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# A New Era for Small Caps?

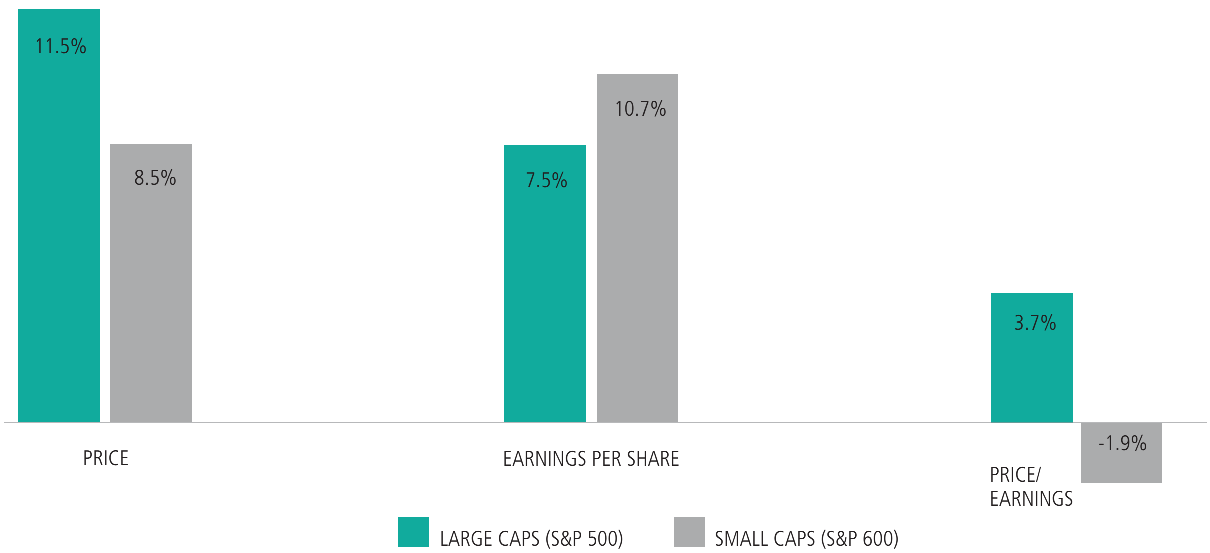
## After a decade of lagging market results, stocks of small companies seem poised for a resurgence.

Small company stocks have generally disappointed investors in recent years, not because of their fundamentals, but due to the relative strength of large companies since the Global Financial Crisis. The difference is reflected in the combined multiple (or valuation) expansion of large caps and multiple contraction of small caps, even as the latter generated stronger earnings growth over more than a decade.

A few factors favored large caps over this period: First, we saw continued globalization, where large companies expanded their distribution into new markets and shifted their labor forces from high-cost locations like North America to lower-cost regions like Asia. Second, with their extensive access to capital, large caps were generally able to lock in very low, fixed interest rates over long periods. Third, many could relocate their headquarters outside of the U.S. to benefit from favorable tax treatment. This optimal combination allowed them to enhance their profit-and-loss statements and gain favor with investors. Smaller U.S. companies, in contrast, generally don’t have access to long-maturity debt and tend to be located and generate most of their business domestically—a weakness when global expansion was all the rage.

**VALUATIONS—NOT EARNINGS—HAVE DRIVEN LARGE CAPS' RETURN ADVANTAGE**

Annualized Change, 2011 – 2024




Source: Furey Research Partners, Standard & Poor's, as of June 30, 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

## Deglobalization and Valuation

Today, however, we are in the midst of secular change as businesses gradually deglobalize. Although the trend started to emerge prior to 2020, the COVID-19 pandemic reinforced concerns about far-flung supply chains, especially for high-value products such as pharmaceuticals and semiconductors. We are now seeing a reshoring and "friendshoring" of those supply chains to the U.S., Mexico and Canada, with domestic capacity being supported by extensive government spending through the federal Inflation Reduction Act and CHIPS Act. In our view, this should disproportionately benefit small caps, which generate over 80% of their revenues in the U.S.[1]

