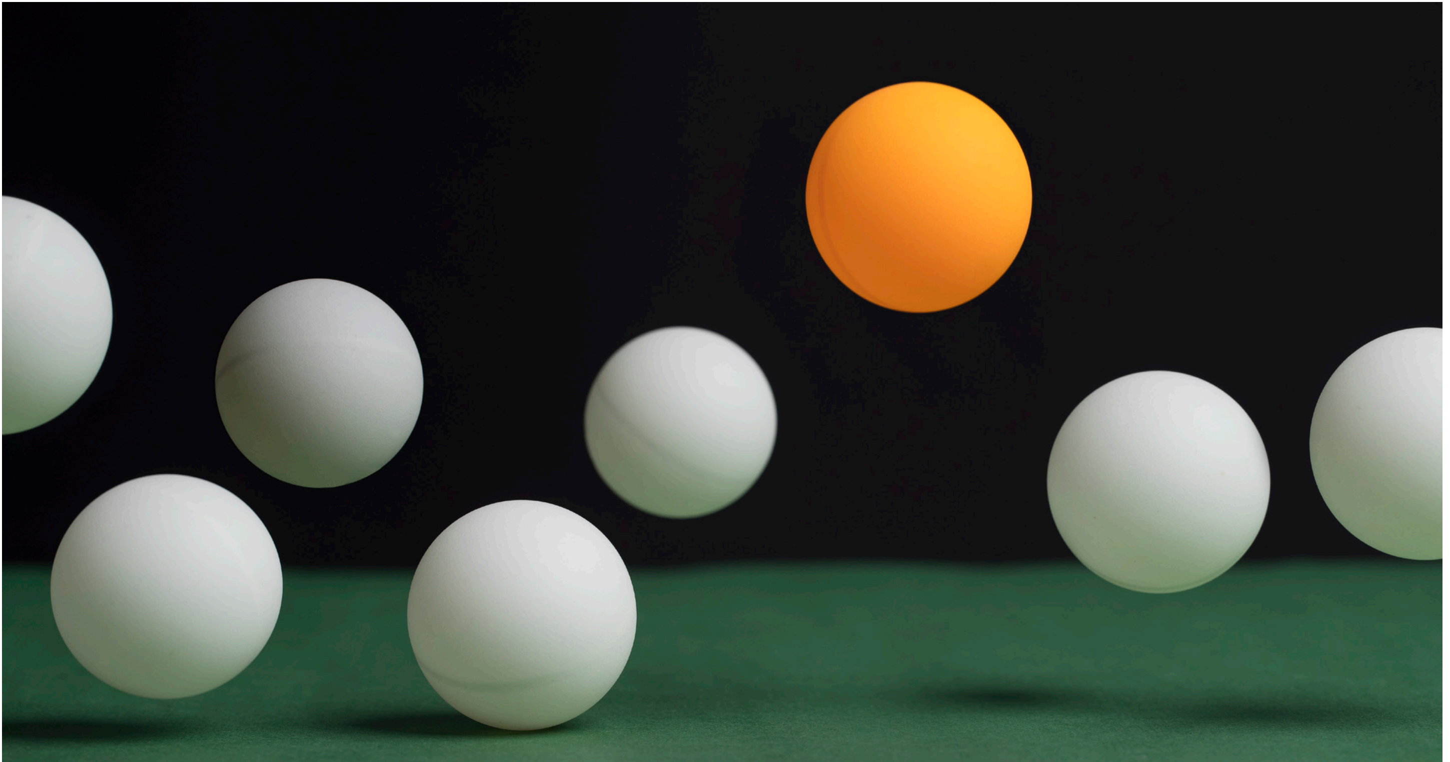
MARKETS IN FOCUS
Small caps are not a monolith



Under the surface: Hidden-gem opportunities

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By Matt Orton, CFA, and Joey Del Guercio

It stands to reason – and is taught in university finance classes – that small caps should both outgrow and outperform large caps over an investment cycle. After all, there's a reason we assign a size premium to small-cap companies in the Fama-French extension of the Capital Asset Pricing Model (CAPM) to calculate a company's expected return. The size premium embodies the mathematical assumption that small companies outgrow large companies.

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To many investors, however, this doesn't seem to be the case anymore. Institutions and investors used to seek diversification from small caps, but some have turned a blind eye to this asset class as a result of accommodative monetary policy over the last decade alongside the introduction and explosive growth of new alternative assets such as private credit. The recent relative outperformance of large caps is very dissimilar to the historical oscillations we used to see between these two strata of equities. Now, faced with more competition and recent poor relative performance, small caps are losing space in portfolio allocations and receiving much less attention than they have over the past few decades.

