



ACG Insights: Small Cap Comeback?

Executive Summary

- A few Large Capitalization stocks have dominated portfolio performance for years, leaving other areas of the market at attractive valuation levels
- Small Caps, despite recent underperformance relative to Large Caps, have a history of prolonged periods of outperformance (Exhibit 1)
- Both absolute and relative valuations in Small Cap are historically attractive (Exhibits 2 & 3)
- The negative impact of higher interest rates and possible recession may already be baked into Small Cap prices, which tend to outperform coming out of recessions (Exhibit 4)

Background

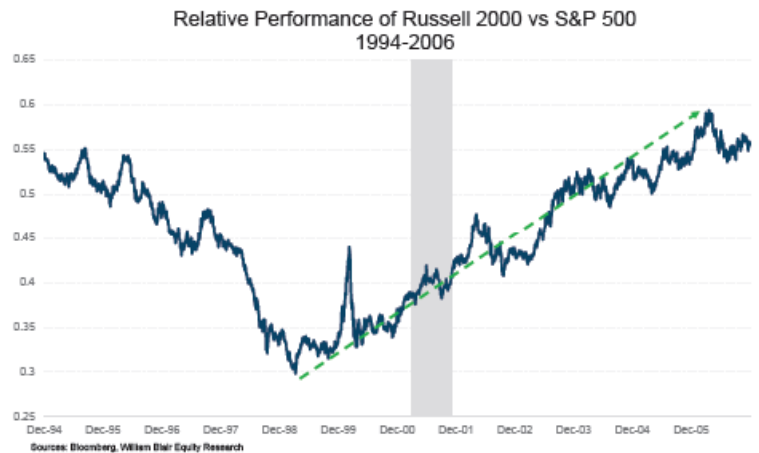
The state of markets to this point in 2023 has put asset allocators in an interesting spot as we think about portfolio positioning. On one hand, US Large Cap, and more specifically US Large Cap Growth, has driven performance in most portfolios for several years. The former “FANG” cohort has evolved into the “Magnificent Seven” (Apple, Alphabet, Microsoft, Amazon, Meta, Tesla, Nvidia) to neatly package the big tech companies that have come to dominate major market indexes. Through October of this year these seven companies make up about 30% of the S&P 500 and have returned over 70% in 2023 while the remaining 493 companies in the index have risen only about 6%¹. On the other hand, the narrow recent performance profile has left other areas of equity markets in attractive positions based on relative valuations. Take away US Large Cap Growth and you could almost throw a dart to find an area of the market that looks ripe for some mean reversion. One area looking increasingly attractive is US Small Cap, where investors may have already priced in worries over higher interest rates, recession, and tepid economic growth. The flashing disclaimer would be that valuations can stay elevated or depressed for indefinite periods, making perfect timing virtually impossible.

¹ Goldman Sachs

Exhibit 1: Small Cap vs. Large Cap in the 2000's ²

Why Bother with Small Caps?

The easiest answer is that they tend to outperform over time, and they do have precedent of significant outperformance over Large Caps. Exhibit 1 (right) shows the relative performance of Small Cap companies relative to Large Cap from the late-1990's through mid-2000's, a period encompassing a significant tech bubble and a recession. In terms of annualized returns, the S&P 600 (Small Cap) returned about 11.5% per year from 1999-2006 compared to 3.5% for the S&P 500 (Large Cap)³.



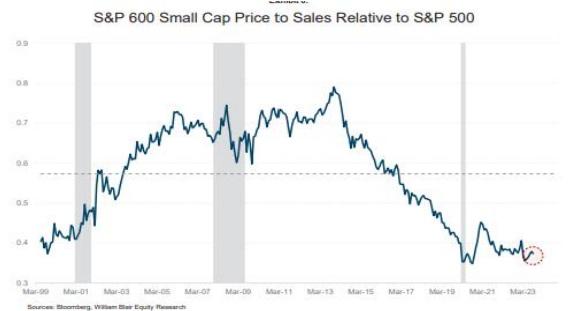
Recent performance tends to have the gravitational pull of a black hole in the investment world, and it has been hard to ignore the outperformance of mega-cap technology companies in recent years. The “Magnificent Seven” will likely maintain their influence on market indexes for the foreseeable future due to their market positions and breadth. At some point the question will shift from the market dominance and growth prospects of the market leaders to how much investors are willing to pay for more projected growth.

