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# 2018 OUTLOOK – TAX REFORM, RISING INTEREST RATES AND A REVERSION TO THE MEAN?

## Why 2018 may favor small-cap over large-cap stocks

Q&A with Sandy Villere III
Partner & Portfolio Manager

**Q. As we near the end of 2017, we are in the ninth year of a bull market. Where do we go from here?**

A. 2017 was really the year of what we call "the FAANG stocks" – Facebook, Apple, Amazon, Netflix and Alphabet's Google (parent company of Google). As of December 6, 2017, we see stocks like Amazon (AMZN up 53.67% YTD), Facebook (FB up 53.03% YTD), and Netflix (NFLX up 49.60% YTD) performing strong into year-end. As we look into next year, we could see money rotate into small-cap stocks as opposed to some of those larger-cap, more popular and expensive stocks. I believe that potentially lower corporate tax rates, rising interest rates, and a reversion to the mean all favor small-cap stocks over large-cap stocks.

**Q. What impact might a possible tax reform have?**

A. Looking at corporate tax reform, lower corporate taxes could add $12-15 to the S&P 500 earnings in 2018. The S&P 500 has the potential to generate $150 per share so that the market would be trading at 17.6x vs. 19.6x, and therefore be cheaper than what is currently anticipated. I think rates potentially dropping from 35% down to 20% will be another reason small caps may be poised to do well. Small-cap domestic companies pay much higher taxes than their comparable large-cap companies, so a lower tax rate has the potential to be a big tailwind for smaller companies.

**Q. You mentioned that higher interest rates may favor small-cap stocks. Why, and what changes do you anticipate in interest rates for 2018?**

A. I anticipate interest rates will go up starting with a hike in December and potentially three more times in 2018. As interest rates go up to battle inflation, we could see the dollar increase. This may be very detrimental for larger-cap multinationals that are selling more expensive goods and services abroad, but may likely favor small-cap companies that get most of their revenue from the United States.

Q. **You also highlighted a reversion to the mean. Can you elaborate?**

A. In 2017 thus far, we have seen the Nasdaq up 28% and the S&P 500 up about 18%, whereas the Russell 2000 is only up 13%. If you look back to 1926, small caps have historically returned closer 12% annually versus larger caps at 10%. So, I believe a reversion to the mean may put small-cap companies in good stead.

Q. **Do you expect any specific headwinds in 2018?**

A. I believe a possible delay in the tax cut, or even a smaller than anticipated tax cut, may lead to headwinds in 2018. The Tax Reform Bills have gone through both the House and the Senate, so now we have a House-Senate Conference Committee that is tasked with crafting the final law to be signed. While that may be delayed, I believe it will happen in 2017, although we may not see the actual rate decline from 35% to 20% for corporations until 2019 if it's more Senate-oriented. The final rate may only drop down to around 22%, and not quite as low as 20%.

I think the Federal Reserve has to be very careful about raising rates. To some extent, they want to see "more arrows in the quiver," and make sure that if there is ever another financial crisis or other significant disruption to the markets that they have the ability to lower rates again.

The Fed also has to battle potential inflation. With the global economy heating up and strong US GDP growth, the Fed is constantly watching out for inflation. The Fed needs to stay ahead of it, which historically has meant raising rates to battle inflation and avoiding an environment of stagflation, which is a period of high inflation and no growth.

Q. **Investors have continued to favor passive strategies, as evidenced by recent flows. What do you see as the risks associated with passive strategies, particularly during a pullback or correction in the market?**

A. About a decade ago, 20% of all the assets in the US were in passive strategies. Today, it's closer to 35%. As we are close to an almost nine-year bull market, many people have started to get complacent since those passive strategies tend to work very well in an up market. However, as we saw in 2008 and 2009, when you are in a down market with 100% in passive strategies without any cash or knowledge of exactly what you own, it can be a tough environment.

We prefer an active strategy because we have the potential to raise cash, can be selective and buy stocks that we know – including visiting with their management teams – and also avoid certain companies. We believe doing these things may give us a better opportunity and leave us better positioned to potentially outperform in a down market. Although there has not been one since March of 2009, as we know, down markets do occur.

Q. **Where do you see opportunities in this market environment?**

A. There is a great deal of money moving from active to passive strategies that we believe has artificially propped up many of the large-cap tech stocks and some of the bigger holdings inside of some of those indices. We continue to invest in and look for small- and mid-size companies that are trading at reasonable multiples, that haven't yet been added to those indices, and that is where we believe value is going to be.

 

Q. **Tell me about your investment approach and how the Villere Balanced Fund (VILLX) is positioned as 2017 comes to a close.**

A. Our investment approach is always to buy companies with low debt and strong free cash flow. We like companies with low price to earnings relative to growth, and look for companies that dominate a niche. They might be out-of-favor in the short term, but have major competitive advantages, which we believe offers us a good opportunity.

We are currently at the minimum end of the range for the fixed-income component in our Fund because we anticipate that interest rates may be going higher. We can hold 25-40% in bonds, and we are hovering right around 25% as of the end of the third quarter. We can also be 60-75% in stocks, and are right around 65% in stocks for the same period.

We believe an active, selective investment approach will be important in 2018. We own predominantly small-and mid-cap stocks, as opposed to large, for the reasons we talked about earlier. We anticipate interest rates going higher, impending corporate tax reform, and a reversion to the mean, which all have the potential to lead to small-cap companies performing better than their large counterparts.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

## RISK CONSIDERATIONS

**One cannot invest directly in an index.**

**Mutual fund investing involves risk; principal loss is possible. Investments in smaller and medium sized companies involve additional risks such as limited liquidity and greater volatility. The Balanced Fund will invest in debt securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a great risk of loss to principal and interest than higher rated securities. The Equity Fund may invest in foreign securities through ADRs. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. The Equity Fund's ability to invest in initial public offerings (IPOs) involves a higher degree of risk than more seasoned companies.**

**Small- and Medium-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies.**

**Past performance does not guarantee future results.**

**Earnings growth is not representative of the fund's future performance.**

**Active investing has higher management fees because of the manager's increased level of involvement while passive investing has lower management and operating fees. Investing in both actively and passively managed mutual funds involves risk and principal loss is possible. Both actively and passively managed mutual funds generally have daily liquidity. There are no guarantees regarding the performance of actively and passively managed mutual funds. Actively managed mutual funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.**

NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded only over-the-counter and not on an exchange.

Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization and serves as a benchmark for small-cap stocks in the United States.

The S&P 500 is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. The stock index does not incur expenses and is not available for investment.

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.

Price to Earnings (P/E) Ratio is a common tool for comparing the prices of different common stocks and is calculated by dividing the current market price of a stock by the earnings per share. The P/E ratio is not a measure of future performance or growth.

Fund holdings and sector allocation are subject to change at any time and should not be considered a recommendation to buy or sell any security. Click here for current top 10 holdings of the Villere Balanced Fund. Click here for the current top 10 holdings of the Villere Equity Fund.

*You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. This and other important information is contained in the Fund's summary prospectus and prospectus, which can be obtained by calling 866-209-1129. Read carefully before you invest.*

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