



It (May Be) a Small World After All

After strong outperformance in 2022, value stocks—and small cap value stocks, in particular—have trailed growth stocks significantly thus far in 2023 as investors crowded into a very narrow cohort of megacap technology-related names.

Perhaps even more noteworthy than the divergence between value and growth returns overall, however, has been the yawning performance gap between large cap growth and small cap value stocks.

Despite the frequent underperformance of small cap shares since the global financial crisis, however, longer-term trends suggest to us that they remain a viable strategic allocation. Small cap stocks—particularly small cap value stocks—have delivered higher returns than large caps over full investment cycles in the past, and the current low valuation of small caps suggests that an inflection point in relative performance may be due. Furthermore, the limited analyst coverage and thin trading volumes typical of the small cap space historically have provided ample opportunity for thoughtful active managers to deliver returns in excess of indexes.

We believe a disciplined, research-intensive investment approach can help identify temporal weakness in otherwise solid companies while avoiding “value traps” that are cheap for a reason.

KEY TAKEAWAYS

- While early 2023 favored small-cap stocks, investors soon returned to the megacap names so successful in the immediate aftermath of Covid-19 on expectations that the end of the Federal Reserve’s rate-hike cycle was near.
- Though small cap stocks—and small-cap value stocks, in particular—have significantly lagged year to date, longer-term performance trends and stretched relative valuations suggest the potential for resurgence.
- Small caps are a particularly volatile and inefficiently priced segment of the US equity market, and these dynamics often create opportunities for disciplined active managers to identify undervalued small cap names with specific catalysts for earnings recovery.
- First Eagle’s Small Cap team employs a disciplined, research-intensive investment approach to identify temporal weakness in otherwise solid companies while avoiding “value traps” that are cheap for a reason.

Renewed Growth Momentum in 2023 Led by Megacap Stocks

The repressed interest rates that predominated in the decade-plus following the global financial crisis helped support the valuation of growth stocks at the expense of value names. From the market's March 9, 2009, bottom through the end of 2021, the Russell 1000 Growth Index outperformed its value counterpart by 524 basis points on a total-return basis; the gap of 161 basis points between growth and value within the small cap universe was directionally similar, if of a lesser magnitude.¹ The math of higher discount rates exerted itself in 2022, however, as the rapid rise in policy rates resulted in a profound increase to the cost of capital. Not only did this prompt a broad selloff in risk assets of all stripes, it also brought about a rotation in style leadership across capitalizations, as investors demonstrated a preference for value names with free cash flow in the here and now relative to the promise of future flows typical of growth stocks.

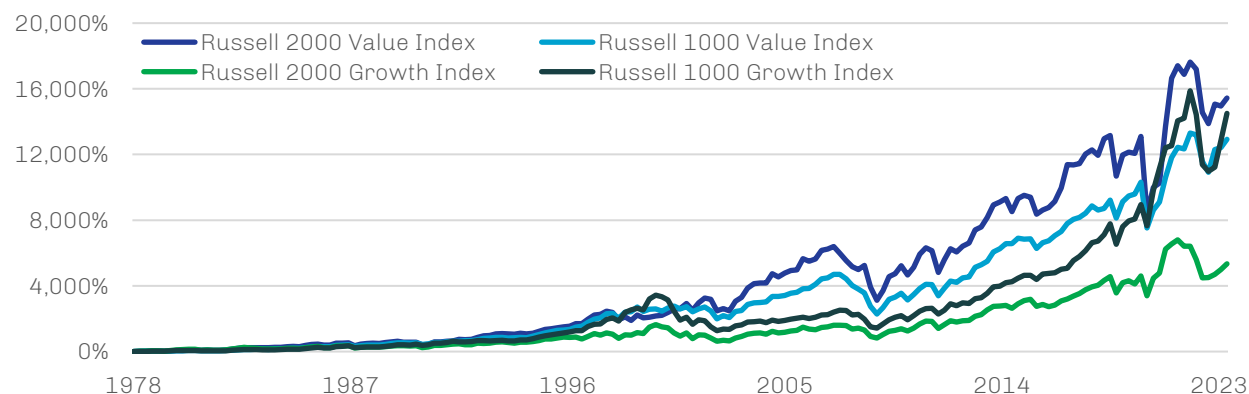
Thus far, 2023 has been a different story, as markets have sought to interpret signals from the Federal Reserve about the future trajectory of rates. However, easing inflation readings during the first half and increasing signs of systemic fragility—most notably the March failures of a few regional banks in the US—fueled expectations that the end of Fed rate hikes may be near and led to a renewal of pre-2022 market dynamics, including the outperformance of large cap growth stocks. The change was led by a very narrow cohort of megacap stocks within the S&P 500 Index; the top five stocks in the index—Apple, Microsoft, Alphabet, Amazon and Nvidia—comprise 22% of the index's total market cap and accounted for more than half of its 16.9% gain in the first half of 2023.² Earnings releases to date suggested operational resilience among these very large technology and consumer discretionary stocks, and enthusiasm around advances in generative artificial intelligence helped support multiple expansion. In contrast, the Russell 2000 Index gained 8.1%, with the value component of the index climbing only 2.5%.³

