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The Conundrum of Investing in Small-Cap Value Tech Stocks

We see opportunities in under-the-radar companies like laser manufacturers, but you can't take a passive approach to finding them.

GLOBAL VALUE EQUITY

KEY TAKEAWAYS

- After the tech sector significantly outperformed the benchmark in 2019, the 2020 reconstitution of the Russell 2000® Value Index cut this sector's weight by 40%. Poor performing sectors in 2019, such as energy, increased in weight following the reconstitution.
- Sector exposure can shift markedly from year to year, limiting passive investors' ability to potentially benefit from technology trends.
- The range of quality across companies is vast in the Russell 2000 Value Index's tech sector, making stock selection and fundamental analysis critical to help avoid value traps. Certain small-cap tech firms in the laser industry have compelling company-specific drivers that we believe make them attractive investments.



JOE HINTZ, CFA
Investment Analyst
Global Value Equity



MIKE RODE
Senior Client Portfolio Manager
Global Value Equity

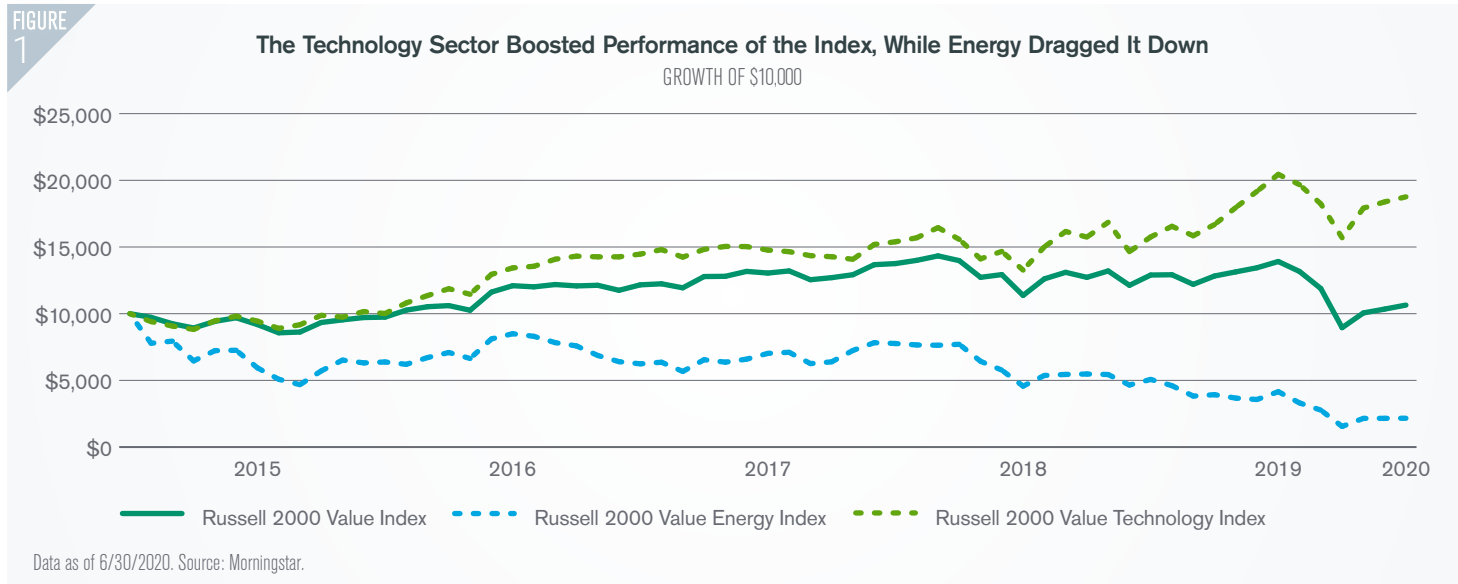
Small-Cap Value Tech Stocks Massively Outperformed in 2019, but Energy Stocks Not So Much

It's no secret that large-cap tech stocks have driven market returns over the last few years. Lesser known is the fact that small-cap value tech equities have also performed strongly in recent periods.

In 2019, for example, the information technology sector within the Russell 2000® Value Index was up nearly 55%, almost double that of the next closest sector. The tech sector has continued to outperform the Russell 2000 Value Index in both the first and second quarters of 2020. (Source: FactSet) Sector allocation is clearly critical in helping determine overall returns for small-cap investors.

Figure 1 shows the outperformance of the small-cap value tech sector over the last five years versus the index and poorly performing energy sector. The small-cap energy sector is made up of many U.S. exploration and production companies facing operational inefficiencies and low oil prices.

Passive portfolios lock investors into predetermined sector exposures with little regard for overall business quality or risk parameters. We think this can lead to much higher levels of exposure to challenged industries than investors may realize.



Small-Cap Tech Is a Victim of Its Own Success

Those investing in a small-cap value passive strategy would have enjoyed the impressive 2019 gains but then experienced a sharp reduction in their tech exposure. The June 2020 reconstitution of the Russell 2000 Value Index cut the technology sector's weight by 40%, from nearly 11% to 6.6%. This reduction was more than six times the decrease in the next largest sector.

