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PREMIUM MARKETS

'There's an enormous catch-up trade': These 5 small-cap stocks are destined to soar, according to a stock researcher behind a top-11% fund in the last 5 years

James Faris

- **The stock market may not be heading for a crash, but current leaders may pull back.**
- **Beaten-down small caps are due for their day in the sun, according to market veteran Ethan Meyers.**
- **Here's how to spot quality companies in the undervalued group, and five names to buy.**

COURTESY OF HARBOR CAPITAL

Ethan Meyers

Even casual stock-market observers must find it hard to ignore the warnings that this backdrop is eerily similar to the dot-com boom and subsequent bust.

But unlike many others concerned about lofty valuations and the few stocks leading the market, Ethan Meyers doesn't draw comparisons between now and 1999, when he was new to investing.

Words like "bubble" and "crash" weren't in Meyers' vocabulary during a recent interview with Business Insider. The research director at Westfield Capital Management is instead focused on finding attractive stocks through a bottom-up fundamental process.

Once Meyers identifies worthy investments, he shares his insights with the appropriate portfolio managers, including those on the Harbor Small Cap Growth Fund (HASGX) Westfield is a subadviser for. He and his team must be onto something, as that fund has been in the top 11% of its category in the last five years and had a top-14% finish in 2023, according to Morningstar.

The beauty of Meyers' position is that he doesn't get tunnel vision about one type of investment. But that's not to say he doesn't pick favorites.

"I have a small-cap strategy, I have a large-cap strategy, and I have everything in between, and we all live within a growth world," Meyers said. "But who's my favorite child? I mean, I think right now, the opportunities for returns in small-cap are significantly better than they are in large."

Why smaller companies are bound to enjoy a revival

US stocks are at all-time highs, but that doesn't tell the full story of what's happening in markets.

While the S&P 500, in aggregate, has been on a tear for most of the last four months, the typical stock's performance is nothing to write home about. The headline numbers certainly look strong, Meyers noted, but hundreds of companies are still posting rather pedestrian returns.

At-home investors often take a simple approach when it comes to asset allocation: rely on index funds or pile money into successful companies they know, like Amazon, Apple, and Microsoft. The result is a steadily widening gap between the haves and have-nots.

"What's happened over the last several years is, there's just been this incredible push of assets into an incredibly small number of very compelling large-cap growth stories, and you've reached market concentration levels that historically would suggest that there's an opportunity for mean reversion," Meyers said.

Many companies have been abandoned in this top-heavy market, Meyers said. As a result, there's an abnormally large valuation split between leaders and laggards, where less heralded stocks are trading at a 30% to 40% discount to the top performers.

That extreme discrepancy is unjustified and unsustainable in the long term, Meyers said, echoing what 180 Degree Capital's Kevin Rendino recently told Business Insider. In time, the researcher is confident that the gap will narrow, though he acknowledged that it may take years.

"You can't push so much capital into so few companies sustainably for a long period of time," Meyers said. "Sooner or later, that is going to break. And when it does, and you take just a little bit of market cap from maybe a couple of multi-trillion-dollar companies and you sprinkle that into the rest of the market, you can create the opportunity for some significant return potential."

Critics of this dynamic sometimes argue that the AI-driven rally that's fueled the success of Nvidia and other chipmakers has gone too far and is destined to unwind.

Instead of calling for a meltdown for the market's favorite companies, Meyers emphasized the stocks destined to rebound once investors shift their focus away from pricey growth names.

"These companies are already being rewarded for that in their valuations, whereas the rest of the market just isn't — it's been left behind," Meyers said.

Meyers continued: "So there's an enormous catch-up trade. I could see the largest stocks in the market going sideways for the next several years where the rest of the market catches up and creates a much broader market opportunity. And that's going to be great for active management, and it should be really great for us and for our small- and mid-caps."

How to capitalize on the coming small-cap rally

Just like the market's most recent rally has had a handful of winners and tons of losers, Meyers believes indiscriminately investing in smaller stocks broadly would be a mistake.

