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U.S. Small Cap with a Value Tilt

Three Good Reasons with a Side of The Simpsons: *Exxxxcelllent*

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It's clearly no surprise that markets are acting like a spoiled brat, and when things don't go as expected, tantrums immediately ensue.

But to be fair, the macro landscape, consisting of a global energy crisis, the Russia-Ukraine War, recession fears, supply chain disruptions, other geopolitical tensions, and rampant inflation, is very challenging.

In the United States, central bank officials pivoted sharply after the first quarter from tentative to solidly hawkish, and even after raising rates with a steady cadence over the past four months, Federal Reserve (Fed) officials remain resolute in hiking and holding rates higher to defeat public enemy No. 1 – inflation. But what does this mean for U.S. equities, and more specifically for U.S. small cap stocks? You may want to consult with The Simpsons. **Yes, you read that right**; the American animated sitcom has an uncanny reputation for predicting the future. Perhaps most famously, the show predicted Donald Trump would become President of the United States and did so way back in 2000! We wouldn't dare claim to be *that* clairvoyant. And while – to our knowledge at least – they haven't specifically foretold of small cap equities' success, they might be persuaded to do so after reading our take. We think a soft landing for the Fed is improbable, and given the environment, we currently see (at least) three favorable signals for why *reasonably priced* U.S. small cap stocks might appeal to investors.

Bear Market and Recession – The Good News

First, U.S. small cap stocks are currently in a bear market. Since peaking in early November last year, the Russell 2000® Index is down 24.5% through August, while the Russell 1000® Index is down 18.2%, since peaking in early January. In that time, and in fact more broadly since 1999, analysts have been more negative on small cap prospects than on their larger counterparts; however, current levels suggest the tide may be shifting in favor of small cap equities.

Our research indicates that analysts are more likely to revise earnings estimates up for large cap companies than they are for small cap companies. The analyst revision ratio depicted in the chart below measures the number of analysts revising earnings up divided by the number of analysts revising earnings down, so a higher ratio means more analysts are revising earnings up than down, while a lower ratio indicates more analysts are revising earnings down than up. Since 1999, the large cap up/down earnings revision ratio has averaged 1.2 (the dotted blue line), while the small cap up/down earnings revision ratio has averaged 0.9 (the dotted gray line). In other words, on average, for every analyst lowering estimates for large cap companies, 1.2 analysts are raising estimates, whereas for small cap, for every analyst reducing estimates, 0.9 analysts are raising estimates.

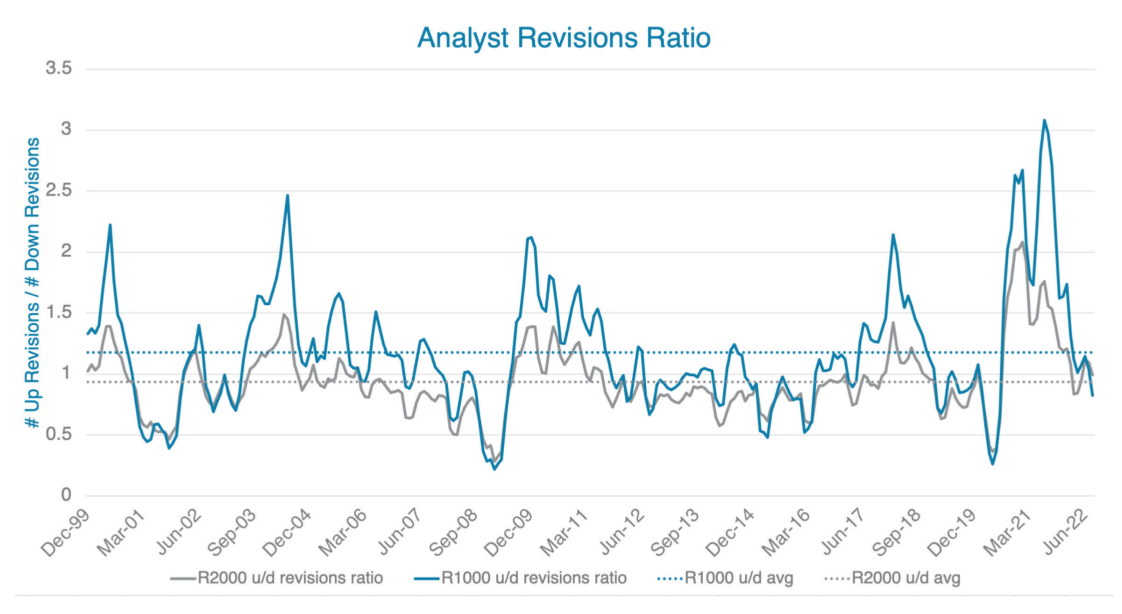
But why have analysts been more bullish on large cap stocks?