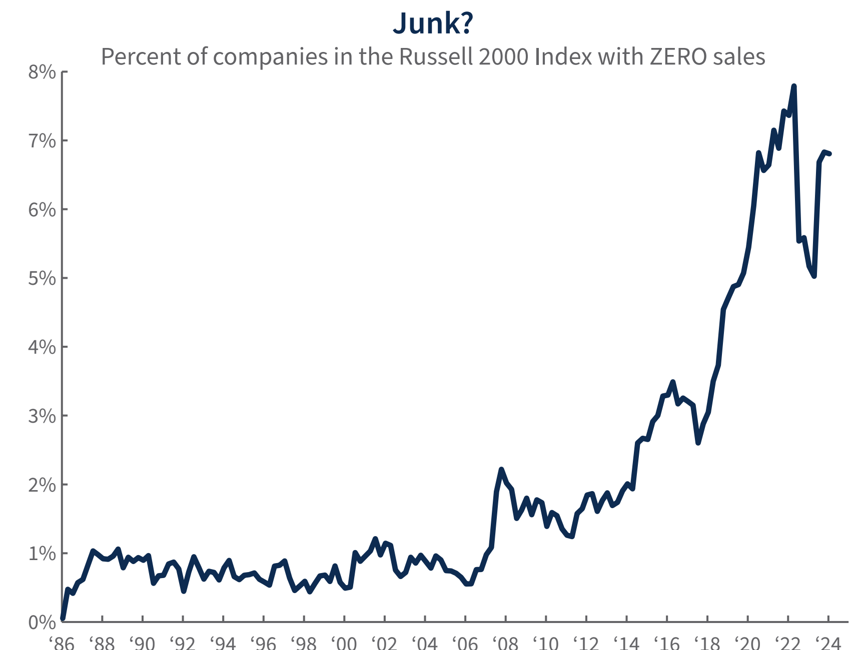
We would argue that small caps deserve more of a place in investor portfolios than they're getting. Many of the criticisms against the asset class paint it as a monolith. In reality, small caps are incredibly diverse and require an active approach.

What is a small cap?

Small caps have evolved significantly and span a wide range of company sizes and levels of sophistication. Commonly, a small-cap company has a market capitalization between $300 million and $2 billion, but there's currently a company in the Russell 2000® Index with a market capitalization in excess of $50 billion.[1]

One major mistake investors make is taking the Russell 2000 Index to be a reflection of the average small cap. Doing so fails to recognize some extreme differences in operating models and overall quality between sectors and industries (notably biotechnology). Understanding this nuance is essential when analyzing small caps. Roughly 42% of companies in the index didn't have earnings in 2023, and the same amount aren't expected to be profitable in 2024. Right now, almost 7% of the index doesn't even have sales, let alone earnings. Moreover, 42% of the index's debt is revolving, compared to the S&P 500 Index's 7.8% proportion of revolving debt.

But this leaves us with 40% of the Russell 2000 Index – 779 companies – that are profitable and don't have any revolving debt. There are some bad apples, but they are not and should not be considered typical small caps. The important thing to take away with small caps is that the benchmark isn't the ballast. This index spans from niche high-quality businesses boasting defendable moats and consistent cash flows to biotech companies with no revenues awaiting one binary U.S. Food and Drug Administration outcome after another.



Source: Bloomberg and Furey Research Partners, as of 3/31/24.

It's important that investors not anchor their opinions of small caps to generalizations they hear about the Russell 2000. While we agree that a lot of the Russell 2000 is junk, we think there are plenty of attractive companies hiding behind the misleading narrative about the index. Quality and selectivity should permeate all investment decisions, but this is even more true down the market-cap spectrum. The dispersion in quality between companies within the index has grown steadily over time, and we believe quality small caps – those with high returns on equity and strong balance sheets, plus robust earnings growth and free cash flows – deserve an allocation in most portfolios, and especially in every portfolio that decides to hold small caps. These high-quality companies undeniably outperform their junky peers over the long run and are less susceptible to deep drawdowns. After all, are you going to sell the company with earnings or the one without earnings during a recession? The negative generalizations that have shaped the market's consensus that small caps are effectively garbage provide attractive opportunities to those willing to look under the surface. Small caps are not the monolith they're all too often painted to be.

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of March 31, 2024.

