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Small Cap Stocks: Brighter Days Ahead?

By: Phil Fabrizio, CFA

A long-held tenet of investing is that small market capitalization stocks (small cap stocks) should produce a return premium relative to those with large market capitalizations (large cap stocks) over time.[1] Traditionally, this assumption was predicated on the expected higher growth potential, greater risk, and lesser liquidity of small cap stocks when compared to their large cap brethren and was also supported by a historical pattern of small caps' outperformance versus large caps over extended periods of time.[2]

Yet, in recent years small cap stocks have frustrated investors with underwhelming performance relative to large caps, calling into question whether a small cap return premium still exists that would support an allocation to the asset class. In this paper, we will examine the historical record of small cap stocks' performance relative to large caps, reasons for the recent small cap performance shortfall, and discuss factors that may lead to the reversal of this performance gap.

Historical Performance of Small Cap Stocks

Exhibit 1 below depicts the performance of small cap stocks, represented by the Russell 2000 Index, compared to a widely referenced large cap stock benchmark index, the S&P 500 Index, over various trailing time periods ended 6/30/2024:

Exhibit 1: Small Cap vs. Large Cap Trailing Performance

	1 Year	3 Year	5 Year	10 Year
Russell 2000 Index (Small Cap)	10.1%	-2.6%	6.9%	7.0%
S&P 500 Index (Large Cap)	24.6%	10.0%	15.0%	12.9%

Source: FactSet as of 6/30/2024. All data expressed as total return (including dividends); returns for periods longer than one year are annualized.

As the exhibit highlights, the last few years have been particularly challenging for small cap stocks on a relative basis. Over the trailing three years, for example, the Russell 2000 Index has lagged the S&P 500 Index by 12.6 percentage points annualized.

Looking at a longer history, however, we see that there have been other periods in the past when small caps experienced a sustained period of underperformance versus large caps. The chart in Exhibit 2

[1] The market capitalization of a stock equals the stock's price multiplied by the number of shares outstanding. Small capitalization stocks are generally defined as those with market capitalizations less than $2 billion.

[2] A well-known research paper produced in 1992 by Nobel laureates Eugene Fama and Ken French introduced the "Fama French Three-Factor Model" for pricing stocks based on research indicating that small capitalization stocks tend to outperform large capitalization stocks over time.

below shows the historical relative performance of small cap and large cap stocks measured over rolling three-year time periods:

Exhibit 2: Small Cap vs. Large Cap Performance Differential

Source: FactSet. Trend line depicts the difference in annualized returns between the Russell 2000 Index and the S&P 500 Index over rolling three-year periods through June 30, 2024.

As seen in the chart, over the last 40 years there were two other distinct periods when small cap stocks underperformed: from the mid-1980's to the early-1990's, and from the late-1990's through the early-2000's. During the latter period, in fact, at one point the three-year performance lag for small caps reached an astounding 20 percentage points. The latest string of small caps' underperformance has not reached the same magnitude, but has lasted for a longer duration, extending back to 2014.

Current Headwinds for Small Cap Stocks

There are multiple drivers of this performance disparity in recent years that have combined to present a perfect storm of challenges for small cap stocks. To start, small cap companies typically borrow more money given they are generally less profitable and have less cash on hand. As borrowing costs have risen rapidly over the last few years, many small cap companies subsequently have been challenged with higher debt costs negatively affecting their profitability (and subsequently pressuring their stock prices).

The current stage of the business cycle, where interest rates remain high and economic growth is slowing, also serves as a hindrance, as small cap stocks tend to be more sensitive to economic cycles than large cap companies. As such, small caps typically perform better coming out of a recession as well as when economic growth is expanding. Instead, an environment where growth is slowing tends to favor larger companies with higher quality balance sheets.

In addition, market sentiment has shifted in recent years in favor of large cap companies seen as having the greatest growth potential. Specifically, growing investor enthusiasm for technology-related companies—exemplified by the meteoric rise of the so-called "Magnificent 7"[3] in recent years and excitement around companies benefiting from the development of artificial intelligence technology—has

[3] "Magnificent 7" cohort includes Apple, Microsoft, NVIDIA, Amazon, Alphabet, Meta Platforms, and Tesla.

fueled the performance of large cap stock indices. In fact, the largest sector in the S&P 500 Index is the high-flying technology sector, which makes up more than 30%[4] of the index by value; over the 12 months through 6/30/2024, that sector appreciated 42%.[5] In turn, large cap stocks have continued to attract a much greater share of investors' capital, which has helped drive their prices even higher.

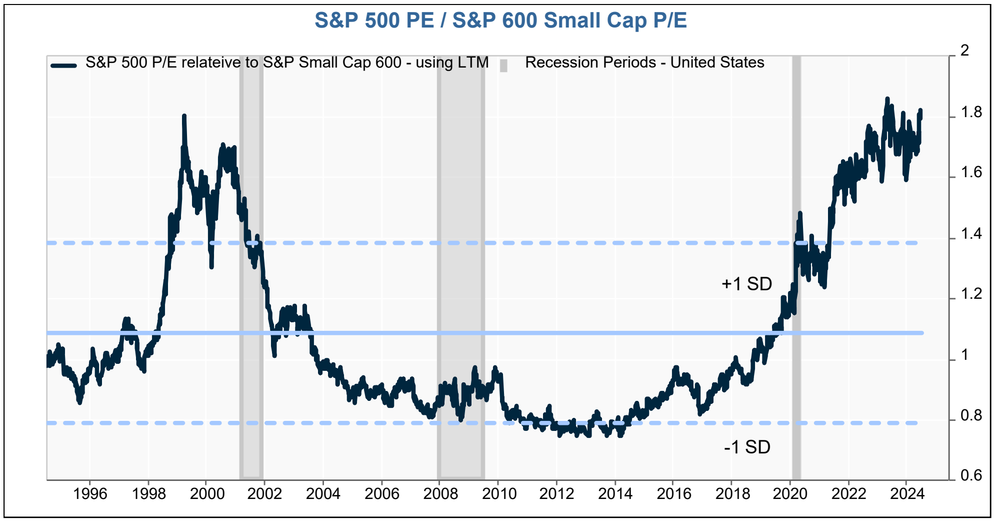
In contrast, small cap stock indices are anchored to certain economic sectors that have been more out of favor with investors of late. The Russell 2000 Index, for instance, has an approximate 35%[6] combined weighting to financial and industrial stocks, which are the two largest sector weightings in the index, versus 21% combined in the S&P 500 Index. In the financial sector, many of those companies include small regional banks whose stocks have faced pressure since the Silicon Valley Bank crisis in 2023.

