Why Small Caps Now

Aristotle Capital Boston, LLC

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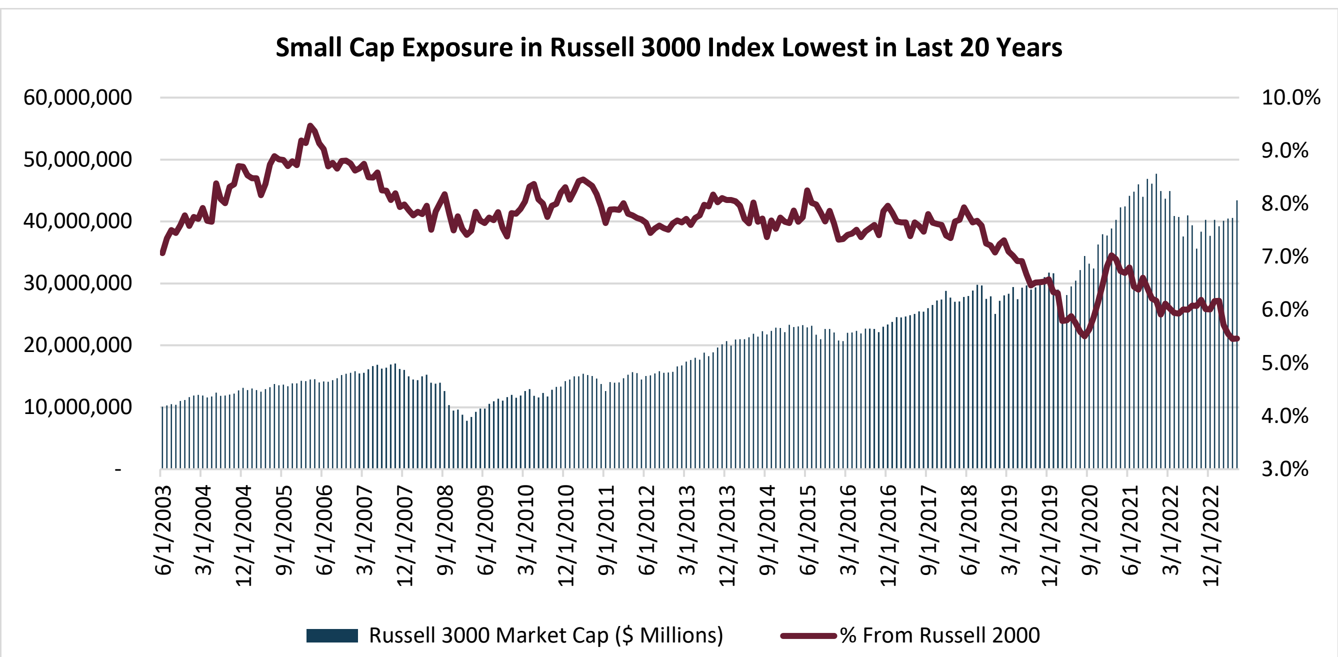
Two economists are walking down the street and find a one-hundred-dollar bill lying on the ground. A little while later, one of them turns to the other and asks, "was that a one-hundred-dollar bill on the ground?" To which the other one replies, "nope, if it was someone would have picked it up by now."

While the joke pokes fun at the efficient market theory in economics, the same could also be said about the current state of U.S. small caps. A universe composed of thousands of small companies; we believe the Russell 2000 Index is ripe for active investors looking for mispriced stocks due to limited sell-side research coverage. However, for many years the opportunities in the small cap space have largely been ignored.

The last decade has been a story of large cap outperformance. Since June 2003, the Russell 3000 Index has grown four-fold, largely on the strength of the large cap companies in the Russell 1000 Index. As the chart below illustrates, the market capitalization of the next two thousand companies in the Index has fallen from a high of 9.5% to a twenty-year low of 5.5% in the spring of 2023.



