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Small-Cap Equities | Perspectives

Diving into the Depths: Capturing Dispersion with Small-Cap Equities

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Introduction

You probably see this all too often—the latest "hot take" from calls for a radical shift in a traditional investing approach, shunning an entire asset class in reaction to a short-term trend. The latest target appears to be small-cap equities. In 2021, a noticeable gap in performance appeared between the small-cap Russell 2000® Index and the S&P 500® Index. The S&P 500 gained 28.7% that year, while the Russell 2000 gained just 14.8%.

By the end of 2021, some market participants began to question not only the Russell 2000's future performance but its very relevance. Some of the more ominous observations made about the index include:

- A less accommodative Federal Reserve (Fed) would hinder future small-company performance.
- The sell-off in Q4 2021 was pricing in a future recession.
- The Russell 2000 has never had four consecutive years of positive double-digit returns.

Sure enough, all those premonitions came to fruition in 2022. From January 1, 2021 to May 31, 2023, the S&P 500 outperformed the Russell 2000 by 23%.[1]

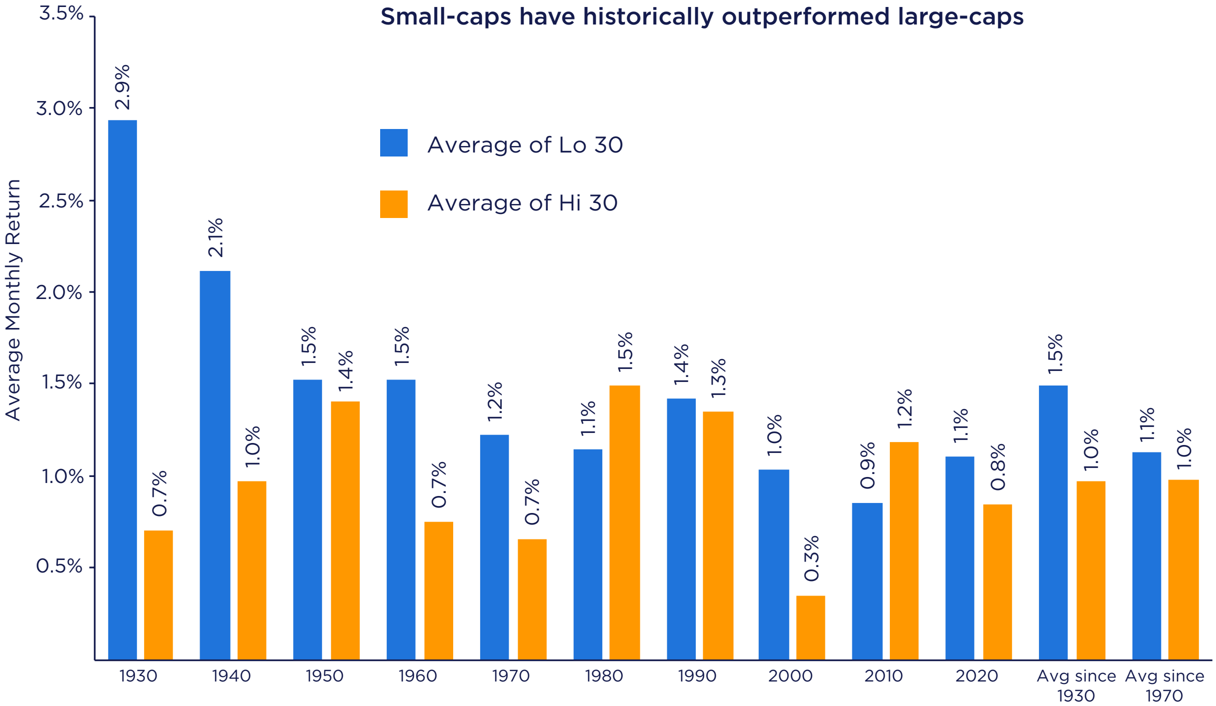
Due to the underperformance of small-caps, many of the conventional reasons for holding small-caps may no longer seem justified with today's macroeconomic backdrop. We don't hold that belief. On the contrary, small-caps currently present potentially significant opportunities for long-term investors. Even though risks are involved, investors should still consider the advantages of investing in small-caps, especially considering their compelling valuations compared to large-cap peers.