When vetting companies for the Harbor Small Cap Growth Fund, Meyers said he looks for quality stocks with low volatility and high earnings growth, which he noted is a top predictor of success over time. Those traits are relative and should be based on the market and peers, as should their valuations. How a firm is valued is crucial, which is why small caps stand out now.

"We don't overpay for growth for the sake of growth," Meyers said. He added: "We go where we find the best growth opportunities, and we let the bottom-up process shape the portfolio."

The strength of a company's growth matters much more than Meyers and his peers than how it's generated. That's why they'll invest in firms that are reliant on economic growth and more defensive names that can hold up in any environment. Having that balance creates consistency.

"We're willing to look at everything," Meyers said. "We're disciplined in our process and our philosophy, but we're willing to look at cyclical growth as well as secular growth."

While there aren't many hard-and-fast deal-breakers that would keep Meyers from investing, the market veteran said lower-quality companies would need a compelling case to enter the fund.

The word "quality" can have different meanings for different investors. Meyers defines it as having some combination of strong profit margins and free cash flow, a clean balance sheet, and pricing power, or potentially accelerating returns on invested capital. It's also crucial to have a capable management team that can deliver those results consistently.

Not every company will fit that mold — especially if they're trading at a cheap valuation. One of Meyers' missions is to determine if that discount is warranted or an oversight by the market.

"Everything that we do, we believe there is some uncovered opportunity or some risk premium that's been built into the stock that's inappropriate," Meyers said. "Investors can do the work and come around to sort of understand what we think we already know about these businesses, that we have an opportunity for, maybe let's call it, 'a second way to win,' if you will."

Meyers continued: "So the first way is just faster profit growth. And then the other way you win is if you can close some of that discount to intrinsic value and you create some multiple expansion in your stocks."

5 top stocks to own now

Investors searching for small-cap stocks to buy are in the right place. Below are five firms that Meyers is most excited about now, along with each's ticker, market capitalization, and thesis.