A few reasons for the relative optimism (i.e., large over small) likely include:

- lower risk
- higher visibility into earnings
- access to (cheaper) capital
- economies of scale
- negotiating favorable terms with suppliers

*In this paper, references to large cap stocks and small cap stocks are those represented by the Russell 1000® Index and Russell 2000® Index, respectively.

This was especially the case during the pandemic, as analysts were clearly more favorable on large cap stocks than small cap stocks. As shown, the revision ratio for large cap stocks, the solid blue line, peaked at more than 3, while the revision ratio peaked at just over 2 for small cap, the solid gray line.



That said, sentiment may be changing. Analysts were perhaps a little too optimistic with large cap earnings and have taken them in rather drastically year to date. The revision ratio for large cap stocks is now below the long-term average and below small caps, while small caps are above their long-term average, leaving the largest spread in favor of small caps relative to large since at least 1999. As one may have guessed, there is not necessarily a correlation between large caps outperforming small caps and analysts favoring large caps. This would not make much sense given analysts seem to have a strong, enduring bias for them, but the current trend of analysts favoring small caps is encouraging for small cap company fundamentals.

Second, recession also appears priced in for small cap stocks. Earnings per share for the Russell 2000® has fallen 22% since the beginning of the year, and consensus forecasts next year's earnings growth at -1.6%. Recession could be good because small cap stocks tend to perform quite well exiting recessionary environments.

Based on The National Bureau of Economic Research (NBER) recession indicators, during the past six downturns, small caps returned 13.8% on average in the six months after the midpoint of a recession and returned 17.6% on average in the six months following the end of a recession. Large caps do well, too, returning 8.0% and 10.3% on average, respectively. Of course, many unknowns remain – have or will we enter a recession and, if so, how long will it last? We have had two consecutive quarters of negative GDP growth, but is that enough to qualify as a recession? NBER hasn't made it official yet. As of this writing, the Atlanta Fed expects year-over-year GDP growth for the third quarter to be 0.5%. This isn't exactly white-hot growth expectations, but it is not exactly recessionary levels either. Nevertheless, **the analyst revision ratio coupled with recessionary performance signal a favorable environment for small caps, suggesting a potential investor preference for small over large**.