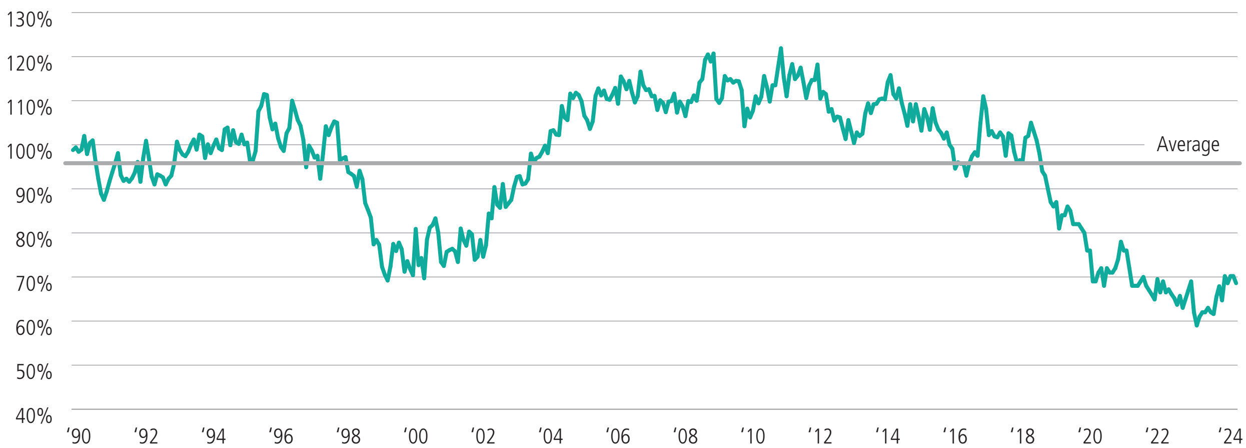
From an investment perspective, we would also point to two elements worth considering. One is valuation, with the small-cap Russell 2000 Index now at a 31% discount to the large-cap S&P 500 Index as measured by trailing price/earnings ratio, compared to the historical average of around 4%. This is in spite of small caps' superior earnings growth—10.7% annualized from 2011 – 2024 compared to 7.5% for large caps.[2]

[1] Source: Jefferies Research, 2023 average annual sales.

[2] Source: Furey Research Partners, Standard & Poor's, as of June 30, 2024.

**SMALL-CAP VALUATIONS LOOK COMPELLING**

Russell 2000 vs. S&P 500: Relative Price/Earnings



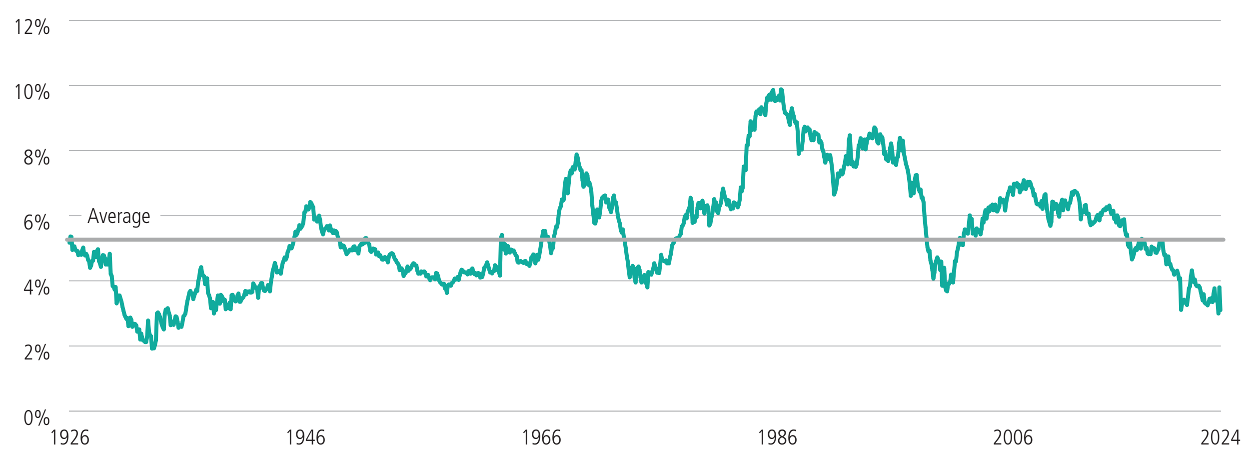

Source: Furey Research Partners, data through June 30, 2024. Median trailing 12-month price/earnings excluding negative earners. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

A related issue is the weighting of small-cap stocks as a proportion of overall equity market capitalization, which at 3.1% has rarely been this low over the past 100 years and represents what we consider an exceptional market distortion. It would take only a small "reversion to the mean" to correct such mispricing, which has historically signaled extended periods of outperformance in the past.