Historically, small-cap stocks have outperformed large-caps in eight of the past 10 decades. Since 1927, small-caps, on average, outperformed large-caps by 6% per year. Since 1970, average outperformance has been 2% per year.

Key Takeaways

- Despite recent under-performance, small-cap stocks have historically outperformed large-cap stocks in eight of the past 10 decades. And they're the only asset class to outperform inflation in every decade.
- The agility and domestic focus of most small companies may help them benefit from current market trends, such as inflation, reshoring of manufacturing, and capital expenditure cycles.
- Investing in small-cap stocks provides unique diversification benefits, as they exhibit different risk-reward profiles and sector weightings compared to their large-cap counterparts.
- Currently, small-cap stocks are at attractive valuations, both relative to large-cap stocks and on an absolute basis. These low valuations could set the stage for multi-year outperformance of small-caps over large-caps, presenting a potentially significant opportunity for long-term investors.

[1] FactSet 5/31/23



Source: Kenneth French Data Library, 5/31/23
Measures all tradable stocks and places them into buckets. Here, it buckets the smallest 30%, largest 30%, and middle 40%, then takes the average of those groups to show performance over time.

At a glance: The case for small-cap stocks

We think small-caps have an important place in a diversified portfolio. This applies not only in the long term but also in the current environment.

Small-caps outperform inflation

Historically, small-caps are the only asset class to outperform inflation in every decade. And they usually outperform large-caps during periods of higher inflation. For example, small-caps handily outperformed large-caps during the inflationary periods between 1976 and 1982.

One reason is that smaller companies can typically react more quickly to increases in the cost of doing business. This allows them to reduce expenses and increase prices, if needed, to maintain profitability.

Recessionary headwinds may already be priced in for small-caps

We may have already seen the worst for small-caps. The recent bear market—the longest since 1948—saw the Russell 2000 fall more than 32% from its peak on November 8, 2021, to the trough on June 16, 2022. As a result, much of the recessionary headwinds might have dissipated for small-caps—presenting an opportunity for 2023 and beyond. Indeed, small-caps tend to sell off faster as a recession approaches but frequently exhibit a swifter recovery upon exiting the recession, offering a compelling entry point for investors.

Coming years offer potential for small-caps to outperform

Small-cap valuations are at historically low levels. This presents a unique opportunity, especially for firms with pricing power that can avoid negative impacts on operating margins. After all, the indiscriminate selling in 2022 didn't spare quality small-cap stocks that exhibited strong cash flow, quality earnings, strong balance sheets and cash on hand. That means there are likely excellent values that are ripe for the picking—particularly since small-caps are often overshadowed by large-cap tech stocks.

Secular tailwinds may carry small-cap seeds

We always advise investors to focus on the long term as part of a prudent strategy. For these long-horizon investors, the opportunity to add diversification with small-caps is especially appealing in light of secular tailwinds that benefit smaller, more resilient companies that primarily serve the U.S. market.

Sticky inflation works for small-caps

Small-caps can be more resilient during times of persistent, or "sticky," inflation. One reason is that they're generally price-takers due to their relative size and limited market influence. During inflationary periods, this can be an advantage, allowing smaller companies to pass on increased input costs directly to their customers without significantly impacting demand.

Small-cap companies' typical focus on niche markets (often in the service industry) also helps them maneuver economic challenges like inflation more efficiently. These service-focused niches tend to lack the intense competition seen in broader markets, allowing small-caps to maintain pricing power during inflationary periods.

Finally, extended bouts of inflation often coincide with periods of below-trend growth. During these periods, small-cap stocks have shown a propensity to outperform—likely due to their size, innovation potential and typically domestic focus.

Domestic-focused small-caps benefit from CapEx and reshoring

Their size, agility and domestic focus also help small-caps benefit greatly from capital expenditure (CapEx) cycles in the U.S. As companies pump money into new equipment, technologies, or facilities, small-caps—particularly those in supportive industries—stand to gain.