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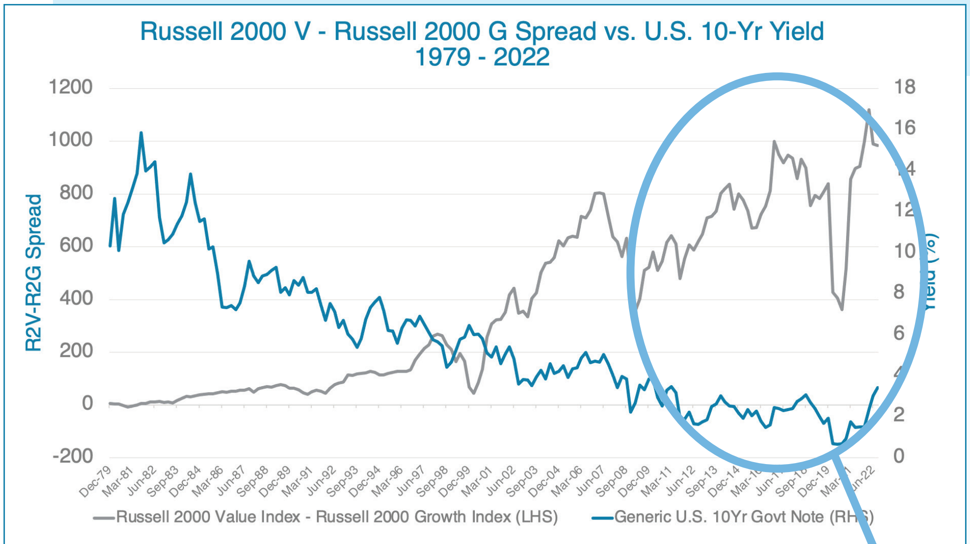
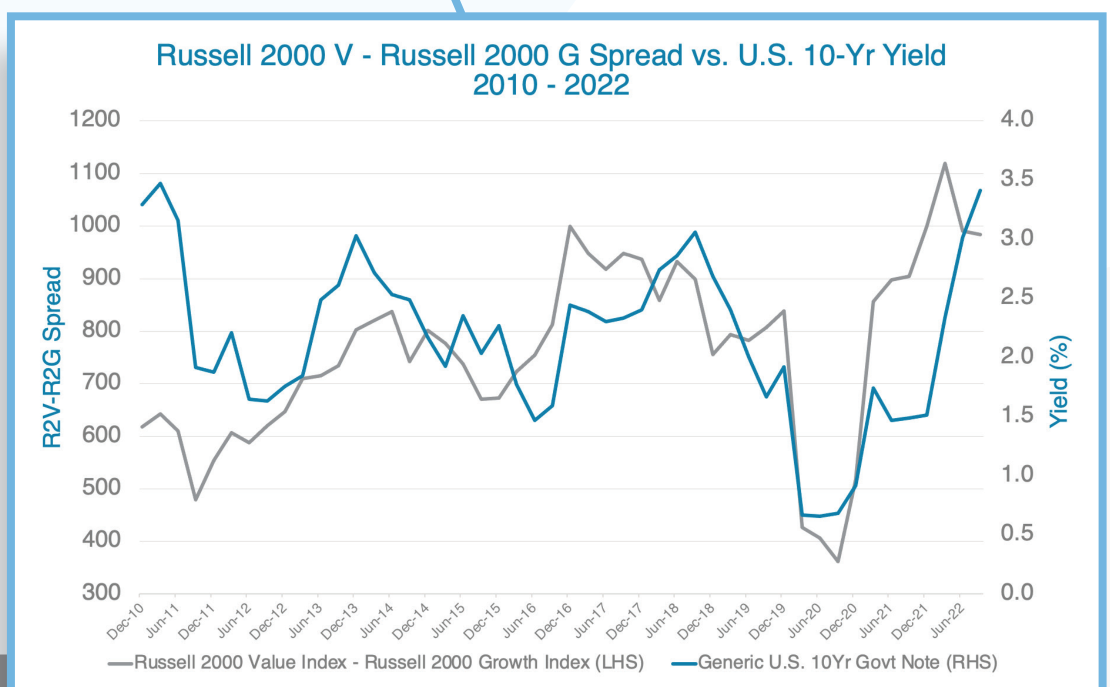
small caps returned **17.6%** on average in the six months after the **end** of a recession

Value-Growth Performance Correlation with Yield

Recently, financial professionals have been debating whether value is ostensibly an interest rate bet. The current strong correlation between interest rates and value performance compels one to believe there is, in fact, a positive relationship; however, this may be a recent phenomenon, and by recent, we mean post Global Financial Crisis (GFC). Over the long term, value performance and interest rates are not correlated.



You can see this in the chart above. The blue line is the U.S. 10-year Treasury yield, and the gray line is the spread in the Russell 2000® Value Index versus the Russell 2000® Growth Index, so when the gray line is moving up, value is outperforming growth. There isn't much of a correlation—positive at least (r = -0.81)—until you get to the aftermath of the GFC (r = 0.45).



The light blue circle highlights the post-GFC era in which the relationship between higher interest rates and value outperforming growth appears to be positive. The callout chart beginning at the end of 2010 illustrates this relationship more clearly.

It's tough to say exactly why there is suddenly a (positive) relationship, but we have a few theories. One possibility is that it has something to do with the unprecedented, persistent, and extremely low interest rate environment. This protracted period of near-zero interest rates has allowed high growth, speculative companies to proliferate, as they rely more heavily on distant future cash flows.

To illustrate this point, consider the composition of the Russell 2000® Index. Prior to the GFC, when interest rates were arguably at more normal levels, the weight of unprofitable companies (also called non-earners) in the Russell 2000® was 14%. As interest rates fell and remained low, speculative companies swelled along with their weight in the Index and valuations; non-earners more than doubled, reaching 30% of the index as of June 2022.

