ROCKEFELLER
ASSET MANAGEMENT

AGAINST THE GRAIN

The Case for High Quality Small-Caps

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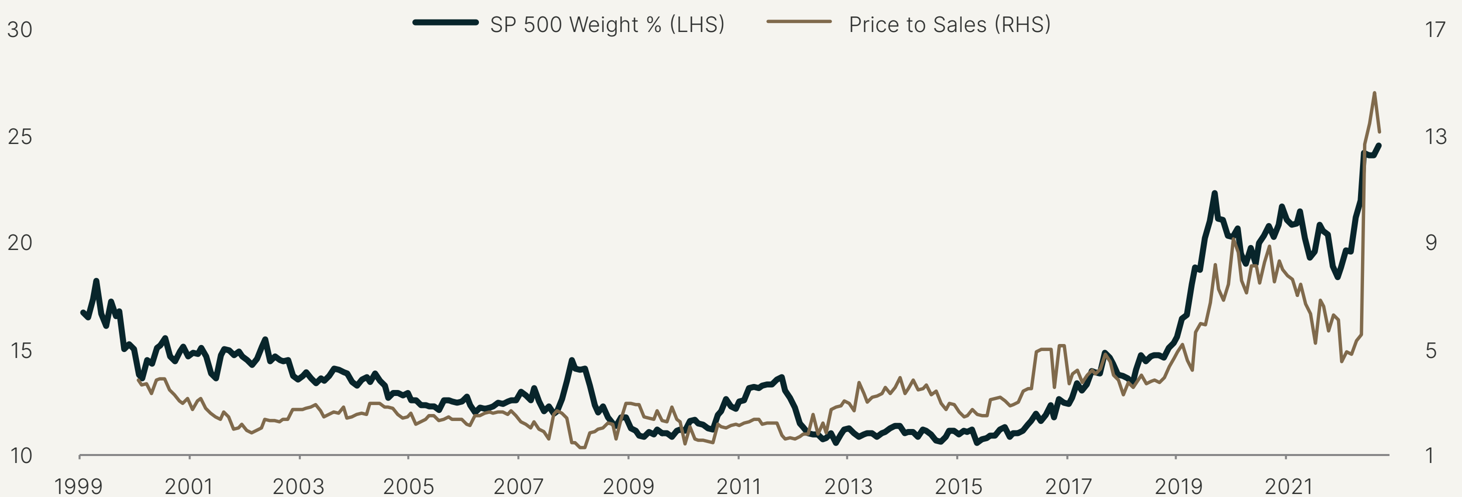
Small-cap stocks have taken a back seat to their large-cap counterparts for the better part of the last decade. But just as "growth" and "value" jockey for leadership positions, so too do small and large-caps. In our view, we're at the tail end of the dominance for large-caps. As such, we believe long-term investors will be rewarded for going against the grain and increasing their allocation to small-cap stocks instead of overweighting large-caps.

Drivers of Large-Cap Outperformance

For the past twelve years, there is no doubt investors have been rewarded for favoring large-cap stocks. This "follow the herd" mentality is demonstrated by substantial net inflows into larger company stocks, versus outflows from smaller-caps. Large-caps have benefited from years of abnormally low inflation and zero interest rates that helped them boost profits and reinvest in their businesses. In particular, the Covid-boost propelled a handful of mega cap tech valuations higher as they capitalized on stay-at-home mandates. Case in point, the combined weighting of just Apple and Microsoft account for roughly 13% of the Russell 1000—a record high. Looked at another way, the largest 10 stocks in the S&P 500 account for 28% of the Index.[1] In fact, as of October 30, 2023 Apple is approaching the market cap of the entire Russell 2000 Index.[2]

Top 5 Weighted Stocks in S&P 500



1 Source: *The Wall Street Journal*, May 30, 2023.
2 Source: Russel

The Case for Small-Caps vs. Large-Caps

Several trends that were tailwinds for large-cap stocks could potentially be headwinds as we shift to more "normal" conditions with higher inflation and interest rates that could remain "higher for longer." While we do not advocate market timing, we see signs of a shift in market leadership that we believe will favor small-cap companies. Here are some factors that could drive the transition.