At the same time, as reflected in small caps' July rally, gains often take place in spurts, making timely exposure to the asset class potentially important to achieving long-term investment success.

**TIME FOR A PERFORMANCE TURN?**

Small Companies' Percentage of U.S. Stock Market Capitalization




Source: Jefferies Research, Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; as of May 31, 2024. CRSP® divides company stocks into 10 deciles by market capitalization. Small companies are represented by deciles six to eight. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

## Opportunity—With Caveats

All this being said, it's important to understand the unique characteristics of the small-cap universe.

First, it's not an insubstantial market: Considered on its own, the Russell 2000 Index has a total value of $2.9 trillion, which for example is more than both France's CAC 40 and Britain's FTSE 100 flagship indices.[3] This suggests that gaining exposure to small caps can mean opening yourself to a range of attractive businesses that can't be found in the large-cap space. The sheer variety of small companies also contrasts sharply with the highly concentrated nature of large caps, where only five companies now represent over a quarter of total index market capitalization[4]—a level not seen since the early 1970s and a key risk, in our view.

The diversity of small caps has a flipside, however, which is the segment's inefficient information flow, as just six Wall Street analysts cover the average Russell 2000 Index stock compared to 19 for the average S&P 500 Index stock.[5] This makes it harder to gather intelligence about companies, but it also presents a major opportunity for active managers who can employ fundamental research to do so.

In our view, differentiation is especially important because while there are many high-quality small companies, many others are unprofitable or burdened by debt. Indeed, about 44% of the businesses in the Russell 2000 Index currently lose money,[6] while average leverage is about 3.8 times earnings.[7] Compounding the risk is the often floating-rate nature of that debt, as many companies cannot access the long-term issuance common for larger names, which can create a serious headwind to profitability when interest rates are elevated or on the rise (although the opposite may be true when rates decline).

## Taking an Active, Quality Approach

The upshot, in our view, is that while small-cap stocks have significant appeal in terms of expanding investment opportunity and diversifying away from the concentration risk associated with large-cap stocks, some have characteristics that are particularly well suited to active managers. Taking that idea a step further, we believe that navigating small caps with a quality lens allows investors to access the best that the segment has to offer while limiting the potential risks.

Along those lines, our team focuses on quality businesses, defined as generating ample and sustainable free cash flow. This can give them the ability to self-finance their operations and growth, rather than relying on the sometimes-fickle capital markets for funding. We prefer market leaders and/or those with significant barriers to entry, which can help insulate them from competitors and protect their cash flow. In our view, they should also be effective allocators of capital, which can give otherwise pedestrian businesses greater power to add value—often through the return of capital to shareholders via dividends and share buybacks. In addition, a strong balance sheet and limited debt can be beneficial, providing a competitive advantage in times of economic stress. Finally, we want to own businesses with a high return on assets, which enhances the opportunity for gains in share price over time.

## Realizing the Opportunity

Although small-cap stocks have provided respectable returns since the Global Financial Crisis, for the reasons we note above, they have often lagged larger companies—particularly the narrow group of technology growth names that have generally driven market results. However, we believe that valuation differences have grown too acute, and that economic and business trends are likely to favor small companies from here. With its distinct characteristics, we believe approaching the segment through an active, quality lens could be the most effective way to benefit from this new era for small-cap stocks.

[3] Source: Jeffries Research, as of December 31, 2023.
[4] Source: Furey Research Partners, as of June 30, 2024.
[5] Source: Furey Research Partners, as of June 30, 2024.
[6] Source: Jefferies Research, as of June 30, 2024. Measured based on generally accepted accounting principles (GAAP).
[7] Source: Jefferies Research, as of June 30, 2024. Earnings represented by earnings before debt, interest, taxes and amortization (EBITDA). Excludes financial companies.

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