Current Valuations

Exhibit 2: Absolute Small Cap Valuations ⁴



Exhibit 3: Relative Small Cap Valuations ⁵



If investor focus shifts to other areas of the market, Small Cap is currently trading at both absolute and relative levels that have made for good entry points in the past. Exhibit 2 (above left) shows P/E levels for the Russell 2000 (excluding non-earners) near-record lows and near levels last seen during the Great Financial Crisis. Relative valuations to Large Cap stocks tell a similar story in Exhibit 3 (above right), which shows Price to Sales of S&P 600 companies near all-time lows relative to S&P 500 companies. William Blair has multiple charts similar to Exhibit 3 that depict the same story using different valuation metrics like Price to Earnings and Price to Free Cash Flow.

² William Blair: *Where are we in the Small-Cap Cycle?*, October 20, 2023

³ Morningstar Direct

⁴ Franklin Templeton

⁵ William Blair

What about Interest Rates and Recession?

The natural question when analyzing something with attractive valuations is to ask why valuations are so low. In the case of Small Cap stocks, higher interest rates and recession fears are logical rationales. Higher rates tend to have more negative implications for smaller companies that have more difficulty accessing capital markets and have a higher proportion of floating-rate debt. A recent Wall Street Journal article suggests that “About 40% of the companies in the S&P 600 have outstanding floating-rate debt with shorter maturities, compared with roughly 10% of companies in the S&P 500...”⁶. Higher interest expense impacts margins and net income compared to Large Cap companies who were able to lock in longer-term fixed rate financing when rates were low.

Exhibit 4: Performance Following Recession ⁷

Recession Periods	S&P 500 12M Post Recession Performance	Russell 2000 12M Post Recession Performance
Jan 1980-Jul 1980	11.7%	25.2%
Jul 1981-Nov 1982	26.3%	30.3%
Jul 1990-Mar 1991	10.8%	18.4%
Mar 2001-Nov 2001	-16.3%	-9.8%
Jan 2008-Jun 2009	15.6%	22.7%
Mar 2020-Apr 2020	47.0%	77.1%

Higher rates also generally portend an economic recession, where Small Caps have tended to struggle before leading the way after the recession (Exhibit 4). Given all the talk of impending recession since the Federal Reserve began hiking interest rates in early 2022, one of the interesting questions today is whether the market has already factored a recession into Small Cap prices to the point that smaller companies see a post-recession period of outperformance without the actual recession.

Conclusion

For investors looking to mitigate some of the concentration risk associated with Large Cap indexes, or just looking for attractive areas of the market within return-seeking allocations, Small Caps are in a period of historically cheap valuations. Getting the timing right is nearly impossible without luck, but there are some catalysts at play that may offer some signals. The backdrop for Small Cap will be favorable if rates have peaked and continue to fall while the economy continues to grow⁸. This kind of macro environment should help earnings in the Small Cap space and has shown signs of being possible as 2023 concludes. There is always the chance that a recession comes from an unexpected source. Recession or no, if valuations still matter in the long-run, then probabilities have shifted in favor of Small Cap relative to Large Cap to the point that a period of outperformance like the early 2000’s is not out of the question.

⁶ wsj.com: *These Stocks Are Trailing the Market by the Widest Margin in 25 Years*

⁷ Glenmede

⁸ Morningstar: <https://www.morningstar.com/markets/markets-brief-is-it-finally-time-buy-small-cap-stocks>

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