Relative Valuations May Support Potential Resurgence in Small-Cap Value

While the recovery of large cap growth stocks in 2023—not to mention their performance since the global financial crisis—has been impressive, longer-term trends tell a different story about relative performance. Small cap stocks represent a particularly volatile and inefficient segment of the equity market, and investors historically have been compensated for these elevated risks with higher returns. As shown in Exhibit 1, small cap value stocks in particular have delivered impressive performance over the long term, outpacing large cap value and growth stocks by a fair margin and small cap growth names by a significant degree.

Exhibit 1. Small Cap Value Performance Has Impressed Over the Long Term

Total Returns, December 1978 through June 2023



Source: Factset; data as of June 30, 2023.

Past performance does not guarantee future results.

1. Source: Bloomberg; data as of December 31, 2021.

2. Source: FactSet; data as of June 30, 2023.

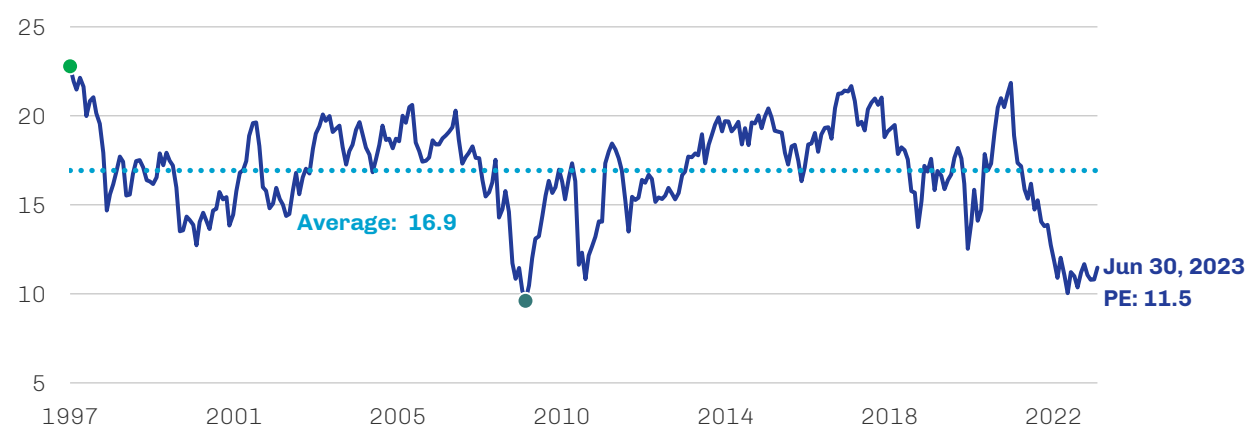
3. Source: FactSet; data as of June 30, 2023.