As a bonus, the localization of supply chains and reshoring of U.S. manufacturing might provide additional tailwinds to CapEx—and small-caps—in the coming years. As larger corporations localize their supply chains to mitigate risks and improve efficiency, they often turn to smaller domestic suppliers. This transition can create a ripple effect of opportunity for small-cap companies that are either embedded in these supply chains or that can strategically pivot to capitalize on longer-term catalysts centered around reshoring.

Small-caps may have lower margin risk

Margin expansion for the S&P 500 in recent decades benefited from lower taxes and lower labor costs due to offshoring. However, growing scrutiny of corporate tax practices and calls for increased taxation on larger corporations—along with increasing wage levels in traditionally low-cost countries—may increase the risk to margin for large-caps. Small-caps, however, are more insulated from these risks.

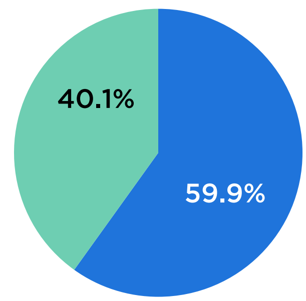
Thanks to their domestic focus and less-complex tax structures, smaller companies may face less upward pressure on tax rates—helping to preserve their profit margins. Small-caps are also less dependent on offshored labor due to their local operational footprints.

Domestic vs. foreign sales, May 2023

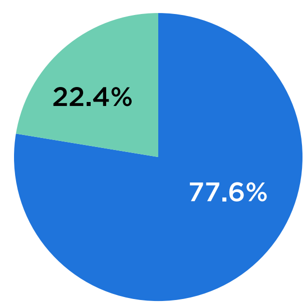
Domestic U.S. sales

Foreign sales

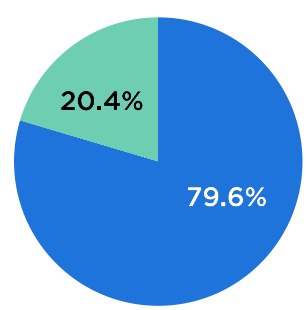
S&P 500® Index (large-cap)



Russell 2000® Index (small-cap)



S&P SmallCap 600® Index



Source: FactSet 5/31/23

Balancing near-term risks against long-term rewards

Despite their advantages, it's vital to understand the short-term risks associated with small-cap stocks. In the current economic environment, there are several challenges investors should consider, along with mitigating strategies.

Risk: High interest rates

Strategy: Look for quality factors

With the federal funds rate likely to remain above 5% for the rest of 2023, it's crucial for investors to manage interest-rate risk within the small-cap universe. Look for "quality factors" that indicate financial strength and resilience, which can help to buffer the impact of a high-rate environment.

Key factors to look for include:

- Consistent free cash flow generation
- High free cash flow to enterprise value (FCF/EV) ratios
- Strong free cash flow (FCF) yields
- Robust return on capital

Risk: Financial sector exposure

Strategy: Monitor indicators such as the Senior Loan Officer Survey

Small-cap stocks are inherently exposed to regional banks and credit conditions. The Russell 2000 Index, a benchmark for small-cap stocks, has a significant Financials sector weight of 14.8%. Consequently, any tightening of credit conditions or emerging banking risks could exert downward pressure on small-cap stocks. For early warning signs of this risk, monitor indicators such as the Senior Loan Officer Survey.

