Retirement Today

An educational series for retirement plan investors

The role of small caps in your retirement portfolio

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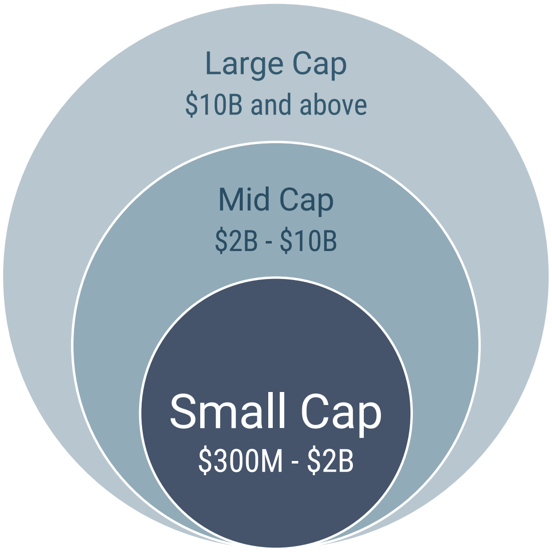
For retirement investors seeking to build wealth over time, some of the best opportunities may come from small companies.

Small-company stocks can be an important part of a well-diversified retirement plan, especially since the stocks of small companies have historically, and over the long term, outperformed the stocks of large companies. These small-capitalization companies (small caps) may allow investors to participate in lesser-known companies with growth potential early in their lifecycle. Small caps may be well-suited for investors with longer time horizons and greater risk tolerance who are seeking potential growth.

What are small caps?

The "small" in small caps refers to a company's market capitalization and not its potential return. This represents the total dollar market value of a company's outstanding shares of stock. Small caps typically have a market capitalization of about $300 million to $2 billion. Small companies may eventually grow into larger companies over time. Large-cap stocks, sometimes called "blue chips," typically have a market capitalization of more than $10 billion. Small-cap strategies invest primarily in the common stocks of U.S. companies with smaller market capitalizations.

Chart 1: **Market Capitalization (Market Cap)**



Reasons to consider small caps

1. **Diversification:** Investors can seek to minimize risk across a portfolio by investing in different types of assets. Small-cap stocks may allow plan participants to diversify by market size. A range of market capitalizations may potentially spread investment risk so that a loss in one type of asset may be offset by a potential gain in another. Diversified assets may react differently to the same market event, and no single asset class (e.g., equities or fixed income) typically outperforms all other investments every year, year-to-year.

2. **Potential Growth:** Small-cap companies may offer the potential for greater growth compared to their larger counterparts. Because of their size, successful small-cap companies can expand more rapidly, potentially doubling or tripling in size, which is much more difficult for a larger company. Since small caps are often start-ups and newer companies, they typically outnumber larger companies, but are often less recognized. This may create mispricing and market inefficiencies that over time can produce opportunities for investors. In addition, small caps are often attractive acquisition targets for larger companies looking to harness higher growth rates or product lines.

3. **Historical Performance:** Investing in small caps may make sense for those saving for retirement. As you can see from Chart 2, the hypothetical growth of $10,000 over 20 years, adding small caps to a long-term investment portfolio can diversify assets and increase growth potential.

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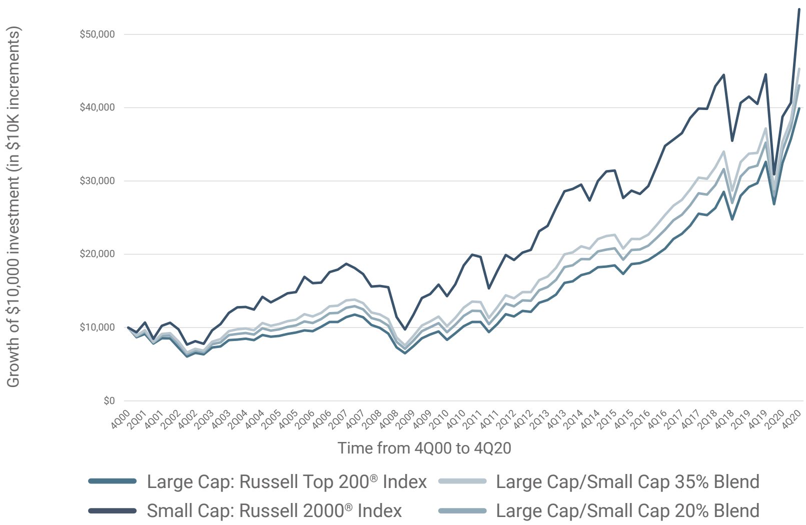
Chart 2: The Hypothetical Growth of $10,000 in Four Indices Over 20 Years