DOMESTIC FOCUS AND DEGLOBALIZATION

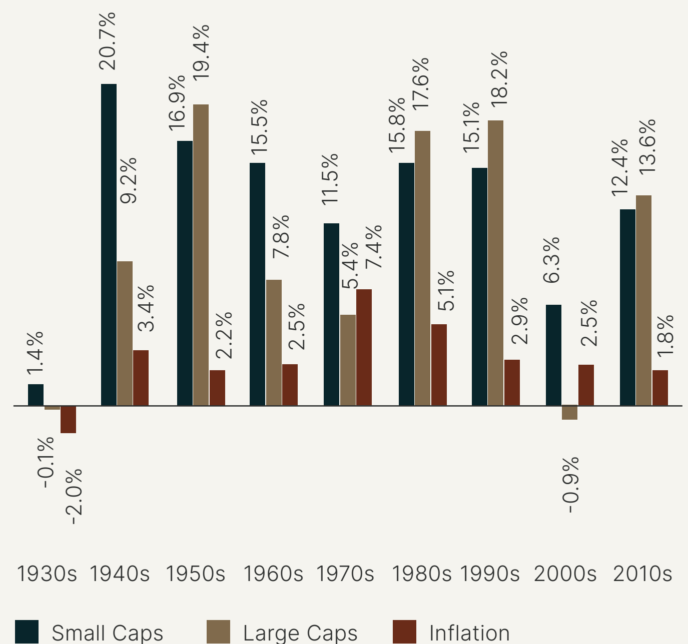
Small-caps are generally more domestically-oriented and derive the majority of their revenues within the U.S borders. The post-pandemic shift toward deglobalization and reducing reliance on China should favor small caps, and some small-cap companies are already beginning to fill in parts of the supply chain previously facilitated by overseas suppliers. Another consideration: the August 2022 passage of the Inflation Reduction Act (IRA) allocates billions of dollars in incentives, grants and loans to support new domestic infrastructure investments in the areas of clean energy, transportation and the environment. This could be a significant boon to smaller companies that have exposure to these areas, whether from their business platform, or as suppliers to companies that need their goods or services.

INFLATION TAILWIND

Since the 1930s, small-caps have been the only asset class to outperform inflation in each decade. With sticky inflation, this could indicate increased interest in well-managed smaller companies, especially those that astutely manage expenses, boost productivity, and that have the ability to pass along higher input costs.

Large Cap vs. Small Cap vs. Inflation

Compound Annual Rates of Return by Decade



Source: Kroll SBBI Yearbook 2023, Strategas Calculations
Large and Small Caps represented by the S&P 500 and Russell 2000 respectively.
Past performance is not a guarantee of future performance

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HOW WILL SMALL-CAPS FARE IN A RECESSION?

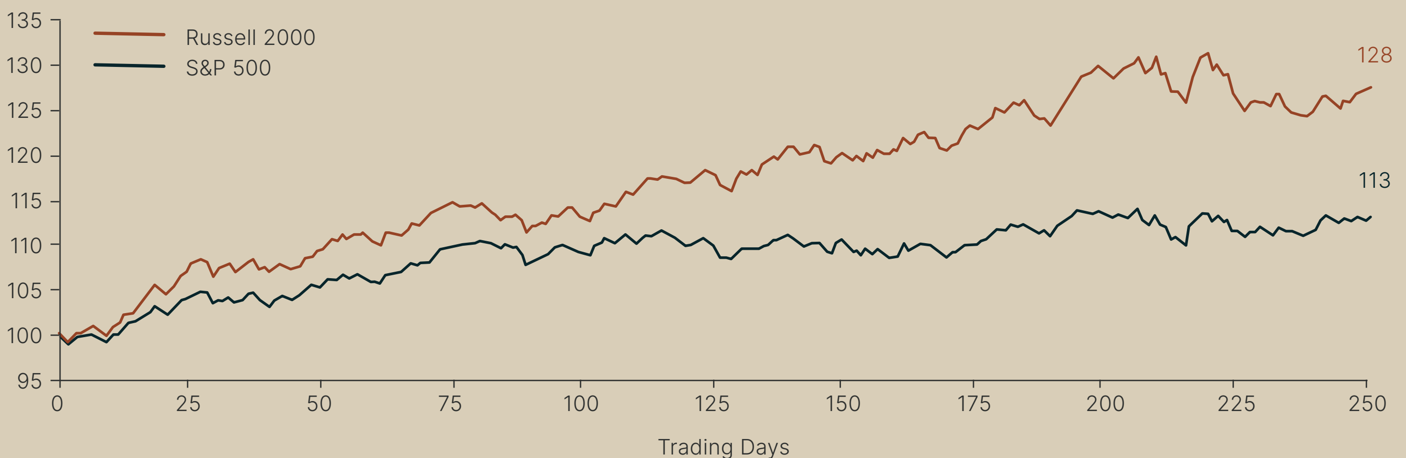
As the Fed continues to battle inflation, fears of a recession and discussion about hard and soft landings have dominated the financial news. Investors tend to look for safety in markets such as these, which may lead them to think now is not the right time to invest in small-caps. We believe these fears may be misplaced for two important reasons.