Risk: Volatility and credit spread

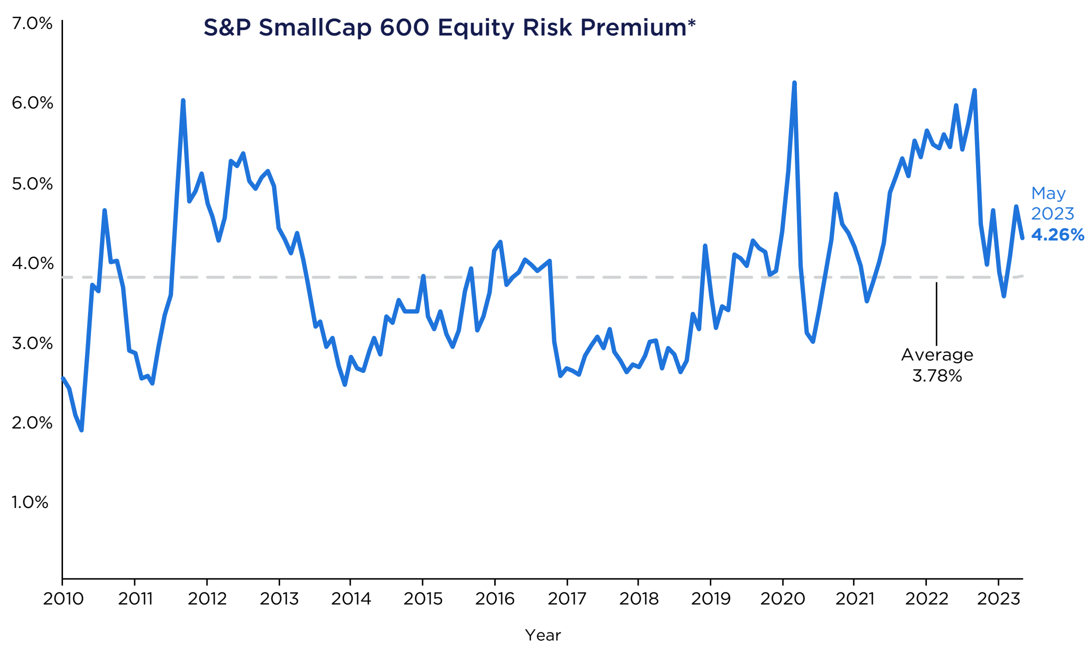
Strategy: Look for quality factors

If credit spreads widen materially, any surges in the VIX or MOVE indexes will pose headwinds for small-caps. This is why pursuing quality factors that can likely offset those headwinds is so important. Against this backdrop of economic uncertainty, widening equity risk-premia for small-caps might offer a compelling case for investors.

Risk: Refinancing

Strategy: Ensure rigorous credit analysis

Smaller companies often have a greater reliance on debt financing, so widening credit spreads can pose a refinancing risk. If credit conditions become more restrictive or costly, lower-quality companies could struggle to refinance their debts. Rigorous credit analysis and quality factor selection in the small-cap space are key.



Source: FactSet 5/31/23

*Y-axis shows the forward earnings yield less the 10-year Treasury yield.

Significant diversification benefits of small-caps

Investing in small-cap stocks provides unique diversification benefits. They exhibit different risk-reward profiles and sector weightings compared to their large-cap counterparts—offering broader market exposure and enhancing portfolio resilience.

For instance, the concentration risk of the S&P SmallCap 600® Index is much lower than that of the S&P 500. This is because the top five stocks in the large-cap index account for nearly a quarter (approximately 22%) of the S&P 500.

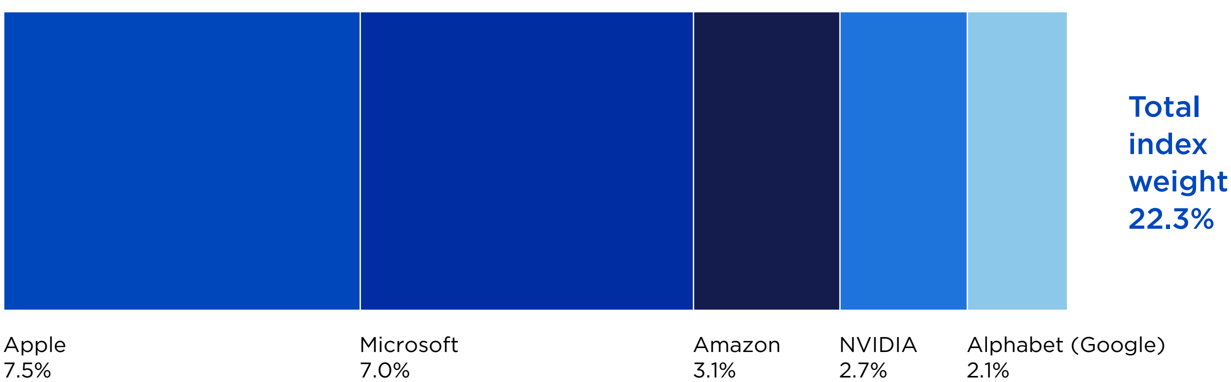
The top five stocks in the small-cap index, on the other hand, make up only 3% of the S&P 600. This year's remarkably narrow leadership from the S&P 500 highlights this point—and sets the stage for a potential "catch-up" trade for small-caps. The timing, however, remains uncertain.

