.

Investors should carefully consider the investment objectives, risks, charges and expenses of the North Star Funds. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at www.nsinvestfunds.com or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and North Star Investment Management are not affiliated. 1629-NLD-10192021

Important Risk Information

Mutual funds have investment risks including loss of principal. There is no guarantee either fund will meet its objective. No-load mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees.

[i] Data Source: Radio Advertising Bureau Fact Sheet
[ii] Data Source: Google Trends
[iii] Data Source: Experian Market Trends Review Q4 2020, p. 21