Let's break down why the negative index generalizations shouldn't keep investors up at night:

- Aren't small caps too indebted?
    - Actually, 50% of companies in the Russell 2000 have no debt at all.
- But doesn't the index have too much floating rate debt?
    - Only 72% of the companies in the index with debt have floating debt. Said differently, only 36% of companies within the index have floating debt.
- That's over a third of the index. Why shouldn't I be worried about those companies with floating debt?
    - Those 709 companies with floating rate debt all had their credit underwritten: 68% of them had earnings in 2023, 76% are expected to have earnings in 2024, and 24% even have negative net debt. After all, only creditworthy companies can take out debt.
- I thought small caps didn't make any money?
    - 8.5% of the Russell 2000 is biotech. By nature, these companies very rarely have earnings. So, yes, it's true that 42% of the index didn't have earnings in 2023, but 20% of those companies are biotech companies that are effectively venture capital assets moonlighting in the public markets.

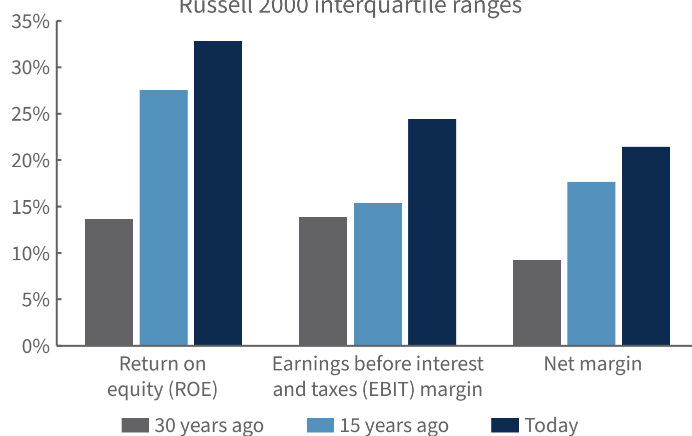
With large caps having been the investment industry darling over the past few years, we believe small caps are poised to make a comeback. Large caps have boasted much higher earnings growth, thanks mostly to the power of the mega-cap companies, fueled in large part by cheap financing. That said, large-cap earnings growth is coming up on much harder comps in the back half of 2024. On the flip side, earnings growth for small caps looks set to re-accelerate in the latter half of 2024, and if this differential in earnings-per-share growth narrows, paired with the gap in valuations, small caps stand to rebound. While the S&P 500 has made 22 fresh all-time highs year to date, the Russell 2000 still sits -13.2% below its November 2021 all-time high. This is true even after the index has rallied 29.6% from the end of October.

Furthermore, small caps present a greater growth opportunity compared to large companies. After all, it's not as tall an ask for a $1 billion company to grow 20% as it is for a $100 billion company to add $20 billion of market cap. To put things in perspective, take the record $6 trillion sitting on the sidelines in money market funds right now. That's roughly 280% of the Russell 2000's $2.1 trillion market cap, compared to 13% of the S&P 500's $45.8 trillion market cap! Small caps don't need as much fuel to take off, and when patient investors redeploy capital into the market, they'll likely look for the highest-quality opportunities as they diversify down the market-cap spectrum.

Make sure to remember that when you hear these generalized negatives about small caps: There are hidden-gem opportunities under the surface. Active management is doubly important with small caps, which are inherently more inefficient than large caps. Where do you think the alpha is with an average of six analysts covering any given company in the Russell 2000 compared to 23 in the S&P 500? Quality-biased, selective active managers have a myriad of opportunities in front of them that deserve more attention.

Quality dispersion in small caps has widened meaningfully

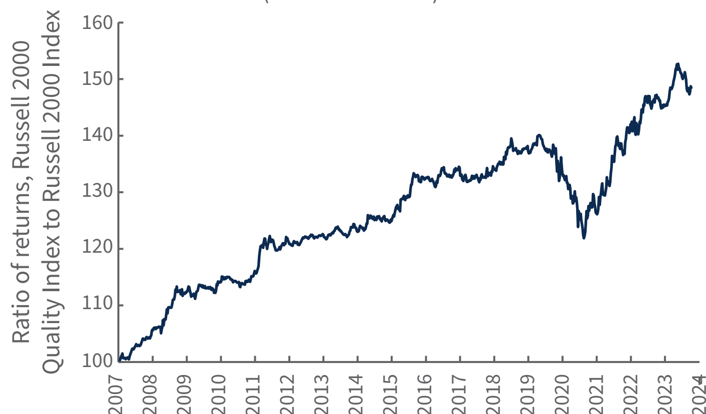
Russell 2000 interquartile ranges



Source: Bloomberg and Furey Research Partners, as of 3/31/24.

