Best of What's Around: Sticking with Large Caps

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Key Points

- Fundamentals continue to support an overweight to large caps (S&P 500) at the expense of small caps (Russell 2000).
- Profitability, profit margins, debt ratios, flexibility/nimbleness, efficiency and market dominance all work to the greater benefit of larger companies.
- Although the Russell 2000 remains the industry standard (and Schwab's) small cap benchmark, small cap investors may want to focus on the higher-quality S&P 600 Index.

As most readers know, part of my role at Schwab is being part of the Asset Allocation Working Group, which makes tactical asset allocation recommendations for our clients who would like to apply a tactical overlay to their strategic asset allocation approach. Schwab has myriad strategic asset allocation models to fit our investors' range of risk/time horizon profiles; and we are firm believers that investors should take a disciplined and strategic approach to investing; even if they desire to apply some shorter-term tactical approaches.

Since March of 2017, we have had an overweight to large cap stocks and an underweight to small cap stocks. Later that year, we moved from an overall overweight to U.S. stocks to "neutral," while maintaining the bias toward large cap stocks. What "neutral" means in our language is that we have been recommending investors keep their strategic allocation to U.S. equities at their targets. But the bias toward large cap stocks has also meant that we have been recommending an overweight to the S&P 500 and an underweight to the Russell 2000 from a benchmark perspective.

It's been a while since I wrote about our tactical recommendations; and given small caps' multiple attempts at upside breakouts over the past couple of years—including late last year—I thought an update was in order.

First, let's look at a chart of relative performance of the two asset classes. As you can see below, since the inception of our tactical shift to a large cap bias, for the most part, large caps have been outperforming small caps (when the line is moving up). There have been a few attempts at small cap dominance—including March to June in 2018 following the S&P 500 correction from January to February that year—but those attempts have been thwarted.

Large Caps Continue to Dominate Small Caps

Source: Charles Schwab, Bloobmerg, as of 1/13/2020. Past performance is no guarantee of future results.

In terms of fundamentals, here is the punch line: about the only factor some small caps have going for them is a valuation discount to large cap companies. In the aggregate though, in terms of forward price-to-earnings (P/E), the Russell 2000 is

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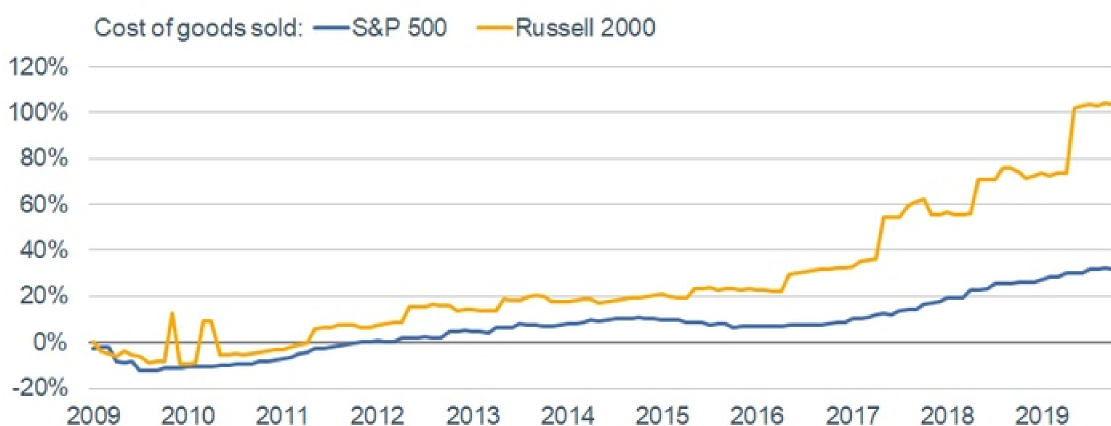
trading at a multiple of more than 25, while the S&P 500 has a multiple of 18.3. The S&P 600 index of small cap companies (discussed later in this report) is trading at a slight discount to the S&P 500.

