Small Cap Silver Linings

Equity markets have gyrated wildly over the past several months as investors sought to get a bead on the trajectory of inflation and the Federal Reserve’s ongoing response to it. The monthly returns of the Russell 2000 Index from June to October, for example, read like an EKG: -8.2%, +10.4%, -2.1%, -9.6%, +11.0%.¹

While persistently high inflation and the attendant policy tightening have pulled stocks decidedly lower year to date, we do not think that inflationary periods are a death knell for stocks. Notably, small cap value stocks historically have outperformed when inflation has run above its long-term median and when interest rates were biased higher.² Though smaller, value-oriented companies are not immune to the headwind of persistent inflation pressure, they do hold certain features; chief among these, in our view, is a relative insensitivity to changes in interest rates compared to more expensive growth stocks.

With the policy path to price stability uncertain, we expect market volatility is likely to remain pronounced. In our view, such an environment may create opportunities to acquire attractive small and microcap businesses that are trading below their normalized values and have specific catalysts for improvement.

KEY TAKEAWAYS

• Financial markets have struggled mightily in 2022, as the Federal Reserve’s aggressive approach to fighting decades-high inflation has weighed on risk appetites.
• Despite the year-to-date troubles evident in equities, inflationary periods historically have not been a death knell for stocks. Notably, small cap value stocks historically have outperformed other asset classes when inflation has run above the long-term median and when interest rates were rising.²
• We believe the main driver of small cap value’s relative outperformance has been these stocks’ limited sensitivity to changes in interest rates relative to growth stocks.
• We expect market turbulence to continue as the Fed forges ahead with its mission to achieve price stability. This type of environment is supportive of our style of investing, as volatility historically has provided opportunities to purchase stocks that are trading below their normalized value and have specific catalysts for improvement.

¹ Source: FactSet; data as of October 31, 2022.
² Source: Bloomberg, Kenneth R. French data library; data as of October 31, 2022.
Bracing for a Hard Landing

In the US, signs of peaking inflation and economic stagnation early in the third quarter inspired hopes that the Fed was prepared to pivot toward a more moderate pace of rate hikes, fueling a rally in risk assets and a decline in interest rates. But those hopes—and the rally—were dashed in late August by hawkish comments from central bankers, sending a number of equity indexes tumbling back into bear-market territory. The Fed’s tough talk was followed up with tough action, as the central bank announced two additional 75 basis point hikes to the federal funds rate at its September and November policy meetings, bringing its benchmark rate to 4% (from 0.25% to start the year). October’s inflation print came in better than expected, however, and futures traders currently are pricing in a 50 basis point hike in December.³

The Fed’s challenge of engineering a “soft landing” for the economy has always seemed extraordinary, and the difficulty level appears only to have increased. Economic contraction in the first and second quarters of 2022 had some observers declaring a technical recession, but ongoing strong job growth and low unemployment levels seem inconsistent with a recessionary environment. Meanwhile, many of the components of core CPI—such as healthcare, education, entertainment and rent—are quite sticky and may not be as quick to soften as commodity-driven inputs, which could keep core inflation prints elevated even as headline numbers ease.

Finding Appeal in Smaller, Value-Oriented Companies

While persistently high inflation and the attendant policy tightening has weighed on investor sentiment to result in a painful year-to-date 2022, such conditions haven’t proved to snuff out stocks in the past. A wide variety of equity sectors and markets have averaged positive annual returns when inflation was running above its long-term median (Exhibit 1) and when interest rates have been heading higher (Exhibit 2). In both instances, small cap value stocks have historically delivered outsized gains.

Exhibit 1. Small Cap Value Stocks Historically Have Outperformed When Inflation Ran Hot...

Average Annual Real Return in Years when US Consumer Price Index Was Greater than the Long-Term Median, January 1927 through December 2021

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Note: Market sectors, capitalizations and styles depicted above are based on the Fama/French classification system.

³ Source: CME FedWatch Tool; data as of November 10, 2022.
We've heard a number of explanations for the historical outperformance of small cap value stocks during these periods. Indeed, there are a few attributes common among smaller businesses that may represent features to larger ones in an environment of rising prices and rates. A smaller product line and workforce, for example, may translate into greater agility when responding to changing macro conditions, whether that means adjusting supply chains, raising prices or rationalizing headcount. In a strong-dollar environment—year-to-date 2022, the US dollar is up more than 15% against a trade-weighted basket of major currencies⁴—that means many US-based multinationals may avoid the currency-translation headwinds that face many US-based multinationals.