Mean reversion historically has had a powerful influence over financial markets, and current valuations suggest that this statistical phenomenon perhaps may soon serve as a tailwind for small caps in general and small cap value names in particular. At 11.5 times earnings, the Russell 2000 Index is currently trading well below its long-term average of 16.9 times (as shown in Exhibit 2).⁴ A low multiple has been a springboard for small cap returns in the past; the last time the index traded this cheaply was during the global financial crisis, and it delivered annual average returns of nearly 30% for the three years that followed. In contrast, the index posted smaller but still positive average annual returns of around 6% for the three years after its 1997 valuation peak.

The last time small caps traded this cheaply was during the global financial crisis, after which they returned nearly 30% on average for each of the next three years.

Exhibit 2. Current Low Valuation of Small Caps Might be Inflection Point for Strong Future Returns

Weighted Average Price-to-Earnings Ratio of Russell 2000 Index, October 1997 through June 2023



	● September 30, 1997	● February 27, 2009	● June 30, 2023
P/E Ratio	22.8	9.6	11.5
Average Annualized Return for Following 3 Years	6.0%	29.5%	TBD

Source: FactSet; data as of June 30, 2023.

Past performance does not guarantee future results.

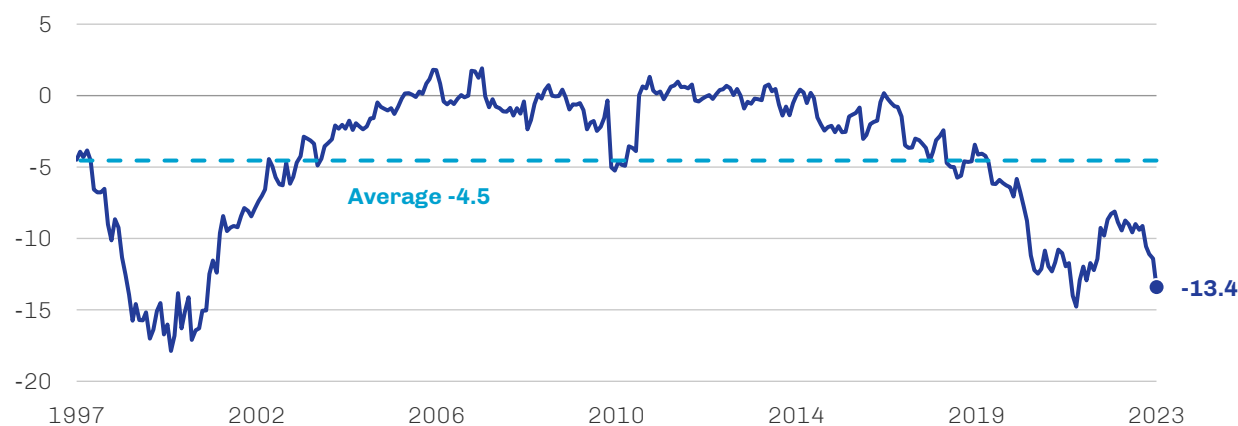
While small cap stocks in general appear undervalued relative to their history, small cap value stocks look even cheaper when compared with large cap names (as shown in Exhibit 3). Small cap value stocks currently trade at a multiple of 8.5 times earnings compared to large cap stocks at 21.9 times earnings—a discount briefly touched in 2021 but not persistently available in more than 20 years.⁵ Even a moderate narrowing of this gap could provide small cap value with a leg up.

4. Source: FactSet; data as of June 30, 2023.

5. Source: FactSet; data as of June 30, 2023.

Exhibit 3. Small Cap Value's Discount to Large Cap Has Widened to Early-2000s Levels

Spread Between the Weighted Average Price-to-Earnings Ratios of Russell 2000 and S&P 500 Indexes, October 1997 through June 2023



Source: FactSet; data as of June 30, 2023.

Past performance does not guarantee future results.

Searching for Potential Winners in a Vast and Varied Opportunity Set

While we believe small cap valuations are broadly compelling, we caution against reading too much into index-level statistics. In our view, selectivity is particularly important in this large and diverse market.