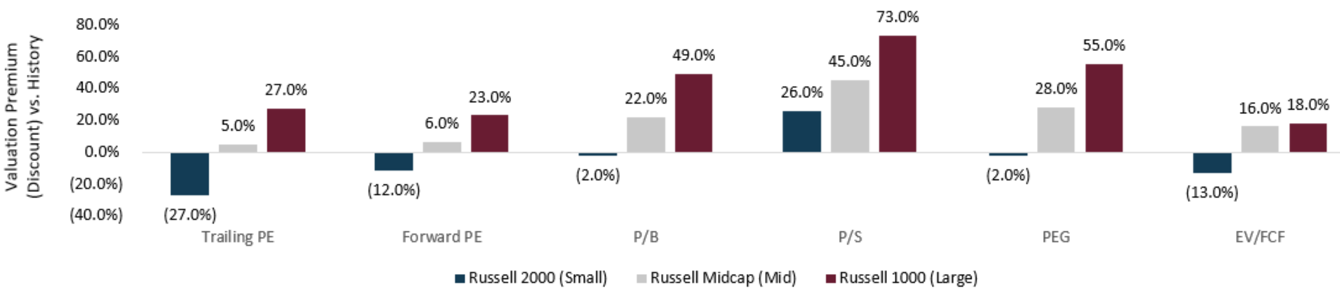
Source: FactSet Monthly Russell Index Data June 2003 – June 2023

You can make the argument that large cap stocks are expensive or that U.S. small caps are cheap. We will focus on the latter, with small cap valuations low versus their larger peers as well as against their own history. Starting at a low in valuations and weaving in multiple tailwinds that could support small cap performance in the years ahead, we believe now may be the time for investors to take a second look.

An Allocation for a Song

U.S. small caps are cheap. Large caps today trade at a historical price to earnings (P/E) premium to small caps not seen since 2001 while mid caps trade at a 25-year high versus their small peers. If we look at a time period greater than many folks have been in the investment industry (1985 – 2023), small caps as represented by the Russell 2000 Index currently trade at a discount to their own history while mid caps (Russell Mid Cap Index) and large caps (Russell 1000 Index) are expensive relative to their own histories across six different valuations metrics such as earnings, book value, growth, and free cash flow.

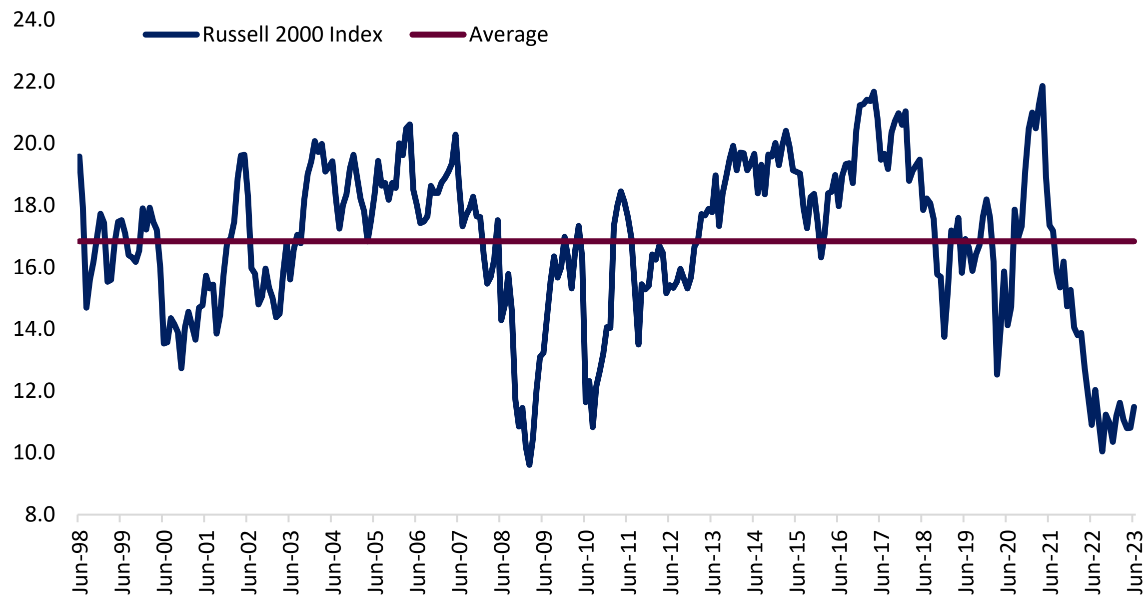
Small caps are cheapest (or most inexpensive) vs. history on all metrics below
Russell 2000, Russell Midcap & Russell 1000: Valuation premiums (discounts) vs. history (1985 – 6/30/2023)



