RBC Global Asset Management

Small but mighty: Harnessing the power of small cap stocks

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"Small cap stocks possess intrinsic characteristics that should be attractive to long-term investors."

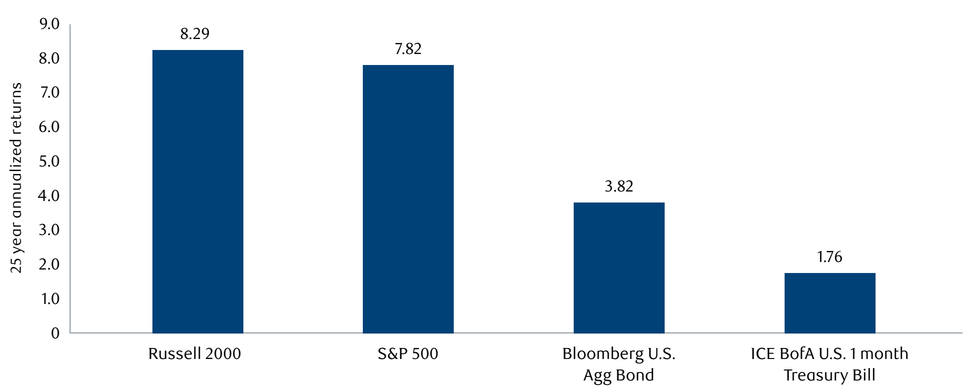
The "Magnificent Seven" reasons why small cap stocks offer a timely and unique investment opportunity.

- Compelling investment diversification.
- Attractive valuation relative to large cap stocks.
- Investor neglect creates high alpha generation opportunities.
- Mathematics of growth.
- Beneficiaries of falling interest rates.
- More U.S.-centric in operations and end markets.
- Recent underperformance creates attractive entry point for this superior long-term performance asset class.

Introduction

U.S. small cap stocks often get "no respect" from investors. This is remarkable, because as an asset class, they have provided compelling long-term performance compared to U.S. large cap stocks and returns well above investment grade bonds and cash.

Exhibit 1: Compelling long-term results annualized returns 1999-2024



Source: Morningstar Direct.

Small cap stocks possess intrinsic characteristics that should be attractive to long-term investors, and there are important near-term catalysts that make them timely investments in the current market environment. Let's dig deeper to fully appreciate what's going on here.

Diversification

Adding small cap stocks to an investment portfolio offers **diversification not only from large cap companies but also from the concentration currently found in the S&P 500 index**. Today, greater than 24% of the S&P 500 index is dominated by just five mega-cap stocks. In contrast, the top five stocks in the Russell 2000 index account for not quite 4% of that index, as measured by weight.

Exhibit 2: Top five holdings

S&P 500		Russell 2000	
Microsoft	7.1	Super Micro Computer	1.9
Apple	5.8	MicroStrategy	0.7
NVIDIA	5.2	Comfort Systems USA	0.4
Amazon	3.7	e.l.f. Beauty	0.4
Meta	2.6	Light & Wonder	0.4
	24.4		**3.8**

Source: S&P Global, FTSE Russell, as of March 12, 2024.

In recent years, the Russell 2000 index has seen broader participation in constituent gains than has the S&P 500. In addition, publicly traded **small cap equity portfolios provide exposure to companies of a size often associated with private equity investing**, but offer greater liquidity, typically lower fees and superior visibility on company fundamentals and valuation.

Attractive Valuation

Following an extended period of outperformance by large cap equities, fueled most recently by the so-called “Magnificent Seven,” **small cap stocks are trading near multi-decade low valuations** compared to large cap stocks. Comparing profitable companies in the small cap Russell 2000 to money-making corporations in the large cap S&P 500, small cap stocks trade at a steep discount on price to trailing twelve months earnings. In fact, over the last 50 years, there have been only two periods of such steep discounts: in 2000, just before the dot-com bubble crash, and in 1973 preceding the crash of the “Nifty Fifty.” The recent run-up of the “Magnificent Seven” may provide the framework for a similar recovery in small cap valuation multiples.

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According to Morningstar, at the end of 2023, the average P/E ratio for the Russell 2000 stocks was 16x, well below its average for the past decade and cheap compared to the 22x P/E ratio for the large cap Russell 1000. Small caps trade at a steep discount on this measure despite producing higher long-term earnings growth. Further, the average price-to-book ratio valuation for small caps at year-end 2023 was barely over half that of large cap stocks. On numerous valuation measures, small caps are historically undervalued compared to their large cap counterparts.

Value-Added Active Management

Institutional neglect creates the potential for significant alpha generation from intensive fundamental research and active management of small cap stocks. Analysts from sell-side brokerage firms increasingly avoid covering small cap companies unless there is specific investment banking potential because the trading activity in many of these stocks cannot justify the cost of coverage. Many buy-side institutional portfolio managers similarly avoid small cap stocks because a) their benchmarks don't include small caps, b) trading liquidity is a greater challenge, and c) research must be generated in-house.