There are thousands of publicly traded small cap and microcap companies across the US with differentiated profiles participating in a wide range of industries. That said, smaller businesses generally share a number of characteristics that distinguish them from larger ones, including narrow product lines, geographic concentration, shallow organizational depth and limited access to capital markets. These characteristics, combined with limited analyst coverage and low trading volumes, have resulted in price volatility that savvy active investors historically have leveraged to generate alpha, as depicted in Exhibit 4.

Exhibit 4. Though Small-Cap Markets Have Offered Alpha-Generating Opportunities...

Active Manager Success Rate versus Index, through June 30, 2023

	MTD	QTD	YTD	1Y	3Y	5Y	10Y	
US Large Blend	40	24	18	25	28	16	8	LEGEND Managers that Beat the Index >75% 50%-75% 25%-50% <25%
US Large Value	36	42	36	44	56	50	44	
US Large Growth	35	35	31	23	9	6	5	
US Small Blend	67	29	47	63	87	76	56	
US Small Value	69	64	78	89	79	80	55	
US Small Growth	43	19	31	24	62	85	73	

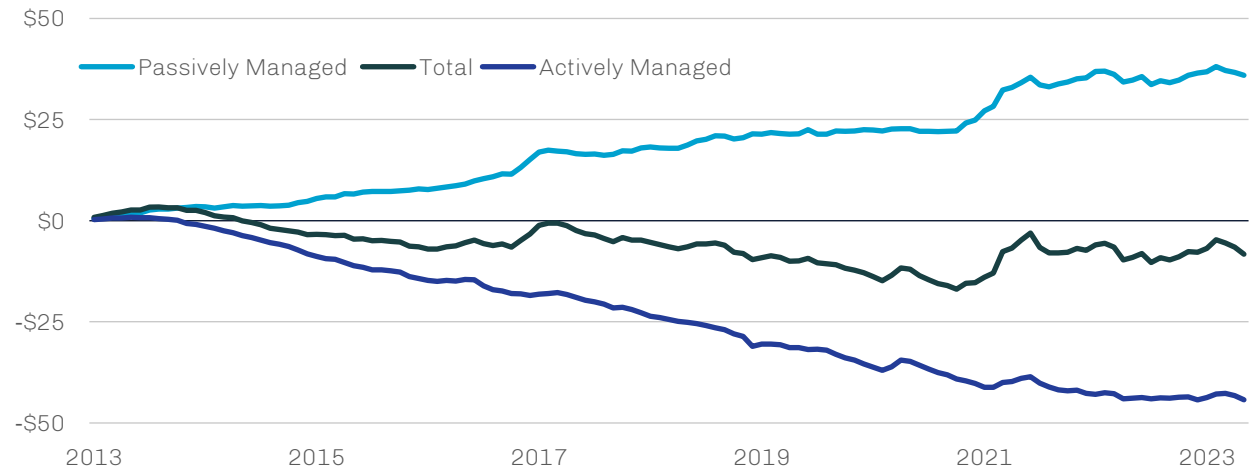
Source: Morningstar; data as of June 30, 2023.

Past performance does not guarantee future results.

Despite the accretive returns generated by active managers in the small cap space, investors have increasingly opted for passive strategies more appropriate for beta exposure in more-efficient markets; this is illustrated in Exhibit 5, using the Morningstar Small Cap Value category as an example. We believe the bias toward passive strategies further enhances the potential an active manager can add through selective investment in names outside the benchmark, including microcap stocks.

Exhibit 5. ...Investors Continue to Flock to Passive Strategies

Morningstar Small Cap Value Category Cumulative Net Flows in Billions, January 2013 through June 2023



Note: Small Cap Value Category includes both open-end funds and exchange-traded funds.

Source: Morningstar; data as of June 30, 2023.

As noted earlier, small cap stocks, due to their higher risk, historically have outperformed large cap names by a fair margin. We believe this performance advantage can be widened further by focusing on businesses that not only are trading at what may be discounts to their normalized valuations but also may have visible and fundamentally sound catalysts for price normalization. This process can help distinguish between temporarily under priced names and “value traps” deserving of low valuations.

We believe discipline exercised in the price paid for stocks should ultimately be rewarded.