There's also a greater concentration risk in large-cap indexes. The top five names in the Russell 1000® Index (Apple, Microsoft, Amazon, NVIDIA and Alphabet), for instance, make up 20% of the total Index as of May 29, 2023. As these names have grown to become such a large portion of the Index, they have an outsized impact on the overall Index's performance.

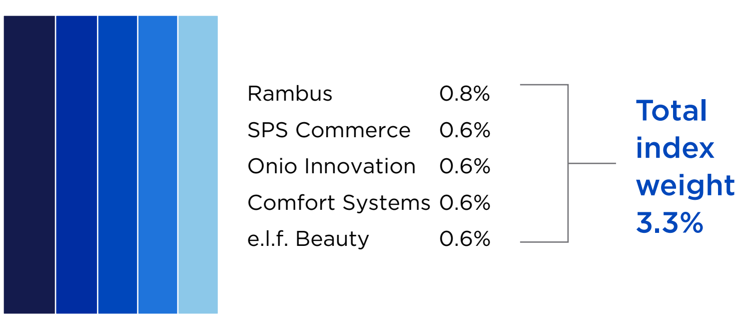
However, the top five names in the Russell 2000 (Super Micro Computer, Shockwave Medical, Inspire Medical Systems, Apellis Pharmaceuticals and EMCOR Group) make up only 2% of the total Index. The high concentration of the Russell 1000 elevates the level of idiosyncratic risk relative to the Russell 2000.

