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Make way for Darwin

In January 2011, Ben S. Bernanke, the Federal Reserve chairman from yesteryear, looked into the CNBC cameras to commend himself on the second round of quantitative easing. "The policies have contributed to a strong stock market, just as they did in March 2009, when we did the last iteration of this," said the doctor of economics. "The S&P 500 is up 20%-plus, and the Russell 2000, which is about small-cap stocks, is up 30%-plus."

Up was the direction, all right—of prices. As for the financial position of the businesses behind the stock tickers, the consequences of central-bank bond-buying have not been so clear-cut. In preview, concerning the Russell 2000—to steal a line from Chuck Royce, small-cap investor par excellence—"The index is not a company you want to buy."

Royce and Steve Lipper, chairman and portfolio manager, and senior investment strategist, respectively, of Royce & Associates, do no short-selling. Long-only value-seekers, they buy low, if they can. QE and QE2 have complicated that deceptively simple M.O. At the Spring 2017 *Grant's* Conference, the two observed that, at year-end 2016, 33.9% of Russell component companies were making net losses. It was close to the highest such percentage in any non-recession year since 1984. And the cohort of loss-making businesses had been on the rise since approximately the time that Bernanke went on TV.

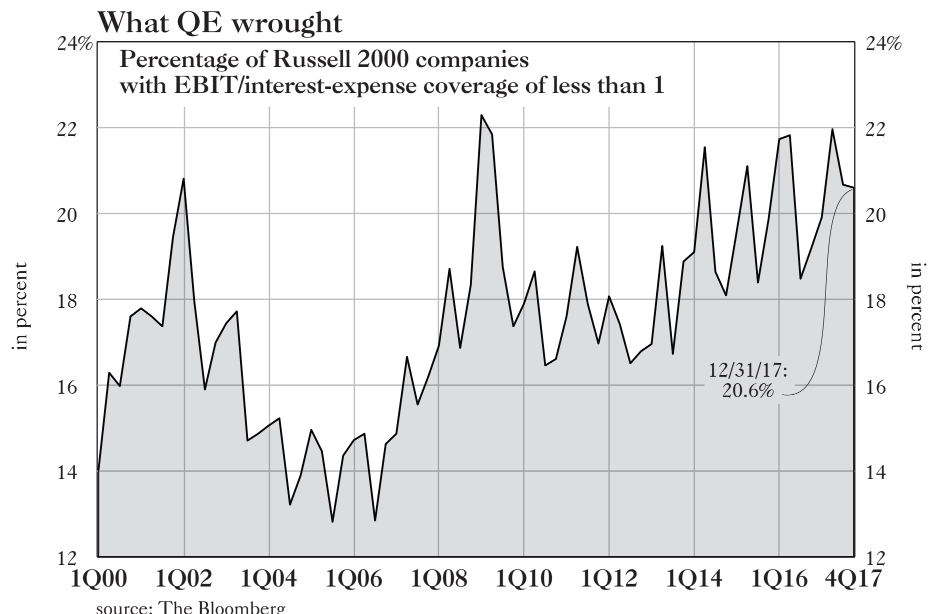
QE made cheap and accessible the financing that prolonged the lives of companies that would otherwise have met their maker in some Delaware courtroom. "What we saw," said Royce one year ago, "was that the Darwinian moment didn't take place. The better-quality company was not able to eat its neighbors and gain market share. There was a postponement of the ultimate sin of having too much leverage. Those stocks did extremely well if they survived."

Reached on Tuesday, Royce and Lipper said that the Darwinian moment is nigh. Upwards of one-third of the Russell's corporate components continue to show net losses. The difference, today, is that those companies are not the ones whose shares lead the index, as they did in 2011–15. That honor increasingly falls to the businesses that actually make a profit.

Volatility is on the rise. The dispersion of prices, ditto. "I love the higher volatility," Royce tells colleague Harrison Waddill. "I do think it is on the path to normal. Normal is where active [management] will do better. Most active managers have a value bent one way or the other. At least they would describe it that way. I think this is healthy in the bigger sense."

If so, higher interest rates are just what the doctor ordered. According to Jessica Binder-Graham, managing director of Goldman Sachs, nearly half of the debt incurred by Russell 2000 companies is the floating-rate kind. At face value, that's $337 billion worth. No doubt, some of this exposure is hedged, but hedges cost money, and they invariably come with a sell-by date. Thus, the upsweep in Libor has special relevance for the small-cap corporate CFO.

There's a credit complication, too. In year nine of this tied-for-second-longest



American business expansion, 20% of the Russell index companies fail to cover interest expense out of earnings before interest and taxes. Sixteen percent fell short in 2007, 18% in 2012. For a blue-chip point of comparison, 8.3% of the S&P 500's constituents show such a deficiency now, compared with 4% in 2012 and 3% in 2007.

You'd suspect that even more than 20% would flunk the EBIT-to-interest test, given that one-third bleed red ink. The answer to the riddle is that lots of loss-making biotech companies are debt-free.

By actual count, Waddill relates, 404 Russell companies out of the not-quite 2,000 (the exact index population is 1,981) are deficient in EBIT coverage; their combined market cap comes to $412 billion. And out of that 404-member club of living dangerously, 46% have issued floating-rate debt, which "amounts to a notional $127 billion," Waddill goes on. "Furthermore, those companies that elect to borrow at floating rates show an average interest-coverage ratio of negative 4.8:1."

"We call it the Risky Russell," says Lipper of the index that's not really a company.

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