1. Ascendis Pharma

Markets Insider

Ticker: ASND

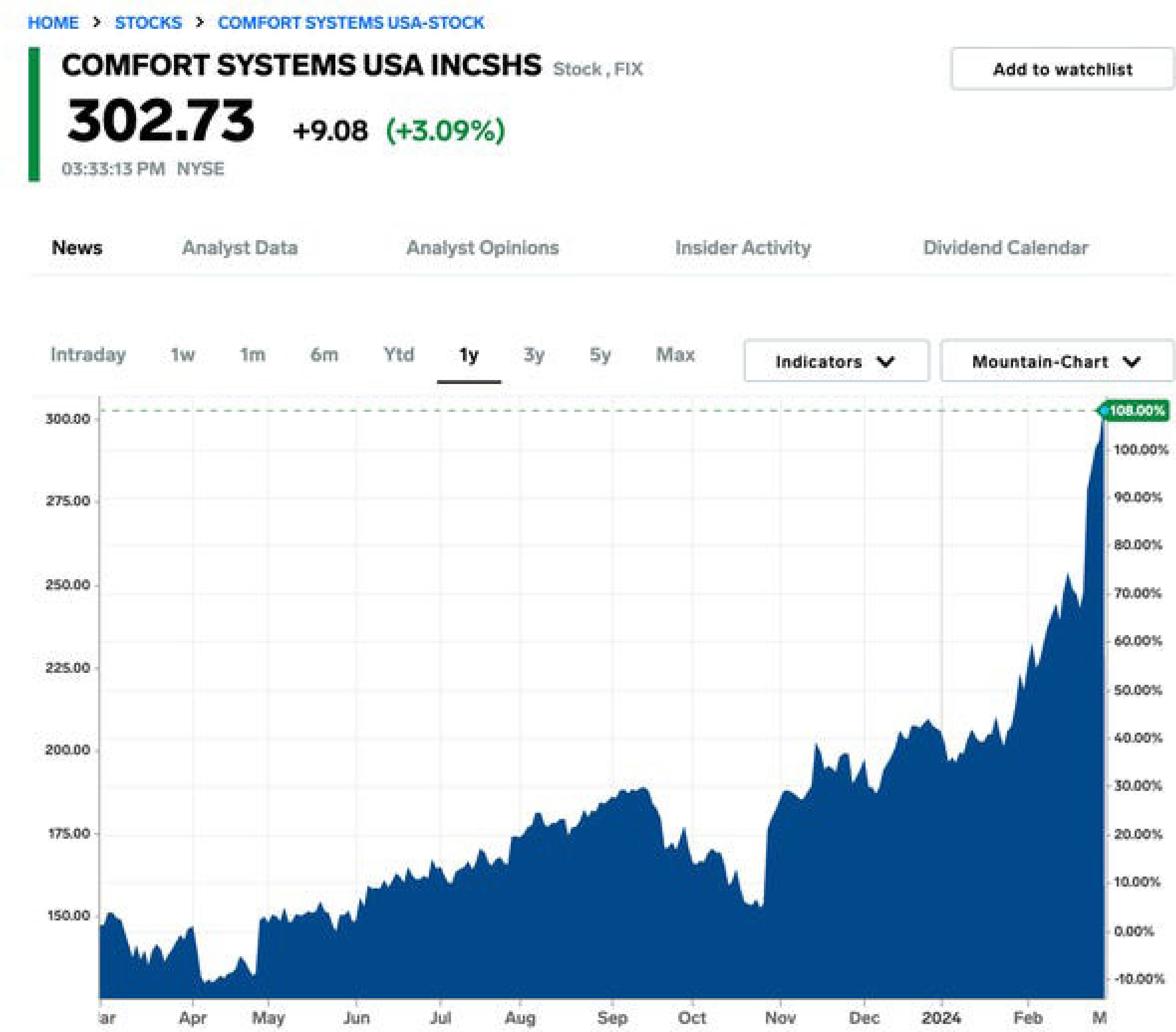
Market cap: $8.5B

Thesis: This biotechnology company is Meyers' best idea, largely due to its exciting TransCon drug development platform used to improve existing complex molecules for safety and efficacy.

Besides improving patients' lives, Ascendis' differentiated method is driving better returns on invested capital and, by extension, profitability. The biopharma firm has tantalizing upside as it brings more drugs online, as Meyers said he expects a pair of its drugs to generate $5 billion in sales and $50 in earnings per share by 2030, which would be far above analysts' estimates.

"The company is just now starting to talk more and show more data around large disease states, which includes obesity," Meyers said. "It's not too hard to think of a scenario here where they could be partnered with a large pharma company for something like a once-a-month delivery of any one of the popular weight loss drugs that are out there. So that's a huge opportunity."