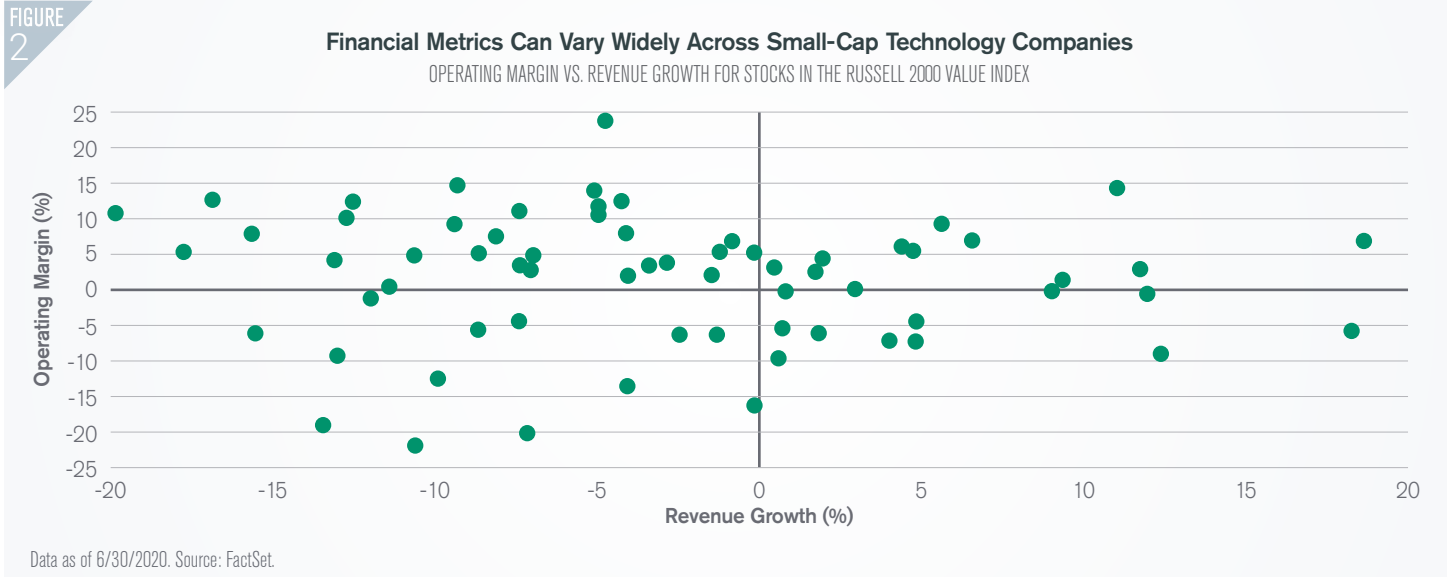
This conundrum is one of many facing small-cap investors. When investing in a passive strategy, investors forgo the opportunity to maintain exposure to historically better performing sectors, such as technology, and avoid historically underperforming and more risky sectors, such as energy. In fact, the weighting of the energy sector in the index increased by over 20%, from 3.7% to 4.5%, after the reconstitution.

Not All Tech Stocks Are Created Equal

Despite tech's broad outperformance in 2019, there is a wide dispersion of quality in the sector. This makes stock selection paramount.

Figure 2 shows the operating margins and revenue growth of small-cap tech stocks as of June 30, 2020. Both are important measures of shareholder value creation, and many of these companies have negative operating margins and/or negative revenue growth. This chart illustrates the inherent risk of investing blindly across a large swath of small-cap value tech companies.

Many companies shown in **Figure 2** may be facing significant business challenges, especially those in the lower-left quadrant, which could ultimately lead to a permanent loss of capital for investors. These stocks might be value traps, companies whose valuations appear statistically cheap but, in fact, whose businesses are fundamentally impaired and unlikely to recover.



While most companies in the small-cap value tech universe may be facing challenges, critical analysis can help to determine which of them remain fundamentally sound. Fundamental stock selection can identify temporarily out-of-favor companies that have strong assets, capable management teams and competitive positioning—which we believe can help drive superior risk-adjusted returns compared to the hands-off approach of passive investing.

Lasers: An Attractive and Underappreciated Industry

Our focus on quality and competitive dynamics led us to the laser industry, which offers compelling opportunities within the small-cap value tech sector.

“Laser” originated as an acronym for “light amplification by stimulated emission of radiation.” A laser device converts an energy source into a focused light beam and manipulates it in specific ways. Laser products range from fiber lasers for cutting steel in manufacturing, to diode lasers for surgical and dental procedures in dentistry, to excimer lasers for vision correction treatments in ophthalmology.