1. While it is true small cap valuations often decline when there are fears of an economic downturn, based on current valuations, we believe that much of the bad news may already be priced into shares.
2. Small-caps can be more nimble and tend to get a boost when economic conditions improve. They may also bounce back more quickly than larger companies. As a matter of fact, small-caps have outperformed large-caps following each of the last six recessions, dating back to 1980.

Since we don't know when a recession begins until after the fact, getting ahead of the curve with a larger allocation to small-caps could be rewarding.

S&P 500 & Russell 2000 Performance 12-Months Post Recession

Indexed to 100



Source: Strategas. Average Performance 12 Months Post NBER. Recession Trough Date ('80, '82, '91, '01, '09, '20) Past performance is no guarantee of future performance.

POTENTIAL PERFORMANCE ADVANTAGE OF ACTIVE MANAGEMENT

The potential benefit of small-cap active management is evident when looking at historical performance trends. In the *Morningstar* Small Blend Category the majority of active funds outperformed the Russell 2000 Index over 1-, 3-, 5-, and 10-years.

As of September 30, 2023

Past performance is no guarantee of future performance.

Source: Source Monringstar. Includes only the oldest share class of a active funds within the small blend category for the periods ended 9/30/23. 146 out of 174 funds outperformed the Russell 2000 for the 1-year period; 150 out of 167 funds beat it for 3-year period; 131 out of 158 did so for the five-year period; and 88 out of 131 funds beat it for the 10-year period.

ATTRACTIVE EARNINGS GROWTH AND COMPELLING VALUATIONS

While, small-cap earnings growth have lagged large caps in 2023, they have historically offered higher earnings growth than larger-cap companies over a full market cycle.

2024 EARNINGS & SALES GROWTH (%)

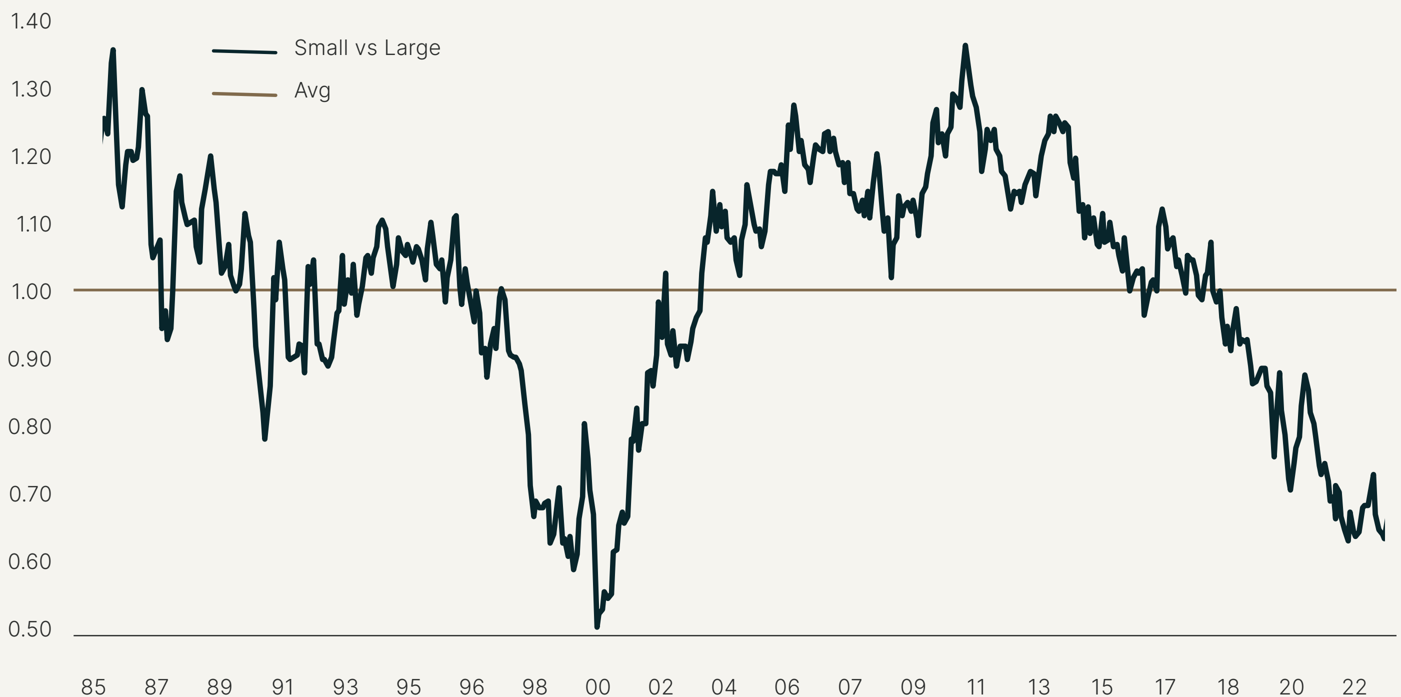
	Small Caps		Mid Caps		Large Caps	
	Earnings	Sales	Earning	Sales	Earnings	Sales
2022	9.3	15.4	12.9	12.7	5.0	11.0
2023e	(8.9)	(1.6)	(9.7)	(0.4)	0.0	2.3
2024e	7.4	3.4	8.6	3.9	9.8	3.3