Are Better Times Ahead?

Certainly, it is hard to state that investors should be disappointed in an asset class that has returned 10% over the trailing year. Yet, many asset allocators relying on the small cap return premium when developing portfolio construction strategies continue to look for "silver linings" in the recent relative struggles of small cap stocks. In our view, we believe there are several factors that may position small cap stocks for better relative performance down the road.

For one thing, the divergence in performance between small and large cap stocks has led to an extreme distortion in the relative valuations of the two camps. Looking at the price-to-earnings (P/E) ratio of large cap stocks relative to that of small caps, we see in Exhibit 3 that large cap stocks are trading at a relative valuation premium of well over one standard deviation above the long-term average. As the chart also shows, this large cap valuation premium has trended above the historical average for over five years and has only continued to expand over that time:

Exhibit 3: Equity Relative Valuations

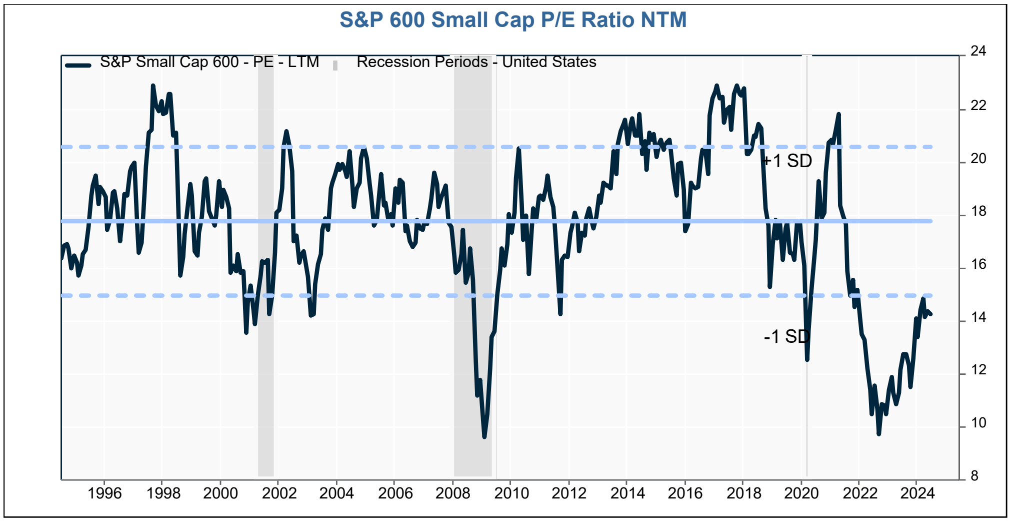


Source: FactSet as of 6/30/2024. S&P 600 Index is used to represent small cap stocks because it excludes unprofitable companies.

[4] Source: FactSet, as of 6/30/2024, based on market capitalization
[5] Source: FactSet, as of 6/30/2024
[6] Source: FactSet, as of 6/30/2024

In addition, simply examining the P/E ratio of small cap stocks alone paints a similar picture. **Exhibit 4** below highlights that small cap stocks recently traded at a P/E ratio of approximately 14x, approximately one standard deviation below the asset class's long-term average of nearly 18x:

Exhibit 4: Historical P/E Ratio of Small Cap Stocks



Source: FactSet as of 6/30/2024

Thus, small cap stocks look significantly discounted from a valuation standpoint, whether analyzing them relative to large caps or versus historical averages. While valuation itself isn't necessarily a catalyst for near-term stock performance, it is worth noting that small cap stocks enjoyed a strong relative performance period in the years after the valuation disparity between small- and large-cap stocks last reached such extremes, in the late-1990's.

In considering other factors that could help provide a tailwind for small cap stocks, one of the most important, in our view, would be a declining interest rate environment. This would help ease borrowing pressures on small cap companies and help boost their profitability. While the likelihood of the Federal Reserve cutting interest rates has diminished since the start of the year, should the Fed eventually enact a rate cut small caps would likely be positioned to perform better. Another scenario that could benefit small cap stocks is if expanding economic growth leads to an acceleration in profits at smaller companies.

Outside of the macro environment, a sustained environment where a handful of mega cap technology stocks are not driving the majority of equity market performance would likely narrow the relative performance gap between large and small stocks as well.

Conclusion

Despite recent relative performance trends, we believe small cap stocks are still an important asset class for investors to utilize when constructing a diversified portfolio. While small caps currently face multiple challenges, they have historically rewarded patient investors with attractive returns. While we cannot predict the timing of a return of the small cap return premium, we believe it is reasonable to expect several of the current headwinds to dissipate over time, which should provide a better environment for small cap asset class performance moving forward.

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