What Is Today's Opportunity in Small Cap Stocks?

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by Megan Roach

of Russell Investments

In each of the past three calendar years, small cap stocks in the U.S. have lagged their large cap counterparts by roughly 6-7% per year. This trend accelerated even more dramatically in the first quarter of 2020 as small caps underperformed large caps by over 10%—a magnitude larger than any quarter over the past 40 years, including the golden years of megacap growth leadership in the late 1990s.[1]

Understandably, investors in 2020 have been concerned that small businesses would be irrevocably damaged by government-mandated lockdowns intended to stem the global COVID-19 pandemic, which was reflected in a peak-to-trough decline of nearly 42% for the Russell 2000® Index in under 20 trading days. **With these losses still fresh on our minds, what should investors consider when deciding both their long-term strategic allocation to small cap equities as well as what tactical opportunities may exist over the next few years?**

Long-term allocations

On a strategic basis, the case for maintaining a long-term allocation to small cap equities remains strong. Russell Investments' 10-year strategic asset class forecasts put both global and U.S. small cap equities near the top of the pack for expected absolute returns, second only to emerging market equities.[2] While investors should remain aware that this higher expected return likely comes with a higher level of annualized volatility, we maintains the view that small cap stocks are an important source of growth for return-seeking investors that provide diversification benefits relative to large cap companies, both domestically and abroad.

Near-term opportunities

Moving on to the nearer term opportunity in small caps, our investment process centers on the consideration of three key variables for dynamic portfolio management tilts: cycle, valuation and sentiment.

Cycle

According to analysis completed by BofA Merrill Lynch, the absolute performance of small cap equities since 1979 has been most correlated with macroeconomic indicators of domestic economic activity, consumer and business owner sentiment and investor risk appetite. When these metrics are increasing, typically so are small cap stocks. With global economic activity grinding to a halt in early 2020, the underperformance of small cap stocks has held true to these historical relationships. However, as governments around the world have unleashed vast monetary and fiscal stimulus—in many cases targeted directly at ensuring the viability of small businessesthrough low or zero interest loans and forgivable grants—the forward-looking picture becomes more positive.

Notwithstanding the risk of a potential setback on COVID-19 infection and death rates aseconomies reopen around the world, the data released thus far during the second quarter—namely, improving leading economic indicators,lower unemployment and the contraction of high-yield spreads—are all likely to be wind at the back of small cap stocks. Additionally, the potential for the pendulum of globalization reversing course in favor of reshoring could prove bullish for small caps over an even longer horizon. As highlighted in a recent blog post by my colleague Mike Smith, history has demonstrated that coming out of economic recessions, market leadership can and often does change. Indeed, in the 15 occurrences of a business cycle trough since 1926, the more cyclical orientation of smaller cap equities has driven outperformance over the subsequent 12 months of 8.4%, on average, with a hit rate of 87%.[3]

Emotions can be a serious threat to an investor's financial health. Which is why it's important to know how to keep your head above water in the cycle of investor emotions.

Valuation

Between stunning market volatility and a record number of companies pulling estimate guidance in 2020, what investors are paying for small cap stocks (and what they are getting for their money) has become increasingly unclear. The forward P/E (price-to-earnings) multiple on the Russell 2000® Index has swung wildly from a trough of 11x in late March (the lowest level since February 2009 and 20% below its long-term average) to a near-record high of over 19x today. The cause of today's *expensive* P/E multiple is due both to both the dramatic second quarter rally in equity markets (the numerator) and the relatively few sell-side analysts who cover small cap stocks slashing their earnings estimates (the denominator) in a vacuum of company guidance. So, does that mean small caps aren't a good value? Not necessarily.

First, small caps entered 2020 trading at their largest discount to large caps in the past 18 years and continue to be on offer for a lower multiple of expected earnings than large caps' 21x.

Second, the level of valuation dispersion *among* small cap stocks has spiked to over five standard deviations above average[4], which means that there is a historically high level of opportunity to build a portfolio of undervalued securities within the small cap space. In doing so, investors need to be aware that, even before the pandemic-induced recession we currently find ourselves in, over a quarter of companies in the Russell 2000 Index were unprofitable and debt levels among small caps had swelled well beyond leverage levels during the GFC (Global Financial Crisis).

As these statistics for small caps overall will likely get worse in the coming quarters, it reinforces the need for a discerning eye in selecting *which* stocks to include in one's portfolio to make sure that the price paid accurately reflects the case-by-case situation of each small business through this tumultuous time. With nearly 60% of Russell 2000 companies having five or fewer sell-side analysts covering them (compared to just 1% for S&P 500 companies), today's market environment provides ample opportunity for skilled stock pickers to separate the small cap wheat from the chaff. Again, in the 10 occurrences of a spike in valuation spreads since 1926, smaller cap equities have outperformed over the subsequent 12 months by an average of 4%, with a hit rate of 90%.[5]

Sentiment

As noted at the beginning, sentiment for small cap stocks relative to large caps has been poor for quite some time. Investor preference and resulting price momentum has been decidedly in favor of megacap growth names, a trend that is accentuated as incremental dollars are passively invested only according to current market capitalization (bigger begets bigger). This trend even accelerated during the first-quarter sell-off as many of those business models thrived under stay-at-home orders.

However, of the CVS trio, sentiment is the one that can turn on a dime. While surely too early to call a trend, we have seen evidence in recent weeks that incremental buyers are increasingly turning their attention *toward* smaller, cyclical companies, with the greatest acceleration potential in a global economic recovery driving small cap stocks up nearly 24% versus large caps' 20% during the second quarter's historic rally.[6] This again rhymes with the 23 occurrences of market recoveries since 1926 where smaller cap equities have outperformed over the subsequent 12 months by an average of 10.5%, with a hit rate of 83%.

The bottom line

As shared with readers a few weeks ago, we expect the road to recovery to be uneven. In this environment of uncertainty, no one should be surprised to find that the performance of small cap stocks may acutely reflect those forward, backward and side steps along the way. However, small caps remain one of the most fruitful and diversifying strategic allocations within the return-seeking portfolios of both institutional and individual investors alike. Additionally, the current opportunity afforded by the very nascent phase of the world's next economic cycle, large valuation spreads and early indications of a shift in sentiment build a compelling case for considering a tactical allocation to small caps as well.

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[1] Source: Russell 2000® Index, S&P 500® Index
[2] Source: Russell Investments research
[3] Source: Russell Investments research
[4] Source: National Bureau of Economic Research, Empirical Research Partners Analysis
[5] Source: Russell Investments research
[6] Source: Russell 2000® Index, S&P 500® Index

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