So as demonstrated, discounting high growth stocks back to the present to derive valuation in an ultra-low interest rate environment can lead to very lofty present values. Value stocks, on the other hand, typically already have earnings so are less reliant upon distant future cashflows. But what does that have to do with the current positive correlation? Well, interest rate levels have different implications for growth and value equities. **Meaning at very low levels, high growth stocks are much more attractive because cheap capital encourages risk-seeking behavior, while value stocks are the more mundane, dependable option.**

Another possibility for the recent positive relationship builds upon our first supposition (interest rate levels) and involves the changes in interest rates. Research suggests growth and value stocks do not react differently to changes in interest rates (also called duration); however, coming off such an extremely low base (again near-zero interest rates), we suspect one may need to consider the convexity effect, which is to say that at very low interest rates, changes to interest rates may have a larger impact on stock prices. This second-order effect potentially helps justify the recent positive correlation between interest rates and value's outperformance.

Rising costs of capital might also contribute to in-tandem movement between interest rates and value outperformance. Higher interest rates make borrowing capital more expensive and increase opportunity cost, so as the Fed continues marching higher, competition for investor dollars likely increase, possibly hampering growth opportunities for some of the more highly capital-intensive growth stocks. Also, these companies often carry significant levels of intangibles such as good will on their books. As multiples contract with higher interest rates, valuation of these intangibles should depreciate. Independently, this alone probably doesn't explain the positive relationship between interest rates and value outperformance; however, taken together (interest rate levels, the convexity effect, and higher cost of capital), they are likely contributing factors. This also suggests the correlation may weaken once interest rates reach historically normal levels and changes in interest rates are less dramatic. So, what would a return to normal interest rates mean for investors? This would likely result in a new, lower normal for stocks and especially for high growth stocks, as price multiples adjust. At higher rates regular cash flows are more important drivers of value, so those without cash flow will be hurt the most. Put another way, high growth stocks would become less attractive, while stocks with solid fundamental underpinnings would become more enticing. This, along with the first section of the paper, adds conviction not only for owning small cap equities but small cap stocks with a value tilt.

Value Cheaper Than Growth Relative to History

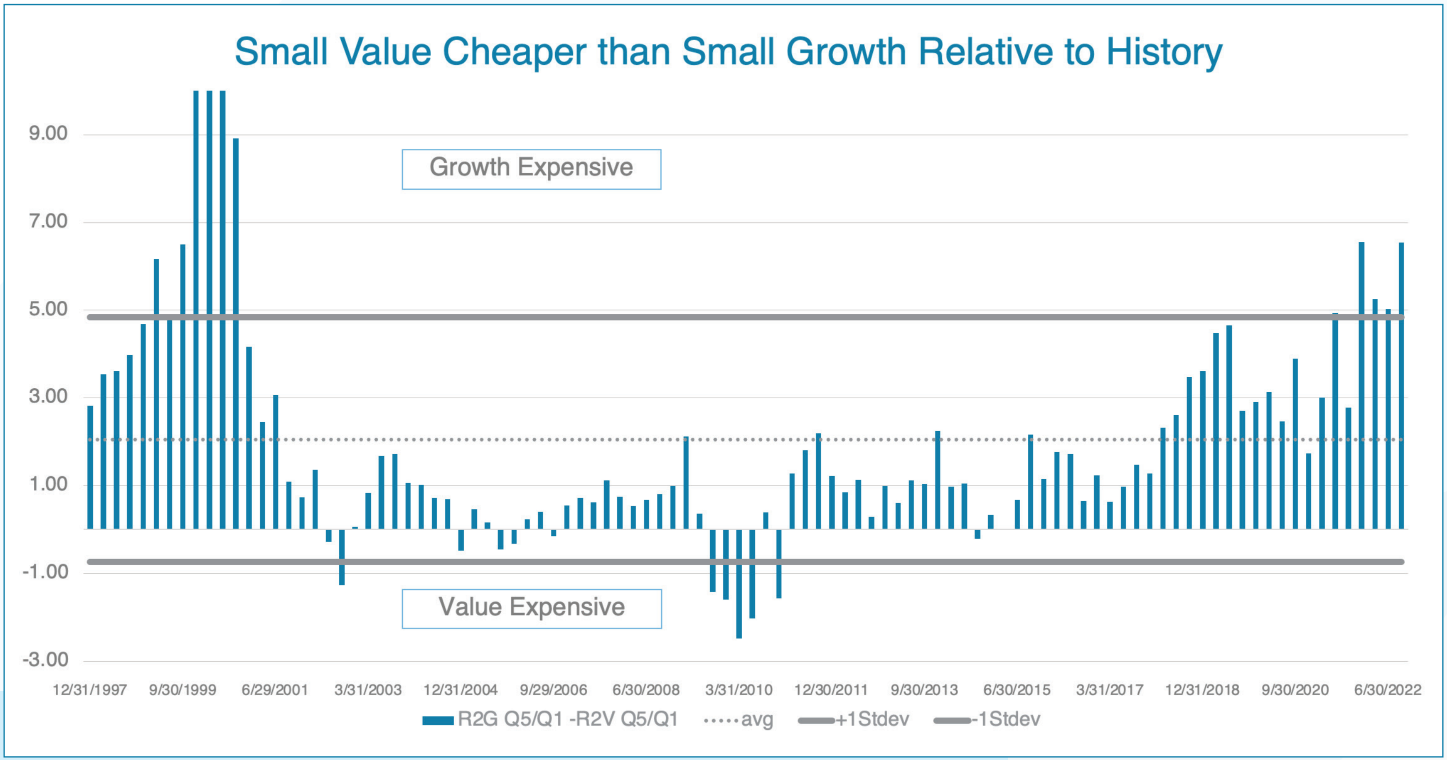
Equally notable, value's discounted price relative to growth further bolsters conviction for a value bias. Many of us recall the sky-high valuation premium growth had relative to value during the tech bubble of 1999/2000. We're not quite at those levels, but value is as cheap as it has been relative to growth since those days (more on this below).

