SMALL/SMID CAP STOCKS: THE OVERLOOKED ASSET CLASS

An Overtightened Spring Positioned to Uncoil

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The stock market is now poised for a meaningful shift that could favor small- and small-mid-cap (smid) stocks over the next several years. History tells us the long-term relationship between small-cap performance versus large-caps runs in cycles. Conditions seem to indicate that a cycle shift is near. While no one can know the precise timing, large/small relative valuations, the relationship between interest rate cycles and the stock market, and earnings growth trends all point to a potential resurgence of quality small- and smid-cap equities.

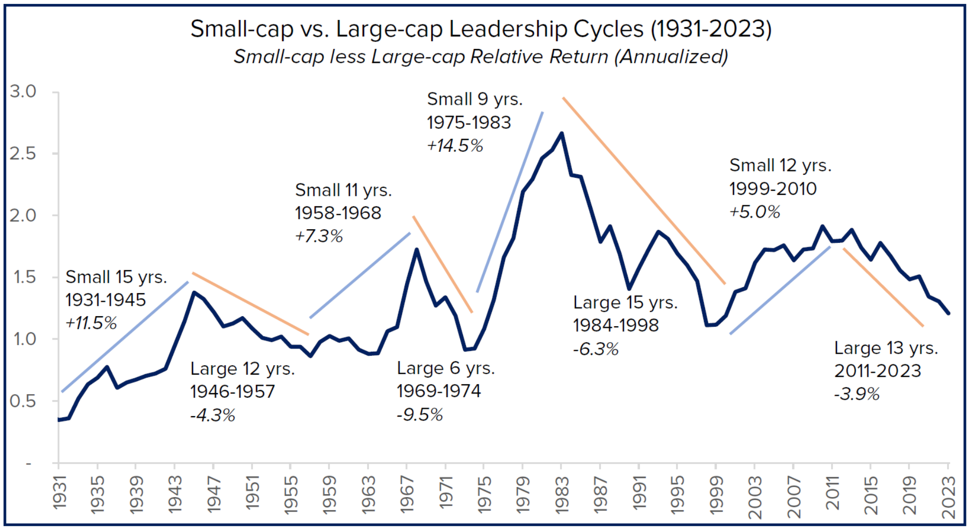
The relative valuation argument is clear. The market's leading technology stocks have had excellent growth but are trading at the upper end of their historic price/earnings multiples (P/E), driving large capitalization-weighted indexes to record heights. Dominated by such heavyweights, the S&P 500®'s estimated P/E for 2025 is 22x. Meanwhile, the profitable components of the Russell 2000® are valued at a P/E of just 16x, a discount of ~30%. The S&P 500® has made twenty-four all-time highs in 2024[1] while the all-time highs for the Russell 2000® and Russell 2500™ occurred on November 8, 2021, and are down 12% and 6%, respectively, from those all-time highs.

Viewed from another perspective, the three giants of the S&P 500®—Microsoft, Apple, and NVIDIA—have formed an elite club of companies boasting market capitalizations of $3 trillion or more. Each has a greater value than the entire market capitalization of the Russell 2000® Index. Combining any two of these technology leaders approaches the $6.7 trillion market value for the entire Russell 2500™ Index.[2] This starkly illustrates the fact that a broad universe of U.S. companies in these indexes has been ignored and that the true intrinsic value of these companies is not reflected in their stock prices.

Such disparity is the result of an extended period of small-cap underperformance. Since 2011, small-caps have lagged large-caps by 3.9% on an annual basis, the second longest such period in more than nine decades—since 1932. This underperformance was, perhaps, tied to subpar U.S. economic growth during a time that technology companies were able to stand out by growing above trend due to cloud computing, SAS software product offerings, and other innovations. The prior period of small-cap domination started in the last century—beginning in 1999 through 2010. A change in leadership is now overdue and we believe the markets could be close to a positive, multi-year inflection point for small- and smid-cap outperformance relative to large caps.

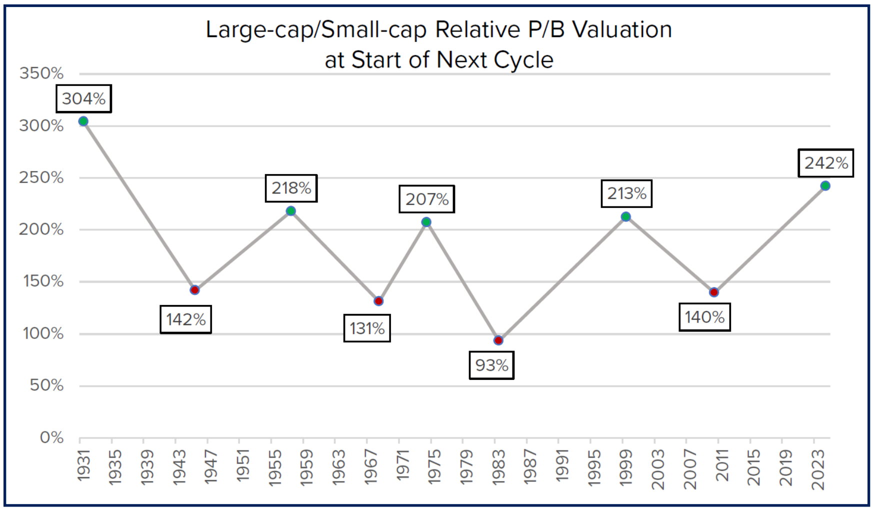
[1] As of May 31, 2024
[2] As of June 25, 2024