Russell 2000 Quality / Russell 2000

(re-based to 100)



Source: Bloomberg, as of 3/31/24

About the authors

Matt Orton, CFA, is Senior Vice President, Head of Advisory Solutions and Market Strategy at Raymond James Investment Management.

Joey Del Guercio is a Research Associate for Market Strategy at Raymond James Investment Management.

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Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Definitions

Alpha is a measure of the difference between a manager's actual returns and its expected performance, given its level of risk as measured by beta. A positive alpha figure indicates the manager has performed better than its beta would predict. A negative alpha indicates the manager performed worse than expected based on its level of risk. Thus it is possible for a manager to outperform an index and still have a negative alpha. In general, however, the higher the alpha the better.

Ballast, in finance, can refer to characteristics, factors or trading strategies that mitigate volatility or provide stability to a security or group of securities. The phrase, "the benchmark is not the ballast," refers to the risk of believing that the universe of securities within a single index provide the level of stability that investors might seek from subgroups of securities within the index.

Beta is a measure of an investment's or manager's sensitivity to market movements, volatility, or systemic risk. In general, the larger the beta, the more volatile the historical performance.

The Capital Asset Pricing Model, or CAPM, is used to calculate the expected rate of return for a particular investment. It does so by considering both the expected returns for both the market and for a risk-free asset, plus the investment's beta. The Fama and French Three Factor Model, also known as the Fama French Model, expands on the CAPM by adding size, risk and value factors to the market risk factor in the CAPM in recognition of the fact that value and small-cap stocks regularly outperform their broader markets. The size premium accounts for small-cap stocks that generate higher returns than the broader market. The Fama French Model was developed in the early 1990s by economist Eugene Fama, who later won the Nobel Prize, and his colleague, Kenneth French.

Comps, short for comparables, carries different meanings depending on the industry and context, but generally entails a comparison of financial metrics – often for two different time periods – or other factors to quantify performance or determine valuation. CPI

Dispersion refers to the range of outcomes in different areas of a financial market or to the potential outcomes of investments based on historical volatility or returns.

Earnings before interest and taxes (EBIT), also known as operating earnings, operating profit, or profit before interest and taxes, can be calculated as revenue minus expenses excluding taxes and interest.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a

company's profitability.

Floating rate debt refers to debts with variable rates of interest, which are often tied to benchmark rates of interest such as U.S. Treasury note yields or the federal funds rate.

Interquartile refers to the middle half of a series of data that lies between the 25th and 75th percentiles in a range of data.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

Mega-cap stocks are the largest publicly traded companies as measured by market capitalization. Generally, this refers to companies with market capitalizations over $200 billion.

A moat, in finance, refers to a business's ability to maintain competitive advantages in relation to its competitors and thereby to safeguard its market share and long-term profits. Investor Warren Buffett popularized the term.

Net debt is a measure of a company's liquidity that reflects how much cash would remain if all debts were paid off immediately. Negative net debt reflects that a company's cash and cash equivalents are greater than its total debt obligations.

A net margin, also known as a net profit margin, measures how much net income or profit a company generates as a percentage of revenue. It can be expressed as a percentage or a decimal.

Quality investing is a strategy that seeks to invest in companies with low debt, stable earnings, consistent asset growth, and strong corporate governance, as reflected in financial metrics such as ratios of return to equity and debt to equity, as well as to earnings variability.

Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.

Revolving debt, often known as a line of credit, allows a borrower to borrow money as needed subject to an established limit and to repay the balanced owed over time.

Indices

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 7% of the total market capitalization of the Russell 3000® Index.

The Russell 2000® Quality Index is one of FTSE's Russell 2000® Single Factor Indexes, which are comprised of securities within the Russell 2000 Index and track the performance of their respective equity risk premium factor. FTSE Russell's factors are supported by a body of academic and empirical research across different geographies and time periods, with strong theoretical explanations as to why the factors have historically provided premium. The Russell 2000 Quality Index applies a consistent and transparent methodology to achieve controlled exposure to its target factor, quality, which coincides with a lower debt/equity ratio, higher pre-tax return on assets, and a lower earnings variability.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

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880 Carillon Parkway | St. Petersburg, FL 33716 | 1.800.521.1195 | RJInvestmentManagement.com

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