Note: as of November 8, 2023. Source: FactSet; Standard & Poor's; Jefferies

Yet this is not reflected in current valuations. On a forward P/E basis, high quality, small-caps have the cheapest valuation in 13 years, comparable to the Great Financial Crisis.[3] They're also historically cheap versus their large-cap counterparts. Over time, this valuation dynamic tends to revert to the mean, meaning small-caps have significant upside potential.

Small caps remain historically cheap vs large caps

Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-7/31/2023



3 Source: BofAUS Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat.

THE POTENTIAL BENEFITS OF ACTIVE MANAGEMENT

We believe active management is critical to adding value by exploiting the inefficiencies in the small-cap market. As is the case with the large-cap market, there are enormous differences between companies within the small-cap marketplace.

High Quality

We're drawn to higher quality small-caps that our research shows have the potential to outperform. We define these as companies with healthy balance sheets, high returns on invested capital, consistent free cash flow, sustainable operating margins, and low financial leverage. We also favor companies with track records of internally generated cash flow and prudently reinvesting in their business. While these stocks may not tend to hit grand slams (e.g., the share price gain of a biotech company that receives an approval of a breakthrough drug), they tend to outperform lower-quality "non-earners" over time, particularly in the current environment where lower quality companies will need to focus on refinancing at higher rates and the valuations will be impacted by the higher cost of capital. Higher-quality stocks may also offer a degree of downside protection, as they tend to have less debt, better cash flow, and are more diversified—offering a potential buffer during economic downturns and periods of market volatility.

Less Analyst Coverage

Given the larger size of the universe, it's not surprising that the typical U.S. small-cap stock has only one-third the number of sell-side analysts than large-caps. In addition, the best performing companies in the large-cap universe are much more concentrated. Case in point, as of September 30, 2023 the largest 10 stocks in the S&P 500 account for 32% of the Index, whereas the largest 10 stocks in the S&P 600 account for only 6%.

This provides an opportunity for active investors to gain a competitive edge by establishing positions in companies earlier than - other investors. A process of rigorous fundamental research, augmented by conducting one-on-one meetings with management, can help identify companies with differentiated business models and confirm (or deny) the quality of the management team and their vision.

In addition, passive strategies can be challenged because small-cap outperformers will eventually "grow" out of the index, and they are forced to reallocate away from their best investments with no control of the timing. Active managers can continually look for new high-quality opportunities and reallocate when valuations are most attractive.

CONCLUSION

Going against the grain when investors are ultra-focused on one area of the market can be difficult. That said, in our view there's a compelling case for a shift in market leadership to small-cap stocks. Rather than attempting to time the market, we feel allocating a greater portion of one's investment portfolio to small-caps is appropriate given current market and economic dynamics. To best take advantage of the compelling case for quality small-cap stocks, we believe active management that focuses on identifying businesses with healthy balance sheets, high returns on invested capital, consistent free cash flow growth, sustainable operating margins, and low net debt to EBITDA is critical for long-term investment success.

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Investing involves risk, including risk of loss. Past performance is no guarantee of future results. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad.

Small capitalization stocks generally involve higher risks in some respects than do investments in stocks of larger companies and may be more volatile

Indexes are unmanaged, and one cannot invest directly in an index

The Russell 2000 Index is a Small Cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

The Russell 1000 Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000 Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The Standard and Poor's 500, or simply the S&P 500, is a stock market index tracking the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Forward P/E is a version of the ratio of price-to-earnings that uses forecasted earnings for the P/E calculation.

EBITDA, or earnings before interest, taxes, depreciation, and amortization, is an alternate measure of profitability to net income.

The Price-to-Sales ratio is calculated by dividing the stock price by the underlying company's sales per share.

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