2. Comfort Systems



Markets Insider

Ticker: FIX

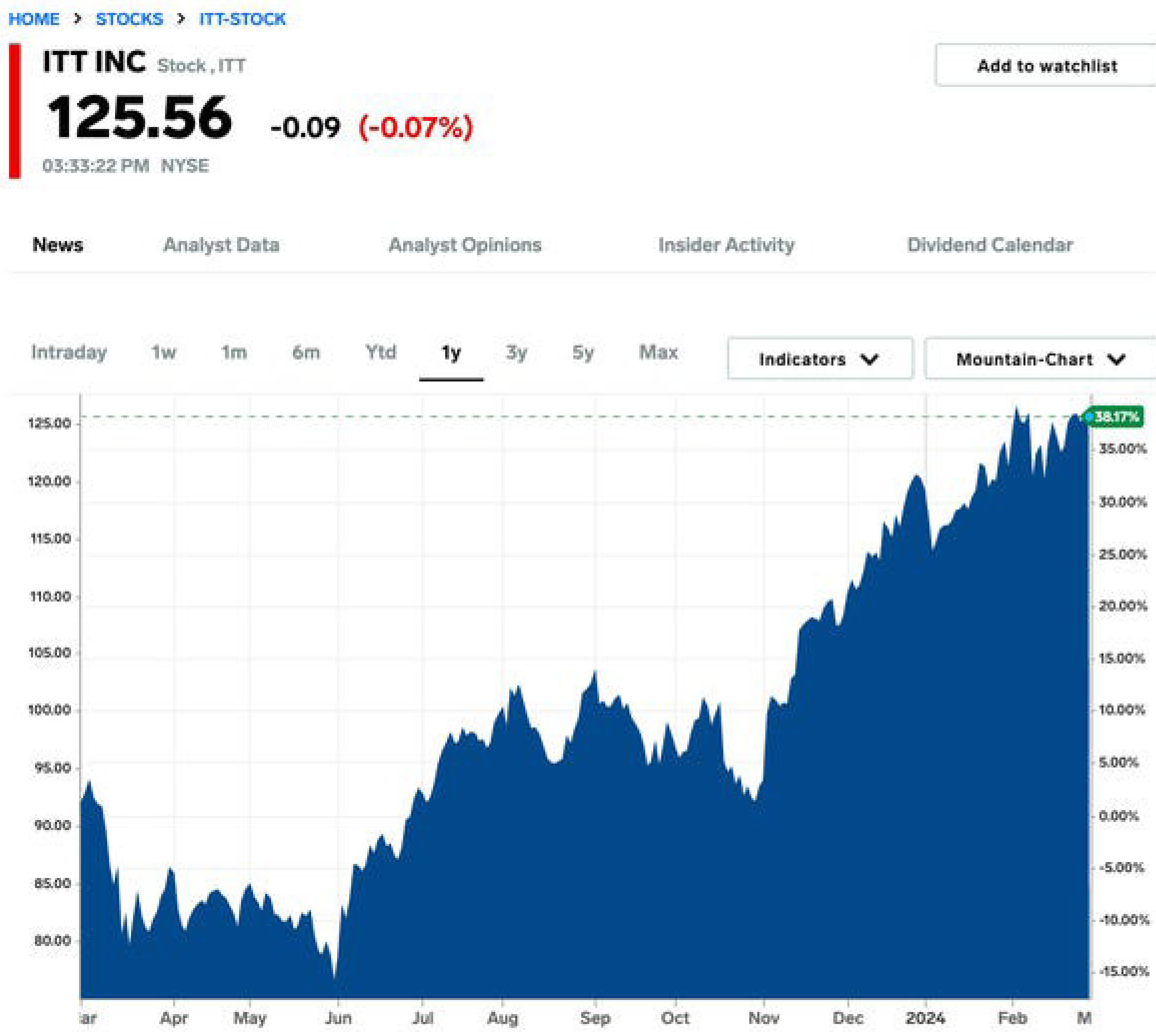
Market cap: $10.8B

Thesis: Comfort Systems is a massive HVAC, plumbing, and electrical contractor that also has a manufacturing business, as Meyers noted. The company should benefit from onshoring and nearshoring, which is when US-based firms source goods from in or near their home country.

Although this HVAC giant is growing revenue across key segments by over 20% per year and has a balance sheet that's flush with cash, Meyers lamented that most investors simply aren't paying attention — even though shares have more than doubled in the past 12 months.

"Incredibly clean balance sheet, incredibly well-managed business where we really like management — and it's totally underfollowed on Wall Street," Meyers said.

3. ITT



Markets Insider

Ticker: ITT

Market cap: $10.3B

Thesis: Most investors seem to gravitate toward exciting, tech-adjacent growth companies instead of a so-called "steady Eddie" like ITT, in Meyers' words. The industrial conglomerate isn't flashy but has incredibly high returns on invested capital that should please shareholders.

Owning growth companies outside of technology and communication services is a strong way to diversify a portfolio, in Meyers' view.

"We have a really nice balance of life sciences, therapeutics, biotech, you've got an industrial name, you've got sort of an industrial manufacturing company, but it really kind of sells into this technology theme," Meyers said.