My research associate, Kevin Gordon, recently worked closely with The Leuthold Group on a small cap research project; and some of what's below comes from those conversations (Leuthold has extremely robust historical data on capitalization ranges). In sum, large cap stocks are currently fundamentally higher quality than small caps, reflected in metrics such as profitability, leverage, economic moats and stability. Although small caps are seen as bigger beneficiaries of business cycle strength—and their sales gains during the best economic times are superior to large caps'—this economic cycle has been unique in its tepid pace of growth.

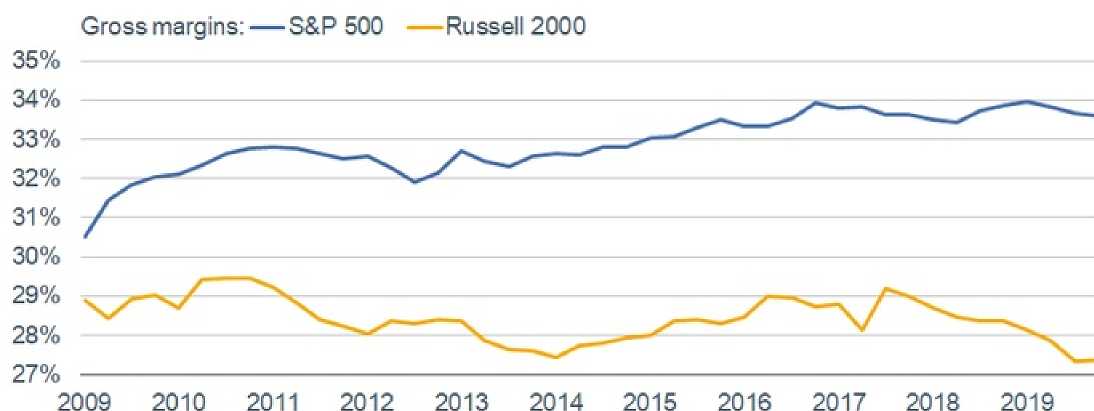
As you can see in the charts below, if you take a step down in the income statement, the superiority of large caps becomes clearer. Cost of goods sold (COGS) is much higher for small caps; and in turn, gross profit margins are significantly lower for small caps. The long-wave macroeconomic trends which have dominated the world scene in recent years—globalization, offshoring, outsourcing, automation and improved efficiency—have clearly benefited the larger multinationals more than smaller companies. In addition, large companies have superior pricing power due to market dominance, oligopolies, innovation and intangibles; which means they can defend their prices even as production costs decline.

Smaller Companies' Higher Costs



Source: Charles Schwab, Bloomberg, as of 12/31/2019. Cost of goods sold is calculated by subtracting gross margin from trailing 12 month net sales. Percentages represent the monthly cumulative change in COGS from 3/31/2009.

Smaller Companies' Weaker Margins



Source: Charles Schwab, Bloomberg, as of 12/31/2019. Gross margin is calculated as a percentage and derived by subtracting cost of goods sold from trailing 12 months net sales.

Tax cut impact

One of the recent attempts at outperformance small caps staged was in late-2017 in anticipation of corporate tax cuts. The fallacy of that move was that although smaller companies had a larger average tax rate than larger companies, a large percentage of them had (and will continue to have) no profits. Basically, it doesn't matter how much your tax rate is cut—if you don't have profits, you don't benefit from a tax rate cut on profits.

The proportion of all exchange-listed U.S. stocks that have reported losses for at least the past three years is about 28%. Only about 11% of the largest 20% of companies by market value have reported losses for at least the past three years;