Low interest rates, stimulus, and record money supply set the stage for growth's outperformance relative to value. Low interest rates induced investors to take more risk, stimulus allowed new entrants to equity markets, many of them chasing high reward opportunities (e.g., meme stocks), and high levels of money supply made access to funds and margin readily available.

But those inputs are changing. Going back to The Simpsons, the recent (growth) environment reminds us of two sort-of opposing characters – siblings Bart and Lisa. Bart is a rule-breaker, can be somewhat reckless, and maintains a free spirit while applying his street smarts, while his sister Lisa follows rules and takes a disciplined approach based on knowledge. The recent run of growth investors – and particularly those participating in the meme mania – take on Bart-like characteristics given their penchant for piling into companies, sending prices soaring, without any real fundamental rationale supporting their decision-making. Lisa would likely argue for a more measured approach steeped in fundamental signals. That said, the Lisa environment has been far out of favor for several years, while Bart has been able to shine. However, it may be Lisa's turn in the spotlight. Not-so-transitory inflation has ushered in a new regime; rising interest rates, lapsing stimulus, quantitative tightening, and liquidity drying up should encourage an equity repricing, likely resulting in a retreat of high growth stock valuations; meaning those who previously preferred the Bart environment would favor Lisa's.

Getting back to the value-growth valuation spread, the chart following, which would surely be approved by Lisa, shows small cap value's valuations relative to small cap growth's*. The bars measure the expensiveness of growth relative to value. Bars breaching the top gray line indicate value stocks are cheap relative to growth, while bars breaching the bottom gray line indicate value stocks are expensive relative to growth. As illustrated, value stocks are currently the cheapest they have been relative to growth since the tech bubble, and growth stocks are reaching valuations only ever seen during the dot-com bubble.

Why does this matter? As the new regime takes hold, investors will reprice equities at a higher cost of capital, likely resulting in lower valuations for high growth stocks; this implies **investors will likely lean more heavily on company fundamentals** when assessing opportunities going forward. We do not think growth stocks will be poor investments going forward; however, those based on fundamentals, like companies with actual earnings (i.e., a value tilt), should perform better. Put another way, investors may finally prefer Lisa's logic over Bart's imprudence.



*Methodology

The computation involves dividing the median price-to-earnings (PE) ratio of the most expensive PE quintile (Q5) by the median PE ratio of the cheapest quintile (Q1) for the Russell 2000® Growth and the Russell 2000® Value. The resulting figure of the Russell 2000® Growth is then divided by the resulting figure of the Russell 2000® Value, providing a measure of expensiveness.

Note that this chart is truncated at 10.