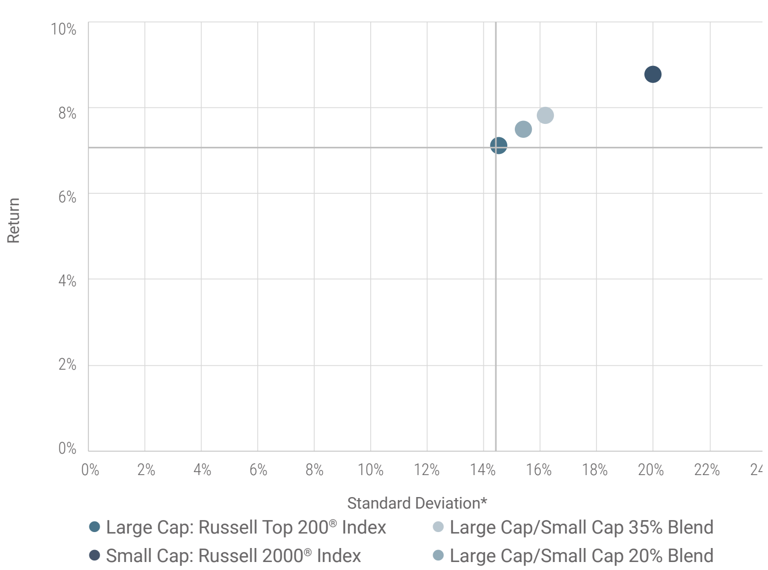
As of 12/31/2020. Source: Callan, FTSE Russell.

This hypothetical illustration shows the growth of a $10,000 initial investment over a 20-year period (ended December 31, 2020). Comparison is made between four hypothetical investments (Small Cap: represented by the Russell 2000® Index, Large Cap: represented by the Russell 200® Index, Large Cap/Small Cap 35% Blend, Large Cap/Small Cap 20%). The "Large Cap/Small Cap 35% Blend" is a hypothetical portfolio of 65% Russell Top 200® Index and 35% Russell 2000® Index, rebalanced quarterly. The "Large Cap/Small Cap 20% Blend" is a hypothetical portfolio of 80% Russell Top 200® Index and 20% Russell 2000® Index, rebalanced quarterly. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges. Investment performance includes reinvestment of dividends and capital-gains distributions. This hypothetical illustration is not intended as a projection or prediction of future investment results.

Managing the risks of small-cap investing

Investors should consider constructing their retirement portfolios in accordance with their risk tolerance and investing objectives. With the greater potential return of small caps comes more potential risk. Small caps tend to have higher risks, especially in market downturns. Small stocks exhibit greater volatility (i.e., fluctuations in value), lower liquidity and elevated risk of business failure. However, there are ways to manage and reduce these risks. Look for strategies that focus on diversification within a portfolio (by company, industry, or sector), higher quality and profitable companies, with processes for improving stock selection. Active managers – those who research and select the stocks in their funds, rather than buying the same stocks included in a benchmark index – often have extensive processes for managing risk.

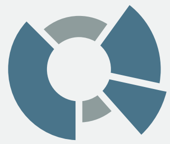
Chart 3: The Risk-Reward Analysis for 20 Years



As of 12/31/2020. Sources: Callan, FTSE Russell

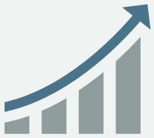
* Standard deviation measures the risk or volatility of an investment's return over a particular time period; the greater the number, the greater the risk.

Key Takeaways



For investors with long-term retirement goals, small-cap stocks may be a **good way to diversify** a retirement portfolio, complementing other kinds of assets like large-cap stocks or bonds.

Smaller companies may **offer the potential for faster growth** and agility compared to larger companies, though this may mean greater volatility in the short term.



Historically, small-cap companies **outperformed and produced greater returns** than their larger-cap peers **over the long term**. They also can add diversity to equity portfolios by company size, and sectors and industries.

Small companies can provide many advantages to retirement portfolios and may play an important role in a well-diversified portfolio, particularly for investors with longer time horizons. Investors seeking growth potential in their retirement portfolio should consider adding small-cap companies to their portfolio in concert with their goals and risk tolerance.

To learn more, visit carillontower.com.

RISK CONSIDERATIONS

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.

Investing involves risk including the possibility of loss. Diversification does not eliminate the risk of experiencing investment losses. Risks include loss of principal and fluctuating value. Investment value will fluctuate, and shares, when redeemed, may be worth more or less than original cost.

DISCLOSURES

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Definitions

The Russell 2000® Index is a small-cap stock-market index of the bottom 2,000 stocks in the Russell 3000® Index.

The Russell Top 200® Index measures the performance of the 200 largest companies in the Russell 3000® Index, which represents approximately 63% of the total market capitalization of the Russell 3000® Index.

Market capitalization ("market cap") refers to the total dollar market value of a company's outstanding shares.

A small cap is a company with a market capitalization of between $300 million and $2 billion.

A large cap is a company with a market capitalization value of more than $10 billion.

Risk-reward analysis is a measure of the expected returns of an investment compared to the risk that must be assumed to earn these returns.

Investment risk is measured by standard deviation, the more volatile an investment, the higher the risk.

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