Top 5 stocks by weight by index

S&P 500 Index



S&P SmallCap 600

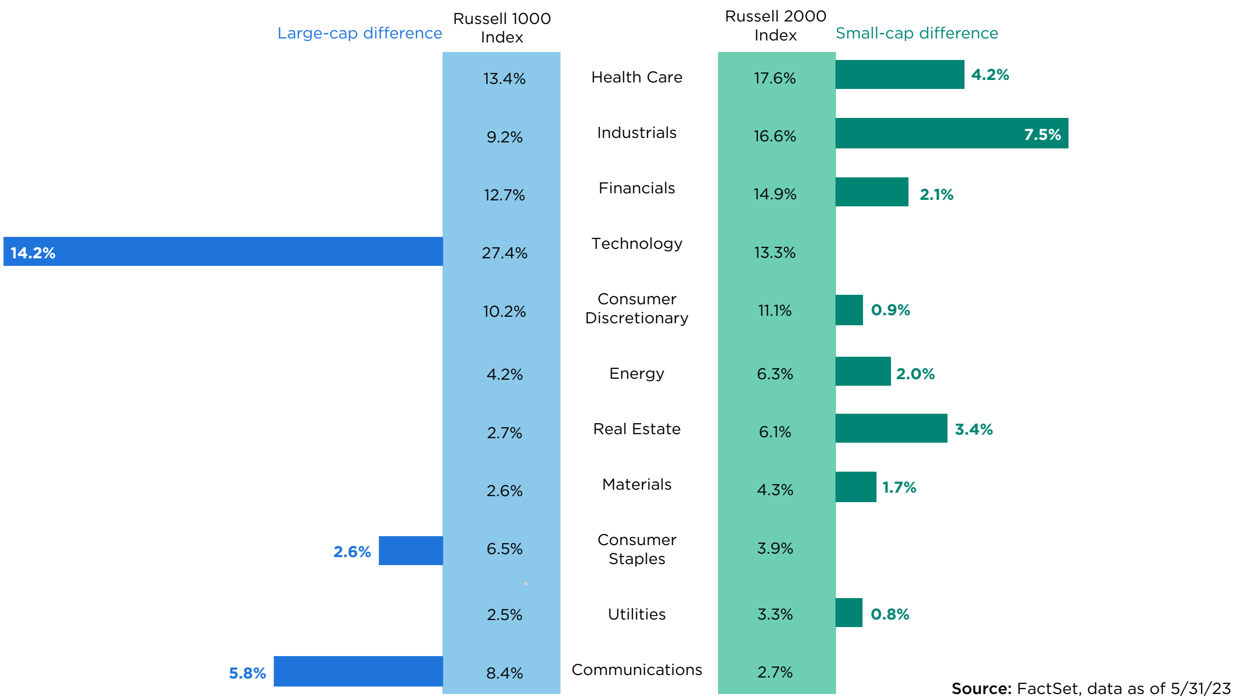


Source: FactSet, data as of 5/29/23

Another benefit of allocating to small-caps is the diversification it provides to portfolios. Small-cap indexes are very different from large-cap indexes in their sector weightings. For instance, information technology is the largest sector in the Russell 1000—at a 27% weight as of 5/29/2023. This is 14% higher than the sector's weighting in the Russell 2000.

Using this example, if the information technology sector experiences a downturn due to regulatory changes, market dynamics, technological disruption or other factors, it would disproportionately impact the performance of the Russell 1000. This could cause it to underperform.

Sector exposure differences between large- and small-cap indexes



Source: FactSet, data as of 5/31/23

The Russell 2000 is currently at a 7% weight in the Russell 3000® Index. The remaining 93% is essentially invested in the Russell 1000. This means that a substantial majority of the market exposure gained through investing in the Russell 3000 is centered around large-cap stocks.

In other words, an investment in the Russell 3000 is, by extension, predominantly an investment in large-cap stocks within the Russell 1000. Investors seeking a balanced exposure to both large-cap and small-cap stocks may need to adjust their allocations beyond what's provided by a single investment in the Russell 3000.

Russell 3000 total stock market index composite by market cap

Source: FactSet, data as of 5/31/23

Attractive valuations

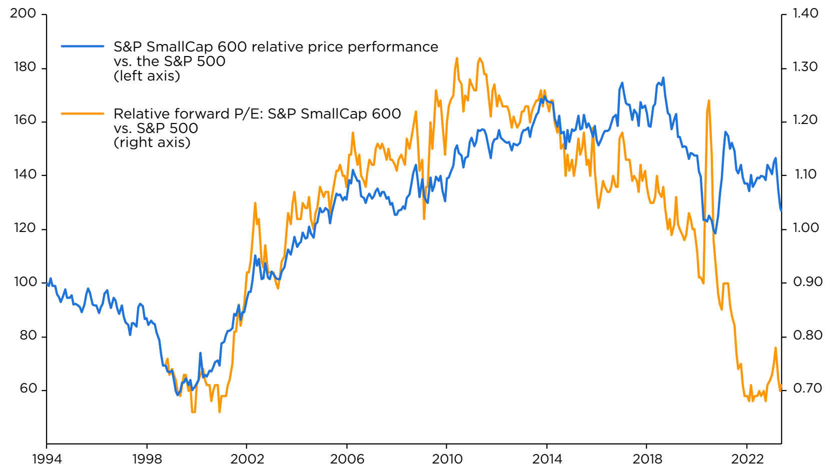
Current market dynamics have brought small-cap stocks to valuations that are not only historically low relative to large-cap stocks but also attractive on an absolute basis.

Relative valuations

The current valuation of the S&P 600 relative to the S&P 500, as measured by its relative price-to-earnings (P/E) ratio, is near historic lows at 0.71. This is well below the 20-year average of 1.08.