4. Meritage Homes

Markets Insider

Ticker: MTH

Market cap: $5.7B

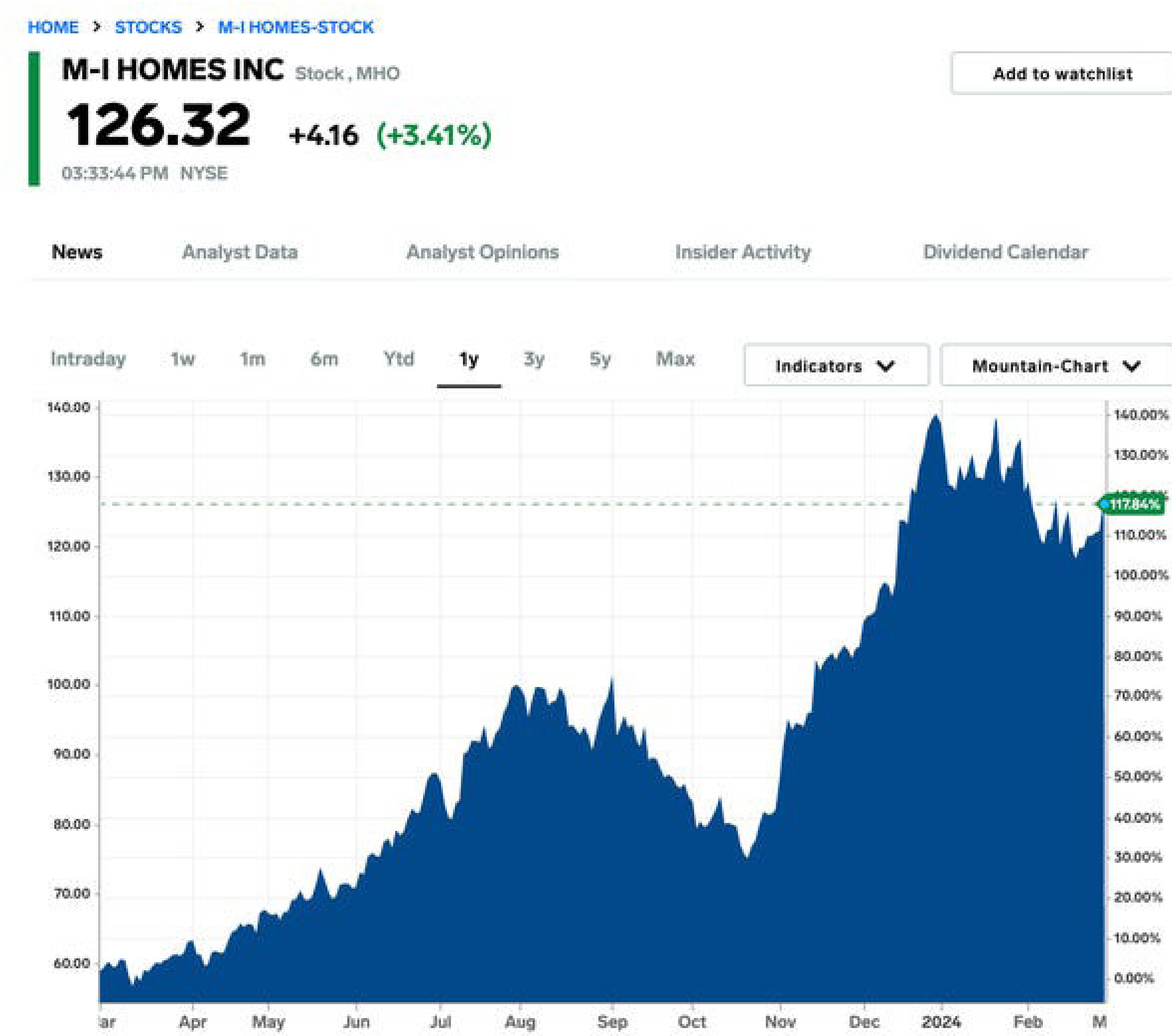
Thesis: Homebuilders like Meritage Homes and M/I Homes haven't been hit as hard by rising interest rates as many analysts would have expected, Meyers observed. Instead, expensive mortgage rates have kept homeowners in place, which has pushed buyers toward new homes.

"People are somewhat trapped in their homes because their mortgages are so low, and they don't necessarily want to move and have to take on the burden potentially of a much higher interest rate," Meyers said. "So you're relying on new home construction to create any and all supply for people that do want to move into a home."

