U.S. Small/SMID Cap | First Quarter 2020

Market Overview–The Bear Market

Executive Summary

- RMB's team has managed through five bear markets
- QE caused the rise of highly levered "zombie companies"
- Stock dispersion is widening, which we believe is good for active managers
- We believe the difference in the winners and losers will be defined by quality management teams
- We believe we are in a position to add meaningful value to our clients in this period of market volatility

RMB Asset Management's Small/SMIDCap team has lived through five bear markets. Each is scary. Each is different. Each has its different causes. Each offers rare opportunities to own great companies at great prices. The last bear market was caused by a housing bubble of epic proportion that created a credit and housing crisis. The solution to that crisis was Quantitative Easing (QE), the outcome of which was the inflation of all financial assets, high stock correlations, and the subsequent outperformance of highly levered (lower quality) companies. Active managers lagged. Passive grew to bubble proportions.

This bear market is different. While most will attribute it entirely to the coronavirus, the COVID-19 crisis is simply the catalyst that exposed the massive misallocation of capital caused by QE. By driving the cost of debt down to essentially zero (ZIRP), risk was mispriced. Companies that should not have had access to capital (aka zombie companies), got it. As banks became more regulated, more credit was generated outside of the regulated banking system. Investors allocated to passive, as high correlations caused many active managers to struggle to outperform. New "innovative" leveraged credit products were sold to solve the equation that was based on low yields. COVID-19 pricked the "financial asset bubble" and diversification did not do a great job protecting investors. So popular systematic strategies like "risk parity" performed worse than expected. The investor's only diversifier was essentially cash and/or high-quality government and corporate debt. What now?

Strategies that ignored liquidity risk and mispriced credit are being exposed and liquidated and bailed out by the Federal Reserve's new liquidity facilities. High-quality equity and credit strategies are proving their worth. We believe that our core strategies differentiate on two dimensions: Active management adds value over the long term. Quality strategies protect capital better in down markets and over the long term. »

How Coming Out of This Bear Market Is Different

QE will not drive winners and losers this time. It will only provide liquidity to keep markets functioning properly. While credit spreads might narrow, which will still be a headwind for higher-quality portfolios, they are not narrowing from 15% like last time, so it is a lot smaller headwind, and we believe we will have an even stronger tailwind coming out of this crisis—HIGH DISPERSION.

Higher dispersion simply means there will be greater separation between the winners and losers as we exit this crisis. High dispersion is good for active managers. Let's start with the losers. We expect lending outside of the traditional banking channel will significantly contract as investors find out that several structured credit, leveraged credit funds that they were sold performed worse than expected. Thus, the traditional banking channels will likely be the source of capital and they will not lend to zombie companies. The zombie companies that could exist because of nontraditional credit from new credit funds aimed at and sourced by investors seeking higher yield will be the losers. And there are a lot of them, and passive strategies will own them because they have to by mandate. Our research core team is currently engaged in management calls daily, connecting dots, using upward volatility to sell companies that might fall into the loser bucket as this shock plays out beyond zombies to other businesses that may experience secular decline in demand, and using downward volatility to buy companies that we have followed for a long time that fall into the winner bucket that we can finally buy at what we consider to be great long-term valuations. In other words, it has never been a better environment for active management than now because the market is exposing the hidden risks of passive investing right after many investors have capitulated to passive and are not in a position to concentrate on the winners. We believe our portfolios are.

Given that we expect high volatility to continue, it is very possible that passive investors face higher volatility and lower returns. Sounds like opportunity to us, if you are active and have a process designed to identify high-quality management teams that we believe will create lasting value over the long term because they have high management skill, adaptive capabilities, and strong corporate cultures that create value for clients, employees, communities, and shareholders. These are the types of high-quality companies we seek to invest in for RMB core equity strategies.

We have been in market turmoil before. It's always scary, but bear markets always create opportunities for those prepared to invest in great companies over the long term that will meet the changing needs of the economy. Our experienced research core team, many with over 20 years of experience, is supported by what we believe is an outstanding institutional research process, platform, and technology.

While the environment created by the COVID-19 virus is difficult and uncertain, we are confident, even excited, about both investment opportunities and opportunities to differentiate ourselves in the current market. We are grateful that we have persisted through challenging times and that we are in a position to add meaningful value for clients through this trying time. ■

RMB Asset Management

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