Sources: BofA US Equity & Quant Strategy, FactSet.

If we dial in on just earnings, small caps trade near their lowest price-to-earnings ratio (P/E) in over 30 years. This is in line with the lows seen during the Global Financial Crisis (GFC) in 2008-2009 and below the lows from the 2001 recession and the COVID recession in 2020.

Price/Earnings (Last Twelve Months) of Russell 2000 Index



Source: FactSet. Based on trailing 12-month earnings. 3/31/1998 – 6/30/2023

We stress the importance of low valuations, as we believe it lays the groundwork for future performance. Since the inception of the Russell 2000 Index[1], the rolling 5-year average return is 10.4% while the current 5-year trailing return is 4.2%. That is important because our research suggests that below-average 5-year return periods historically for the Russell 2000 Index have been followed by a subsequent 5-year average return of 14.9% in 81 out of 81 periods examined.

If we look all the way back to 1925, U.S. small caps have outperformed their large cap peers when analyzing cumulative returns[2]. What is interesting about the market cycle since the Great Financial Crisis is that large caps have outperformed small caps by 300 basis points on an annualized basis[3]. At nearly 14 years, this outperformance cycle by large caps over small caps is well past the historical average of 8-10 years. If history is our guide, cycles start and stop based on valuations. Given the stark contrast in valuations today and the long in the tooth nature of this period, it appears markets have the potential to mean revert.

While some folks may view this analysis as justification to tactically overweight or underweight exposure based on what is happening in the macro environment, we also want to highlight the opportunity cost. The time and energy it takes to research investment managers and change an allocation can be immense. Looking at the average one-year forward return of the Russell 2000 Index following a market bottom, participation in all trading days resulted in a total return of 63.8%. If the first 5 trading days are missed, that return declines to 51.8%. If the first 30 trading days are missed, the average return was nearly cut in half to 37.2%.

The Winds of Change

Forecasting when an event may happen is a challenge, but it's worth touching on potential tailwinds that could support investor interest in U.S. small caps. These tailwinds are noteworthy as they may not seem like tailwinds on their face and have largely been absent from the U.S. since the Great Financial Crisis: inflation, recession, capital spending (Capex) and reshoring.

In 2022, the U.S. Consumer Price Index (CPI) registered its highest readings since the early 1980s. Cresting at a high of 9.1% in June 2022, CPI has steadily drifted lower to 3% in June 2023, as the Federal Reserve's (Fed) prescription of a sharply higher Fed Funds rate, along with decreasing monetary and fiscal stimulus and an improving supply chain, took the steam out of price pressures.

What is interesting about the current moment is that historically, high and falling inflation has delivered a 21.3% average return for U.S. small caps over a sample period of 72 years (1950-2022).

Annual Inflation vs. Small Cap % Return (1950-2022)

Rate of Change	Starting Level: Below 3%	Above 3%	All
Decreasing	17.9	21.3	18.6
Increasing	14.8	15.3	15.1
All	16.5	16.6	16.6

Annual Inflation vs. Small Cap-Large Cap % Relative Return (1950-2022)

Rate of Change	Starting Level: Below 3%	Above 3%	All
Decreasing	-0.1	5.2	3.4
Increasing	-3.6	-6.4	-4.6
All	-1.9	3.8	0.1

Sources: Furey Research Partners. Time period reflects oldest dataset available from Furey Research Partners.