THE DARK BLUE LINE REPRESENTS THE SMALL-CAP TOTAL RETURN INDEX DIVIDED BY THE LARGE-CAP TOTAL RETURN INDEX, STARTING IN 1931. WHEN THE DARK BLUE LINE IS RISING, SMALL-CAPS ARE OUTPERFORMING LARGE-CAPS AND VICE VERSA. BOTH SERIES ARE INDEXED TO 1.0 AS OF 12/31/1925. SMALL-CAP INDEX EMPLOYS CRSP 6-8 DECILE INDEX RETURNS BEFORE 1979 AND RUSSELL 2000® INDEX RETURNS FROM 1979 TO PRESENT. LARGE-CAP INDEX EMPLOYS S&P 500® RETURNS FOR ALL PERIODS. THE LIGHT BLUE AND LIGHT ORANGE LINES INDICATE PERIODS WHERE PERFORMANCE IN ONE SIZE CLASS WAS DOMINANT OVER THE OTHER.



Source: Furey Research Partners

The Federal Reserve may hold a key to the performance of small- and smid-cap stocks. Historically, these indexes generally perform well after the conclusion of a Fed interest rate tightening cycle and then outperform as the Fed cuts rates. The last period of small-cap outperformance (1999-2010) coincided with a slowing economy, the Fed lowering interest rates, and a revaluation of the largest-cap leadership companies, especially the technology bellwethers of that period. To be clear, though, there is not enough data today showing inflation and growth are sufficiently cooling for the Fed to lower rates now.

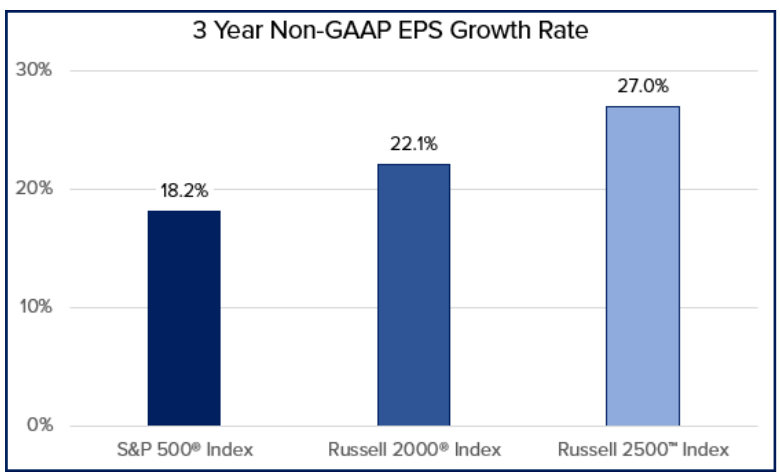


Source: Furey Research Partners

On a price/book basis, the data also indicate we are near an inflection point for the market. Large-cap stocks historically trade at a premium over small-caps, and large-caps are currently trading at a price/book premium of 242% relative to small-caps—the highest level since 1931. We especially like this indicator for measuring relative valuations because a substantial number—more than 1/3—of Russell 2000® components are unprofitable.

Accentuating the valuation argument for quality small- and smid-caps is their strong earnings growth. Annualized earnings-per-share (EPS) growth for the three years ending in Q1 of 2024 was 22% for the Russell 2000®, well above the S&P 500®'s 18% earnings growth. The Russell 2500™'s earnings growth was even higher at 27%. Going forward, earnings comparisons for the Russell small- and smid-cap indexes should be relatively easy because smaller companies were disproportionately hurt by supply chain disruptions and inventory de-stocking, resulting in two years of subpar revenue growth. Now, supply chain disruptions and other lingering post-Covid headwinds are ending, to the benefit of smaller companies.

Helping to drive earnings growth for U.S.-based small-cap companies is the fact they generate the vast majority of their revenue domestically, about 76%, a far higher percentage than S&P 500® companies. Small and mid-sized companies are beneficiaries of the push to improve supply chain reliability and resilience by reshoring business to the U.S. Prominent among those companies are financial and industrial firms, which happen to comprise 34% of the Russell 2000®. Demand for data centers and microchip manufacturing, battery manufacturing for electric vehicles, and broader infrastructure investment is a long-term tailwind for small and mid-sized companies that specialize in providing the materials and services for these trends. It is early in the cycle and we believe it will take many years to play out.



Source: Furey Research Partners

In conclusion, we believe the risk reward for small- and smid-cap stocks is favorable and is positioned to finally attract attention from investors and strategic partners. The U.S. is also well positioned to be a major beneficiary of the reshoring of supply chains which is a long-term trend that could benefit smaller domestically-focused companies. As the economy cools and inflation continues to recede, financial conditions should gradually become less restrictive. Finally, our focus on profitable, niche companies could make them attractive takeover targets for bigger companies or private equity. Current M&A activity has begun to pick up, which could provide a floor to current valuations. The bottom line is that we see a window of opportunity: this could be an especially good time to put money to work in small- and smid-cap stocks.

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The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2500™ Index measures the performance of the small- to mid-cap segment of the U.S. equity universe. It consists of approximately 2,500 of the smallest securities based on a combination of their market cap and current index membership.

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