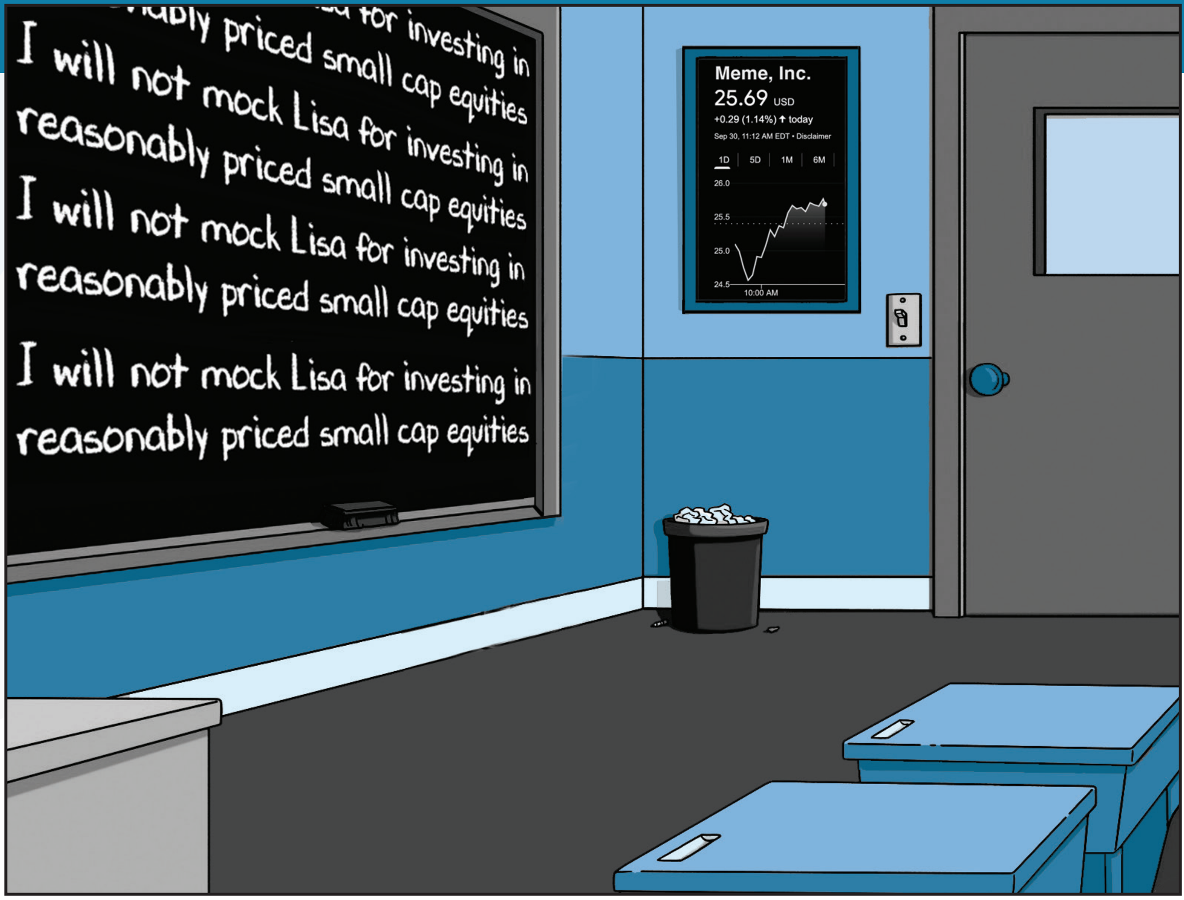
The Takeaway

The selloff across markets presents opportunities for investors, and to be sure, we are in the midst of a regime shift. Capital is no longer essentially free and ultra-low interest rates are a thing of the past, at least for now.

These elements alone change the investment landscape from the previous decade or so and suggest a shift from a Bart-like mindset to a Lisa mentality. We share in her analytical approach and argue the case not only for small cap companies, but also those exhibiting strong fundamentals.

To rephrase, we mean small cap equities with exposure to value, and just in case you are thinking this limits the opportunity set to the designated index style (i.e., value vs. growth index), investors can achieve a value tilt in the Russell 2000® Growth Index just as easily in the Russell 2000® Value Index.

We don't believe we are the only ones with this outlook. Although not necessarily pounding the table on small caps, analysts have turned more bullish on them relative to large, demonstrated through their recent revisions activity. Additionally, the reversal in value-growth performance suggests investors are becoming aware of the economic paradigm shift. **Taken together, one logical place to be is at the intersection of small cap stocks and attractive valuations.** It seems only fair – we've been in a Bart-like environment for years, now it's Lisa's turn. Bart will likely need convincing, though, so the teacher may hold him after school to hammer the point home.



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