Conclusion

While small companies historically have led markets in up periods, March’s banking turmoil appears to have disproportionately punished small and microcap stocks, resulting in extreme discounts to long-term average valuations and perhaps providing favorable entry points. We believe history is on our side, and the potential for mean reversion at the index level may serve as a tailwind for small cap stocks—and small cap value stocks in particular. When this revaluation may occur is unknown, but we believe that those who exercise discipline in the price paid for stocks should ultimately be rewarded.

The opinions expressed are not necessarily those of the firm. **These materials are provided for informational purposes only.** These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation to buy, hold or sell or the solicitation or an offer to buy or sell any fund or security.

Past performance is not indicative of future results.

Risk Disclosures

All investments involve the risk of loss of principal.

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.

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.

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

Active management is an investment management approach in which an investor, a professional money manager or a team of professionals tracks the performance of an investment portfolio and makes buy, hold and sell decisions about the assets in it.

Alpha is a measure of risk-adjusted performance. Alpha measures the amount that the investment has returned in comparison to the market index or other broad benchmark that it is compared against.

Beta is a measure of the fund's volatility (risk) relative to the overall market. The higher the fund's beta, the more the fund price is expected to change in response to a given change in the value of the market.

Exchange-traded funds (ETFs) are a basket of securities that tracks an underlying index. ETFs can contain investments such as stocks and bonds.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Mean reversion is a theory that asset prices will eventually return to their long-term average levels.

Passive management is an investment management approach that seeks to mirror the performance of a designated index. One cannot invest directly in an index. Indexes do not incur management fees or other operating expenses.

Price-to-earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to the earnings per share. Generally, a high P/E ratio means that investors are anticipating higher growth in the future.

Value trap refers to a stock that trades at low valuation metrics but may never appreciate because of intractable problems.

Volatility is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

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

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 higher price-to-value ratios and higher forecasted growth values. 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 large-cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

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 growth (two years) and higher sales per share historical growth (five 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 growth (two years) and lower sales per share historical growth (five years).

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. 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.

Large Blend Morningstar Category: Large blend portfolios are fairly representative of the overall US stock market in size, growth rates and price. Stocks in the top 70% of the capitalization of the US equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of US industries and, owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

Large Growth Morningstar Category: Large growth portfolios invest primarily in big US companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the US equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly expanding industries.

Large Value Morningstar Category: Large value portfolios invest primarily in big US companies that are less expensive or growing more slowly than other large-cap stocks. Stocks in the top 70% of the capitalization of the US equity market are defined as large cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value and cash flow).

Small Blend Morningstar Category: Small blend portfolios favor US firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks, while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Small Growth Morningstar Category: Small growth portfolios focus on faster-growing companies whose shares are at the lower end of the market-capitalization range. These portfolios tend to favor companies in up-and-coming industries or young firms in their early-growth stages. Because these businesses are fast-growing and often richly valued, their stocks tend to be volatile. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value and cash flow) and high valuations (high price ratios and low dividend yields).

Small Value Morningstar Category: Small value portfolios invest in small US companies with valuations and growth rates below other small-cap peers. Stocks in the bottom 10% of the capitalization of the US equity market are defined as small cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value and cash flow).

FEF Distributors, LLC ("FEFD") (SIPC), a limited purpose broker-dealer, distributes certain First Eagle products. FEFD does not provide services to any investor, but rather provides services to its First Eagle affiliates. As such, when FEFD presents a fund, strategy or other product to a prospective investor, FEFD and its representatives do not determine whether an investment in the fund, strategy or other product is in the best interests of, or is otherwise beneficial or suitable for, the investor. No statement by FEFD should be construed as a recommendation. Investors should exercise their own judgment and/or consult with a financial professional to determine whether it is advisable for the investor to invest in any First Eagle fund, strategy or product.

First Eagle Investments is the brand name for First Eagle Investment Management, LLC and its subsidiary investment advisers.

© 2023 First Eagle Investment Management, LLC. All rights reserved.

M-TL-NPD-SMAWOR-D-LT