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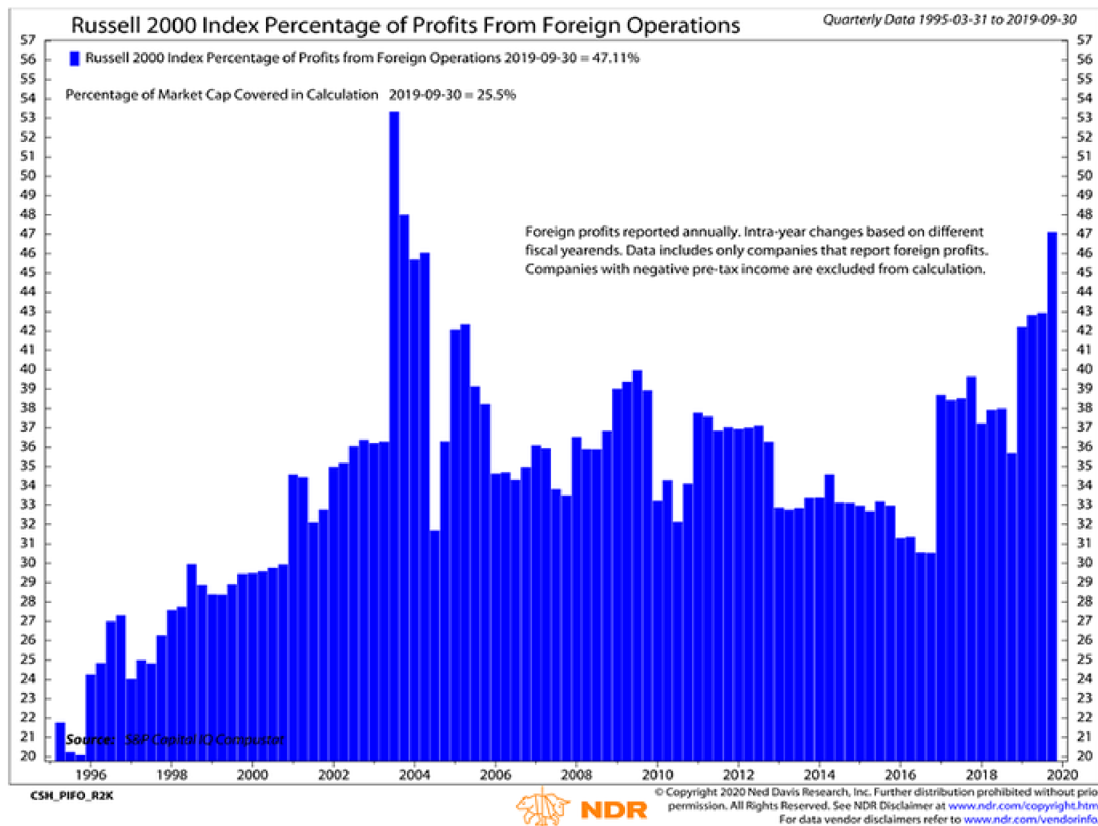
while for the smallest 80%, it's about 37%.

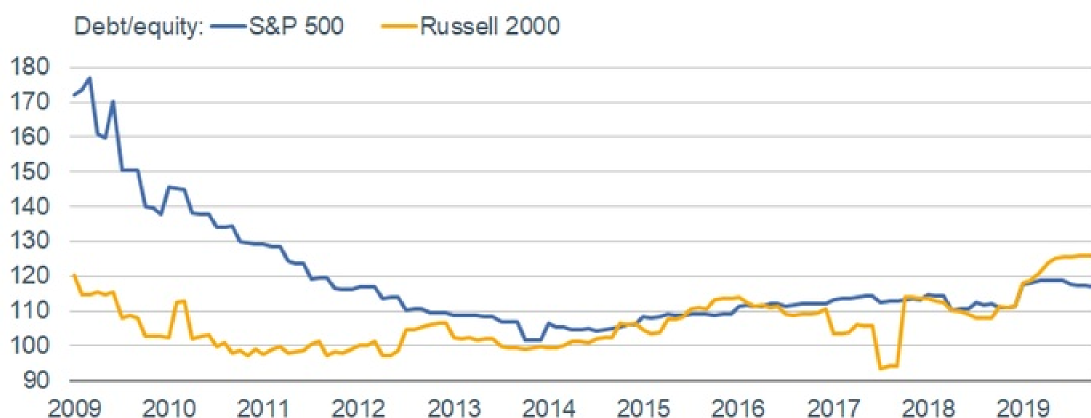
Another attempt by small caps to regain the leadership trophy came in the immediate aftermath of the "launch" of the trade war in March 2018. The fallacy of that move was that although smaller companies are generally more domestically-oriented—and therefore seen as more immune at the outset of the trade war—a surprisingly large percentage of their profits come from overseas operations, as you can see in the chart below. In addition, smaller companies representing cogs in the global supply chain are generally less nimble/flexible than their large brethren.