Comparative lack of sell-side analyst coverage and overall buy-side institutional neglect of small cap stocks create information gaps and pricing inefficiencies that can be capitalized upon by investors committed to intensive fundamental research and active management.

The proof is in the results. **Active small cap managers, on average, have historically outperformed their respective benchmarks more consistently than other equity classes.** As an example, examining Morningstar's Small Blend category as a proxy for active management, the category average beat the Russell 2000 for the 3, 5, and 10-year periods ended February 29, 2024. 87% of funds beat it for the 3-year period, 72% did so for the five-year period, and 59% of funds beat it for the 10-year period, net of fees.

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Exhibit 3: Peer Group returns net of fees

Group/Investment	03.01.21 - 02.29.24		03.01.19 - 02.29.24		03.01.14 - 02.29.24	
	3 year Return (Annualized)	Peer Group percentile	5 year Return (Annualized)	Peer Group percentile	10 year Return (Annualized)	Peer Group percentile
Russell 2000 Total Return Index	-0.94	87	6.89	72	7.13	59
U.S. Small Cap Core Peer Group Median	2.87		7.95		7.45	

Source: Morningstar Direct, as of February 29, 2024.

Mathematics of Growth

We believe that over the long-run, **a company's stock valuation is directly related to the amount of earnings and cash flow it can generate for shareholders**. The valuation multiple at which a company's stock trades is typically closely related to the rates at which it can sustainably grow sales, earnings, and cash flow.

From a purely mathematical perspective, it is simply easier for less mature small cap companies to grow these key financial metrics at faster rates than large and mega-cap companies. Just as babies increase their height and weight at far faster rates than juveniles and certainly adults, less mature companies with successful business plans and able management teams can grow faster than established large cap companies. A small company that is successful locally can expand regionally, then nationally, and finally, globally. Each expansion accelerates growth in a manner that is unavailable to the established global large cap company. For most large cap companies, success is measured by growing at rates slightly greater than GDP rate of growth.

Interest Rate Sensitivity

While our investment approach to small company investing emphasizes solid balance sheets and attractive cash flows, in general, small companies employ significantly more financial leverage than large companies. They also tend to be more reliant on outside financing to support and grow their businesses. According to data from Russell Investments, as of December 31, 2023, Russell 2000 companies had a net-debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio of 3.2x, compared to an average of 1.6x for the S&P 500. This higher level of financial leverage heightens the importance of debt servicing and the level of interest rates for small cap companies.

When the Federal Reserve began its persistent program of raising interest rates to combat inflation in 2022-2023, the period was marked by sizable underperformance of greater debt-burdened small cap companies compared to large caps. **A subsequent easing in rates should inflation subside should disproportionately benefit small cap stocks.**

U.S.-centric

Domestic small cap companies tend to have a much greater portion of their operations and end markets in the United States compared to large cap companies. Currently, **the U.S. economy is an envy of the world in terms of growth, stability, and the rule of law**. For broad-based consumption expenditures, there are few markets to rival the United States.

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Furthermore, domestic small cap companies should disproportionately benefit from the efforts to "re-shore" supply chains and many are beneficiaries of the infrastructure spending bills. Finally, foreign currency fluctuations typically have less impact on domestic companies.

Attractive Entry Point

The best time to increase weighting in a long-term outperforming asset class is after a sustained period of underperformance, and when both fundamental and valuation characteristics are favorable. While **U.S. small cap stocks have had a sizable performance advantage over large cap stocks over the past century** and even since the year 2000, the past decade has witnessed the dominance of large cap returns.

Sales and earnings are projected to grow at a faster rate for the small cap Russell 2000 in 2024 than for the large cap S&P 500. According to Zacks Investment Research, The Russell's year-over-year earnings are expected to grow a healthy 10% in 2024 and a robust 41% in 2025! This compares to 8.4% for the S&P 500 in 2024 and 25% in 2025. Of course, these are estimates, but this improvement in fundamentals combined with the historically low relative valuations of small cap stocks compared to large caps referenced above could be a trigger for change in market leadership.

Final thoughts

Adding small cap stocks to an investment portfolio offers diversification not only from large cap companies and the concentration currently found in the S&P 500 index, but also from alternative investments including private equity. U.S. small cap stocks currently offer a timely opportunity to **gain exposure to an asset class that has historically provided superior long-term investment performance at attractive valuation levels**. Intensive fundamental research and active portfolio management have consistently produced superior returns in this already high-performing asset class.

About Small Cap Equities at RBC GAM

The Enterprise Small Cap team, based in Boston, MA, manages a range of micro and small cap core and value equity strategies. The portfolio management team averages over 30 years of investment experience. The team focuses on identifying companies that exhibit strong business fundamentals trading at low valuations.

The Small Cap Growth team, based in Chicago, IL, manage small and SMID cap growth strategies. The highly experienced investment team focuses on buying high quality, profitable companies and holding them over the long term. This prudent approach to growth investing has yielded portfolios that tend to exhibit low volatility.

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