Demand for new homes will be sustainable since millennials are starting to settle down, Meyers noted, which should drive earnings growth for building companies. However, the researcher said not all companies in this industry will benefit equally.

"The names that we've picked have very unique aspects to them, meaning they're in better geography with better population demographics — people moving to the Southeast or people moving into more affordable homes," Meyers said. "And so we've been very careful with the type of homebuilder that we would invest in, but there's a very real theme towards new home construction at the expense of existing home stock."

5. M/I Homes



Markets Insider

Ticker: MHO

Market cap: $3.5B

Thesis: Meyers' thesis for M/I Homes is the same as his thesis for Meritage Homes.

Harbor Small Cap Growth Fund (HASGX): Average Annual Returns as of 12/31/23

	3 month	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception (11/01/2000)
Harbor Small Cap Growth Fund	12.83%	22.20%	22.20%	-0.03%	14.50	9.53	9.17%
Russell 2000 Growth Index	12.75%	18.66%	18.66%	-3.50%	9.22%	7.16%	6.17%

The Harbor Small Cap Growth Fund gross expense ratio is 0.88%

Performance data shown represents past performance and is no guarantee of future results. Past performance is net of management fees and expenses and reflects reinvested dividends and distributions. Past performance reflects the beneficial effect of any expense waivers or reimbursements, without which returns would have been lower. Investment returns and principal value will fluctuate and when redeemed may be worth more or less than their original cost. Returns for periods less than one year are not annualized. Current performance may be higher or lower and is available through the most recent month end at harborcapital.com or by calling 800-422-1050.

For an updated list of the Harbor Small Cap Growth Fund's holdings and weights, please access HASGX

Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of a Harbor fund before investing. To obtain a summary prospectus or prospectus for this and other information, visit harborcapital.com or call 800-422-1050. Read it carefully before investing.

Risks

Investments involve risk including the possible loss of principal. There is no guarantee that the investment objective of the Fund will be achieved. Stock markets are volatile and equity values can decline significantly in response to adverse issuer, political, regulatory, market and economic conditions. Stocks of small cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

Benchmarks

The Russell 2000® Growth Index is an unmanaged index representing the smallest 2000 stocks with the highest price-to-book ratio and future earnings. This unmanaged index does not reflect fees and expenses and is not available for direct investment. The Russell 2000® Growth Index and Russell® are trademarks of Frank Russell Company

The S&P 500 Index is an unmanaged index generally representative of the U.S. market for large capitalization equities. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

This information should not be considered as a recommendation to purchase or sell a particular security. The holdings mentioned may change at any time and may not represent current or future investments.

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As of 12/31/23, Ascendis Pharma, Comfort Systems, ITT, Meritage Homes, and M/I Homes comprised 12.7% of the Fund's total holdings representing 3.9%, 1.4%, 2.6%, 2.6%, and 2.2% respectively. Fund holdings are subject to change.

Past rankings are no guarantee of future rankings. Morningstar rankings are based on a fund's average annual total return relative to all funds in the same Morningstar category. Fund performance used within the rankings, reflects certain fee waivers, without which, returns and Morningstar rankings would have been lower. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. Morningstar Rankings are for the fund's respective category, as of 12/31/2023. The Morningstar Rankings are based on total returns, with distributions reinvested and operating expenses deducted. Morningstar does not take into account sales charges. The Harbor Small Cap Growth Fund was ranked against Morningstar's Small Growth category, in absolute ranks: 63 out of 597 investments in the category for the 1-year period, 155 out of 563 investments in the category for the 3-year period, 46 out of 528 investments in the category for the 5-yr period, 59 out of 405 investments in the category for the 10-year period.

Important Information

Westfield Capital Management Company, L.P. is an independent subadvisor to the Harbor Small Cap Growth Fund.

Expense ratio information is as of the Fund's current prospectus, as supplemented. Gross expenses are the Fund's total annual operating expense.

Alpha refers to excess returns earned on an investment
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