Smaller Companies' Growing Overseas Profits Exposure



By virtue of that weaker profitability profile, small caps also have higher debt-to-equity ratios on average, as you can see in the chart below. In fact, small caps' ratio recently accelerated above that for the S&P 500. In addition, in terms of financing ongoing operations, larger multinational companies have had access to negative interest rates globally, while small caps do not have that access.

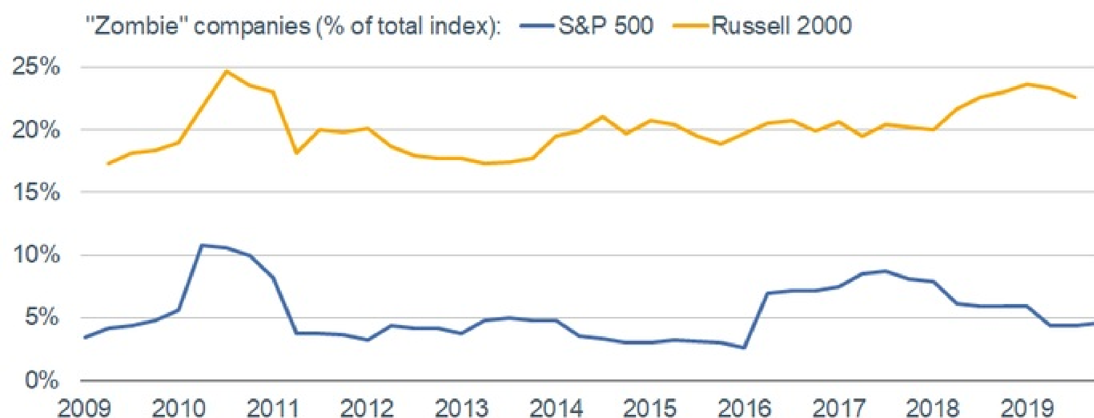
Smaller Companies' Higher Debt/Equity Ratios



Source: Charles Schwab, Bloomberg, as of 12/31/2019.

In turn, there is a much higher proportion of "zombie" companies within the Russell 2000 than in the S&P 500, as you can see in the chart below. "Zombies" are companies with earnings before taxes and interest (EBIT)/interest expense ratios less than 1.

More Zombie Companies in Russell 2000



Source: Charles Schwab, Bloomberg, as of 12/31/2019. "Zombie" companies are non-earning firms defined as ones with earnings before taxes and interest (EBIT)/interest expense ratio less than 1. Percentages represent the total number of "zombie" companies divided by the total number of companies housed in each respective index.

Caveat: according to Leuthold, while there are far more small cap zombies, there are also many more small caps with essentially no debt—meaning they should be able to withstand tougher credit conditions, were they to arise. In addition, for those investors who are looking for high-quality small cap exposure, they may be better served focusing on the S&P 600 index of small caps vs. the Russell 2000. Unlike the latter, the former is a curated index of higher-quality companies which have regularly outperformed the Russell 2000 over the years.

Our outlook for 2020 is for trend economic growth in the United States, but a continuation of the bifurcation that evolved last year—with weaker business confidence/investment, but healthier consumer confidence/spending. Given the high correlation between business confidence and corporate profits, we believe earnings estimates for this year remain a tad too lofty. This should provide a continued healthy backdrop for large cap stocks to outperform their smaller cap brethren. Any meaningful pickup in economic growth—particularly if accompanied by higher inflation—could be the lifeline for which small caps have been clamoring.

Important Disclosures:

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