The market rally since the lows of March 23 has been nothing short of spectacular, overcoming atrocious economic data and disappointing earnings reports. The crash in equities was unprecedented in ferocity, and the rebound has been just the same. This type of market recovery with little retrenchment, particularly when there is real economic damage, is highly atypical. However, the actions of the Federal Reserve and Congress certainly haven’t been typical. In fact, this economic sudden stop has been met with unprecedented monetary and fiscal policy that has reduced the tail risk associated with the COVID-19 pandemic and eliminated the worst case scenarios. These actions have also exacerbated some market discrepancies that have emerged over the past few years, namely the outperformance of large companies over small, as well as growth investing over value.

It is no secret that U.S. small cap equities have relatively underperformed their larger peers over the past several years. Some of the data can be staggering: For instance, over the past three years (as of 3/31/2020), the Russell 2000® Index annualized returns are down nearly -5% per year while S&P 500 Index annualized returns have returned over +5% per year (-4.64% vs. +5.10%). This shortfall has led some investors to question the allocation to small caps in their portfolio. Additionally, during the last two recent market downturns – the fourth quarter of 2018 and the most recent “Coronavirus Crash” – small caps were punished severely and lagged in the ensuing rallies. During the fourth quarter of 2018, the Russell 2000 was down -20.20% vs. the S&P 500 which was down -13.52%. During the “Coronavirus Crash,” the disparity is even more staggering – the Russell 2000 was down -30.61% vs. the S&P 500, which was down -19.60%.

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These significant performance disparities make it easy to wonder whether small caps deserve the same shelf space in a client’s portfolio they once did. Nevertheless, if we know anything about markets, we know that taking a short-term view of the investment landscape is wrought with pitfalls. Let’s dive deeper into the recent relative performance challenges of small caps and, more importantly, why there are reasons for optimism moving forward.
Over longer periods, most market capitalizations tend to perform relatively in line with one another. Over the short and intermediate term, a dislocation in performance can emerge as larger companies have outperformed smaller companies to a degree not seen in some time. Due in part to this relative underperformance, smaller companies exhibit historical levels of value as compared to their larger peers. When looking back at similar periods of underperformance over the past two decades, small caps tend to rebound sharply versus their larger brethren when the tide turns.

The current recovery may be a similar story as small caps outperformed large caps in April with the Russell 2000 up +13.74% vs. +12.82% for the S&P 500. It is also important to note small caps did not originally lead the recovery; rather, small caps have been on a relative tear versus large caps over the past few weeks as talks about re-opening the economy have accelerated. If you believe in the potential for a V-shaped recovery – and every day more and more market action seems to give credence to that refrain – then it stands to reason small caps should continue to do well. Small caps tend to be levered to the U.S. economy and the U.S. consumer given their natural place in our economic ecosystem. As the levers of fiscal relief and monetary backstops are pulled ad infinitum to allay the nation’s greatest fears of vast unemployment and market paralysis, it makes sense small caps would be poised to benefit on a relative basis. Is April the beginning of a sustainable recovery, as seen in the past? Only time will tell, but so far it looks to be the case.

Valuation is another important factor to consider. Due in part to recent relative underperformance, small-cap valuations compared to large caps are at all-time lows last seen over two decades ago in the late ’90s. Why is this important? Going forward, the statistical cheapness of small caps versus large caps provides a strong case for why smaller companies may once again dominate compared to their larger cohort. One can argue whether traditional valuation is relevant in such a volatile market, but savvy investors should continue to view valuation metrics as potential sources of alpha.
Overall, the small-cap universe presents plenty of opportunity right now. Within the small cap universe, it’s also important to pick your specific areas of exposure and to know what you own. The significant performance gap between small cap value and small cap growth that has persisted for the past few years accelerated during the downturn. Through 1Q20, the Russell 2000 Growth outperformed the Russell 2000 Value by 9.9%! That comes on the heels of 6.6% outperformance in 2019 and it’s not likely to stop. Secular growth tailwinds are supportive of sectors like information technology and healthcare, which are larger weights within growth indices. Additionally, persistently low interest rates and a flat yield curve tend to hurt smaller cap financial companies, which are overweighted in the Russell 2000 Value index by 24.5%.

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Overall, the small cap universe presents plenty of opportunity right now. And the significant underperformance of small caps relative to large makes it an even more compelling proposition, particularly for anyone bullish on the future of the U.S. economy. In addition to growth vs. value, there are many other interesting dynamics within the small-cap space that will be reviewed in the next piece – notably, the dynamics behind quality underperformance within small caps and the large discrepancy in earners vs. non-earners that began four years ago.

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Investments in small-cap companies generally involve greater risks than investing in larger capitalization companies. Small-cap companies often have narrower commercial markets and more limited managerial and financial resources than larger, more established companies. As a result, their performance can be more volatile and they face greater risk of business failure, which could increase the volatility of a fund’s portfolio. Additionally, small-cap companies may have less market liquidity than larger companies.

Growth companies are expected to increase their earnings at a certain rate. When these expectations are not met, investors may punish the stocks excessively, even if earnings showed an absolute increase. Growth company stocks also typically lack the dividend yield that can cushion stock prices in market downturns.

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