That said, we believe the main driver of small cap value’s relative outperformance has been these stocks’ limited sensitivity to changes in interest rates. Very low Treasury rates in the years following the global financial crisis translated into very low discount rates and promoted multiple expansion for businesses promising high levels of future growth. This fueled a massive bifurcation of returns between growth and value stocks. For the 10-year period ended December 2021, the Russell 1000 Growth Index outperformed the Russell 1000 Value by 680 basis points; the magnitude was smaller within the small cap universe, but growth still outperformed value by over 200 basis points.⁵

Today’s higher interest rates weigh on the market’s valuation of the longer-duration cash flow streams typical of growth stocks. In contrast, small cap value stocks have historically been less impacted by changes in interest rates, as the valuation of these companies is predicated more on near-term cash flows. Performance year-to-date reflects this tendency; as the 10-year US Treasury climbed nearly 250 basis points in the first 10 months of 2022, the Russell 1000 Value and Russell 2000 Value indexes outperformed their growth analogs by around 1,700 basis points and 1,100 basis points, respectively.⁶

Small cap value stocks have historically been less impacted by changes in interest rates, as the valuation of these companies is predicated more on near-term cash flows.

And while higher interest rates and generally tighter debt capital markets can present challenges to smaller companies with less financing optionality, we believe low levels of bond maturities in the near term should help mitigate this threat for businesses with well-managed capital structures.
A Quick Look at Stagflation

Perhaps the most-feared outcome of an inflationary environment is stagflation—an extended period marked by elevated inflation and sluggish economic growth, as well as high unemployment and deteriorating productivity. We can’t help but notice that current dynamics have sparked a renewed interest in this macroeconomic phenomenon. And while we make no attempt to forecast the future, a look at equity performance during the 1970s, a time when stagflation was commonplace, may be illustrative.

As shown in the exhibit below, the decade was not a complete washout for stocks, though the annual average returns depicted obscure the extreme volatility exhibited during the period. That said, small cap value names demonstrated some resilience during the decade.

Small Cap Value Held up to the Challenges of the 1970s
Average Annual Real Return, January 1970 through December 1979

Note: Market sectors, capitalizations and styles depicted above are based on the Fama/French classification system.
Source: Bloomberg, Kenneth R. French data library; data as of October 31, 2022.
Past performance does not guarantee future results.
A Differentiated Path for Uncertain Times

As bottom-up stock pickers, the Small Cap team is not influenced by market-level metrics when building portfolios. However, it may be worth noting that on a forward price-to-earnings basis, small cap stocks are trading at a discount to large caps not seen since the early 2000s dotcom bust (as depicted in Exhibit 3).

Exhibit 3. Relative Valuations Favor the Small Cap Universe
Relative Forward 12-Month Price/Earnings Ratio, Russell 2000 Index versus Russell 1000 Index: March 1999 through October 2022

While this valuation data may suggest the small cap universe is inexpensive compared to large caps, our Small Cap team focuses on building diversified portfolios of small and microcap stocks that not only are attractively valued but that also have the potential to benefit from catalysts for future earnings recovery, both structural and idiosyncratic. The volatility that has accompanied the year-to-date downdraft in stocks has presented ample opportunities to acquire small and microcap stocks at prices that we believe are unmoored from their fundamentals. This includes a number of companies whose ongoing operational improvements and positive momentum signals have been obscured by the risk-off sentiment prevalent across markets.

The investment environment could get worse from here, but we believe it’s likely that at some point the headwinds weighing on stocks should moderate. The interest rate cycle will mature, inflation will abate, investor interest will re-awaken, geopolitical tensions will ease—and we’ll be holding a large collection of stocks we believe deserve to rebound in price. We believe our portfolio is well-positioned to potentially benefit from a normalization of conditions.

The volatility that has accompanied the year-to-date downdraft in stocks has presented ample opportunities to acquire small and microcap stocks at prices that we believe are unmoored from their fundamentals.
measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium-term (two-year) growth and lower sales per share historical growth (five years). The Russell 2000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

Russell 2000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 2000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (two-year) growth and higher sales per share historical growth (five years). The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

ICE US Dollar Index is a geometrically averaged calculation of six currencies weighted against the US dollar: the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc.

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Past performance is not indicative of future results.

Risk Disclosures

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and micro-size companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. “Value” investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more “growth” oriented.

A bottom-up approach to investing primarily considers factors affecting individual companies and secondarily focuses on industries and economic trends.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

“Bear market” refers to a period during which a market experiences a prolonged decline in price.

There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

All investments involve the risk of loss of principal.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

Core Consumer Price Index (CPI) measures the changes in the price of a basket of goods and services, excluding food and energy, purchased by urban consumers.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities it is also considered a proxy for the total market.

Russell 2000® Index is an unmanaged index that measures the performance of the 2000 smallest companies in the Russell 3000 Index and is not available for purchase.

Russell 2000® Growth Index measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (2 year) growth and higher sales per share historical growth (5 years).

Russell 2000® Value Index measures the performance of the small cap value segment of the US equity universe. It includes those Russell 2000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium-term (2 year) growth and lower sales per share historical growth (5 years).

Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the US equity market by market capitalization. The Russell 1000 Index is a subset of the Russell 3000® Index representing approximately 90% of the total market capitalization of all listed USA stocks.

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (two-year) growth and higher sales per share historical growth (five years). The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium-term (two-year) growth and lower sales per share historical growth (five years). The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

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