[1] *The inception of the Russell 2000 Index is January 1, 1984*

[2] *Source: Ibbotson. Small Stocks—represented by the Ibbotson® Small Company Stock Index; Large Stocks—Ibbotson® Large Company Stock Index; Long-Term Government Bonds—20-year U.S. Government Bond; Treasury Bills—30-day U.S. Treasury Bill; Inflation—Consumer Price Index.*

[3] *Source: eVestment. Based on Russell 2000 and Russell 1000 indices from 1979-June 2023; source for historical returns prior to 1979: Ibbotson SBBI US Small Cap Stocks vs. Ibbotson SBBI US Large Cap Stocks. Cycles defined by peak to trough inflection points in 10-year rolling excess returns. Length in years are rounded to nearest whole number.*

This dynamic has also played out when comparing small caps to their large cap peers. Historically, in this market environment, small caps have generated an excess return of 5.2% compared to large caps[4]. While no one can foresee with certainty the future path of interest rates, we believe this is something to consider as the battle against inflation wages on.

Moving on to the next tailwind, the term "recession" does not sound great for equity returns, but there is some nuance. In the event the fight against inflation tips the economy into recession, we believe small caps may be able to weather the storm better than their large cap peers. Away from starting at a lower valuation, earnings for companies in the Russell 2000 are largely geared toward services. While the S&P 500 has a roughly even split of earnings between services and goods (52% and 48% respectively), earnings for the Russell 2000 are 66% from services and 34% from goods. We believe this is important because, historically, goods spending is two to three times slower to recover compared to services spending, based on prior recessions (the brief Covid recession is an outlier). In light of the pent-up demand following widespread lockdowns, we believe that the post-Covid services recovery will remain strong, despite weaker demand for goods.

Goods spending usually slowed 2-3x as much as services spending in past recessionary periods, with COVID being the exception

		Deceleration in spending growth:
US Recessions	Discretionary Goods	Discretionary Services
1960	-7%	-4%
1970	-13%	-4%
1974-75	-15%	-2%
1980	-13%	-4%
1981-82	-11%	-5%
1990	-11%	-4%
2001	-8%	-5%
2008-09	-15%	-7%
2020	-3%	-21%
Avg.	**-11%**	**-6%**
Avg. ex-Covid	**-12%**	**-4%**

Source: BofA Global Research.

The last two tailwinds we highlight involve slow-moving but potentially powerful changes in the global economy. In the aftermath of the COVID pandemic, many companies are looking at reshoring manufacturing in the U.S. due to supply chain disruptions, trade tensions and geopolitical conflict. According to Bank of America Global Research[5], the number of mentions of "reshoring" on earnings calls went parabolic between 2019 and 2022, from a baseline of just above zero to nearly 100 mentions last year.

In theory, an increase in reshoring will require significant investments in the U.S. The need for more warehousing, small business banking, improvements to aging infrastructure, and energy transition investments are just a few of the areas in focus. All of the money, coming in the form of the CHIPS Act, Inflation Reduction Act (IRA), and the Infrastructure and Jobs Act (IIJA), required to support the shift toward reshoring bodes well for U.S. small caps as they tend to be correlated with capital expenditures. This is another area where the positive benefits accrue more to small caps versus their large cap peers, as the correlation of US Capex growth and sales growth is stronger for the Russell 2000 than the S&P 500.

[4] *Sources: Furey Research Partners. Time period reflects oldest dataset available from Furey Research Partners.*
[5] *Source: Bank of America Global Research. The Case for Reshoring*

A Time for Picking "One-Hundred-Dollar Bills" Off the Ground

We believe cheap valuations and the potential for better days ahead make small caps attractive. No one knows what the future holds, but we believe these factors, along with Aristotle Boston's patient, disciplined and quality-oriented approach, can help our clients meet their investment objectives. While investing can be a challenging and complex pursuit, sometimes the best opportunities are those lying at your feet.

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