It's the little things that count

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Global developed equities ended the first quarter strongly with both the US and Japan equity indices reaching all-time highs[1]. However, these gains were largely skewed towards the larger cap stocks. This is even more prominent in the case of the US market where a handful of mega cap stocks, namely the 'Magnificent 7', have been the runaway outperformers in recent years.

The MSCI World index has risen by 30.0% in US dollar terms over the 3-year period ending March 2024 compared to the MSCI World Small Cap index which gained only 5.3%. Similar patterns persist regionally with the starkest example being in US equities where the S&P 500 posted total returns of 38.5%, whilst the Russell 2000 (small-cap index) fell by 0.4% over the same 3-year period. As a result, equity valuations at the headline index level look stretched and investors are left searching for bargains. We believe investors would do well to look further down the market capitalisation scale for better valuation opportunities.

This performance pattern has persisted for some time and has led small cap stocks to suffer their worst run of returns relative to larger companies in years. As a result, the gap in valuations has widened. Forward price to earnings (P/E) ratios across regions including the US, Europe ex UK and UK suggest that small cap stocks are more attractive versus history when compared to larger caps. Valuation is a strong predictor of long-term performance so small caps will have their day before too long. We believe it is a matter of "when" and not "if".

While it is difficult to ignore the continuing outperformance of mega cap stocks, we believe these trends won't last forever. An allocation to small caps for the longer-term at this opportune time could provide a boost to returns for patient investors.

The rising interest rate environment has certainly been a major headwind for smaller companies as the conversion of revenue into earnings becomes more challenging. Whilst higher rates will impact all businesses, they tend to negatively affect small caps disproportionately. These firms typically carry higher levels of debt on their balance sheet. Small caps tend to borrow at a higher rate (mostly fall under the high yield category) with a larger proportion of debt being floating, making them even more vulnerable to rising rates.

Going forward, rates are more likely to be lower or at least stabilise, which may provide a boost to these smaller businesses which rely more heavily on shorter term borrowing to fund their projects and ongoing operations.

Small cap stocks typically outperform their larger cap peers over the long-run due to the small cap effect, or 'size premium' as it is known. Smaller companies often have a lower level of analyst coverage with some having none at all, which increases the likelihood of market mispricing.

Higher and faster growth potential is another attraction to smaller firms as the products and services of these firms tend to be more niche and they typically operate in growing industries and less mature markets. Finally, smaller businesses are also more likely to be taken over by larger firms so waiting for the market to correct perceived market mispricing is not the only way for investors to capture the upside potential.

Despite the higher volatility nature of small cap stocks, historically investors have been well compensated. Over the last 25 years ending March 2024, they have delivered higher risk adjusted returns, with the MSCI World index returning 6.8% annualised compared to MSCI World Small-Cap index which posted 9.5% annualised.

Attractive long-term returns don't come without risks though. In the short term, challenges will remain if this environment of 'higher for longer' persists. This will dampen the growth and profitability of these smaller companies and could continue to constrain their price. However, cheaper valuations relative to their larger counterparts provide a much-needed margin of safety.

The risk of bankruptcy, leading to permanent loss of capital, is arguably higher in small caps, although as was witnessed during the Global Financial Crisis, this can happen across the market cap spectrum. The business models of smaller firms are also less diversified, and revenues can be more concentrated and cyclical leading many firms to be unprofitable for periods of time. This highlights the greater need to ensure your investment portfolio is optimally diversified and raises the question of passive investment within this area.

We believe the best way to gain exposure to small cap companies, and to manage some of these risks, is to invest via third-party, experienced, active managers who can be more selective in constructing portfolios. Active managers with a strong fundamental bottom-up approach are better placed to extract and digest information associated with these smaller firms, which themselves have more idiosyncratic drivers. The reward can be very high if your portfolio manager can pick the diamonds in the rough.

[1]Footnote: refers to the S&P 500 and Nikkei 225 index.

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