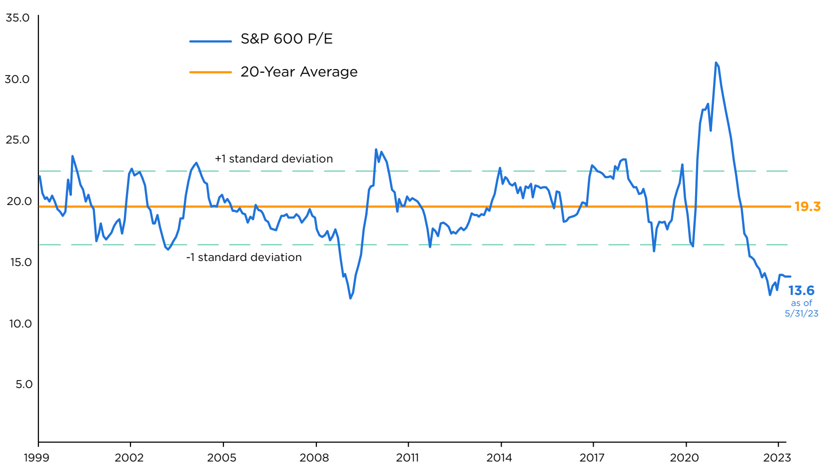
Small-caps have underperformed large-caps so far in 2023. However, when relative valuations are this low, history shows that small-caps could be set up for multi-year outperformance over large-caps.

S&P SmallCap 600® Index relative performance & valuation



Source: FactSet, data as of 5/31/23

S&P SmallCap 600® Index historical price/earnings ratio



Source: FactSet, data as of 5/31/23

Absolute valuations

Small-cap valuations also appear attractive in absolute terms. As of 5/31/2023, the S&P 600 P/E stood at just 13.58—versus a 20-year average of 19.38. The discounted valuations underscore the potential opportunity for investors to allocate toward small-cap stocks.

Historical perspective

Tracing back to the earliest available data from January 1999, the S&P 600 P/E generally stayed within one standard deviation range of its average. Now, however, it's well below the one standard deviation lower bound—a rare occurrence.

In fact, the only other time this occurred for a sustained period was during the Global Financial Crisis, from October 2008 to June 2009. This highlights the extreme valuation level—pointing toward a significant opportunity for long-term investors to buy at a historically cheap discount.

Conclusion: Don’t get swept away by speculation

The importance of a long-term perspective in investment can’t be overstated. Although it’s easy for some to be swayed by short-term trends, it’s crucial to remember that these are often temporary and shouldn’t be a distraction from more significant long-term opportunities.

Small-cap equities, despite recent underperformance compared to their large-cap counterparts, exhibit substantial potential for growth and should not be overlooked. With a consistent historical record of outperforming large-cap stocks, small-cap equities have more than demonstrated their capacity for resilience and robust returns.

Inflationary periods, changes in the macroeconomic landscape and emerging opportunities due to capital expenditure cycles, and reshoring of manufacturing can provide substantial tailwinds to small-cap equities. Their ability to adapt to shifts in market conditions, thanks to their agility and domestic focus, further reinforces their potential for outperformance.

Presently, small-cap valuations are at historically low levels—both relative to large-cap stocks and on an absolute basis. These valuations, coupled with the dispersion benefits that small-cap stocks bring to a diversified portfolio, provide a compelling argument for investors to consider an increased allocation to small-cap equities. This is especially significant in the face of increasing concentration risk in large-cap indexes.

As with any investment strategy, investors must balance the enticing long-term potential rewards of small-cap stocks against the inherent short-term risks. Vigilance in managing interest rate risks, financial sector exposure, volatility and credit spread, as well as refinancing risk, can help to mitigate those challenges.

Ultimately, while the timing of small-cap stocks’ potential “catch-up” trade to large-cap stocks remains uncertain, the historical and prospective evidence strongly supports the continued relevance of small-cap equities within a diversified portfolio. And despite the temporary challenges, small-cap stocks represent an attractive opportunity for long-term investors, providing both value and diversification potential in a variety of market conditions.

About the author

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces.

Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press, and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

He earned his Bachelor of Science in Business Administration with concentrations in Finance and Economics at the University of Richmond, holds Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations and is a member of the CFA Institute.

Russell 2000® Index: An unmanaged index that measures the performance of the small-capitalization growth segment of the U.S. equity universe.

Russell 1000® Index: An unmanaged index that measures the performance of the stocks of the large-capitalization segment of the U.S. equity universe.

Russell 3000® Index: An unmanaged index that measures the performance of the 3,000 largest U.S. companies in the investable U.S. equity universe.

S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

The S&P SmallCap 600® Index seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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