Key characteristics of the laser industry include:

- **Large and Growing Market.** The laser industry is sizeable with a total addressable market of \$15 billion to \$20 billion with an annual growth rate in the high single digits and subcategories that have the potential to grow at even faster rates. While lasers have existed for more than 60 years, the technology only became cost effective about 15 years ago and is evolving rapidly. Forces driving the industry include the displacement of older technologies and nascent greenfield opportunities. For example, laser technology is replacing traditional metal-cutting techniques in areas of manufacturing such as auto production. New and innovative uses include laser-based missile defense systems and other high-tech weaponry in the aerospace & defense industry.

- **“Side-Door” Opportunities.** Despite the large market size, lasers don't fall neatly into the generally accepted tech buckets such as semiconductors, the internet or software. However, lasers provide critical components across these industries that enable 5G connectivity, OLED screen production and electric vehicle batteries, thereby creating side-door opportunities for small-cap value investors to participate in markets that have high growth potential. For example, the pandemic and resulting work-from-home environment have accelerated demand for data, cloud computing, remote access and faster data networks, all benefiting certain types of lasers.
- **High Barriers to Entry.** The lasers market isn't a homogenous universe. It encompasses unique subindustries in which each laser technology requires specialized knowledge and significant levels of investment capital. This creates an environment where companies can target niche markets protected by competitive advantages and barriers to entry. These circumstances have historically led to high and stable returns on invested capital over the cycle.

Case Studies: Lighting Things Up with Lasers

Coherent, Inc. (COHR)

Coherent is a California-based company that offers lasers, laser-based technologies and laser-based system solutions for a range of scientific, commercial and industrial applications.

Coherent's “annealing” tools, known as LineBeam laser systems, play a key role in the manufacturing of OLED screens for mobile phones. Annealing is a heat treatment process that alters the microstructure of a material to change its mechanical or electrical properties. The company holds a near monopoly within the excimer laser annealing segment.

OLED screens are still relatively early in the adoption cycle as new phones move away from legacy LCD screens. They offer better color contrast, lower power consumption and the ability to fold. Apple (AAPL) started using OLED screens in the iPhone X. We understand all 5G iPhones will have OLED screens to accommodate 5G componentry.

Cohrent's market dominance in this niche application provides very high barriers to entry due to the extremely specialized knowledge required to design and manufacture its products. This market dominance has blocked many reputable companies from replicating the technology.

II-VI, Inc. (IIVI)

Also known as "Two Six," II-VI is a Pennsylvania-based engineered materials company whose name comes from groups II and VI of the periodic table of elements. These elements are the building blocks of all things "tech." The company's products sell into multiple end markets, from industrial to communications to semiconductors.

Specific examples of its offerings include creating silicon carbide materials that are critical for building electric vehicle batteries and componentry that helps enable 5G technologies. The latter example ranges from uses in phones to base stations and to the fronthaul and backhaul portions of the network. While not a pure-play laser company, II-VI makes many mission-critical inputs for several types of lasers.

The market widely panned the company's 2019 acquisition of Finisar. We believed the pressure on the stock created an attractive entry point for investors willing to dig deep into understanding the strategic rationale underlying the transaction.

II-VI's management team takes a five- to 10-year view of technology trends, seeking to grow organically and through strategic acquisitions. Its approach has delivered solid growth and margin improvements over the years. The company has a history of acquiring underappreciated and underperforming assets that eventually drive fundamental value after the tech vision comes to fruition.

For example, in 2012 and 2013 the company acquired multiple assets from Oclaro with negative operating margins. II-VI improved the business strategy and operational excellence of these assets. EBITDA margins more than doubled and returns metrics tripled in the company's Photonics segment over the next three years. We believe II-VI's strategy will lead to further success and enhanced share value.

Rigorous Analysis Can Identify Underappreciated Companies and Help Avoid Risk

Although the performance of a few mega-cap stocks overshadowed the broader market this year, the Russell 2000 Value Index has enjoyed impressive gains from some tech standouts of its own. Unfortunately, for small-cap value investors, the future impact of tech stocks may be muted as Russell slashed the sector's weight by 40% when it reconstituted the index in June.

We believe a flexible approach to sector weights can help lead us to quality companies with better growth potential regardless of sector or industry. The laser industry is just one example.

Of course, investing in small-cap stocks does not come without risk. They tend to be more volatile and have a higher level of market risk—or beta—than large-cap stocks. Passive investing in this asset class may also introduce additional risks because quality varies widely, and value traps abound.

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American Century Investments*

4500 Main Street
Kansas City, MO 64111
1-866-628-8826

330 Madison Avenue
New York, NY 10017
1-866-628-8826

1665 Charleston Road
Mountain View, CA 94043
1-866-628-8826

360 E. 2nd Street, 5th Floor
Los Angeles, CA 90071
1-866-628-8826

2 Ice House Street
Hong Kong
+852 3405 2600

12 Henrietta Street
London, WC2E 8LH
+44 20 7024 7080

1 Farrer Place
Sydney, NSW, 2000
+61 2 8823 3403

Taunusanlage 8
60329 Frankfurt, Germany
+49 69 8088 5501



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