SMALL/SMID CAP STOCKS: THE OVERLOOKED ASSET CLASS 2.0

Inexpensive Hidden Gems

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Warren Buffet famously said, "The stock market is a device for transferring wealth from the impatient to the patient." A key to that investment philosophy is buying value, then patiently waiting for the market to recognize what you already know. Sometimes that wait can test the patience of even seasoned investors, given the relationship between small-cap and large-cap performance has historically run in long-term cycles.

We continue to believe a shift from large- to small/smid- caps is underway. Since our initial publication on this topic in June 2024, there have been two monthly periods when the Russell 2000®/2500™ significantly outperformed the S&P 500® only to underperform the next month, which underscores the difficulty of timing a sustainable long-term cycle. While no one can know the precise timing, the list of potential catalysts is growing. This includes large/small relative valuations, declining inflation and interest rates, and relative earnings growth trends, all which point to potential outperformance of quality small- and smid-cap equities over large caps.

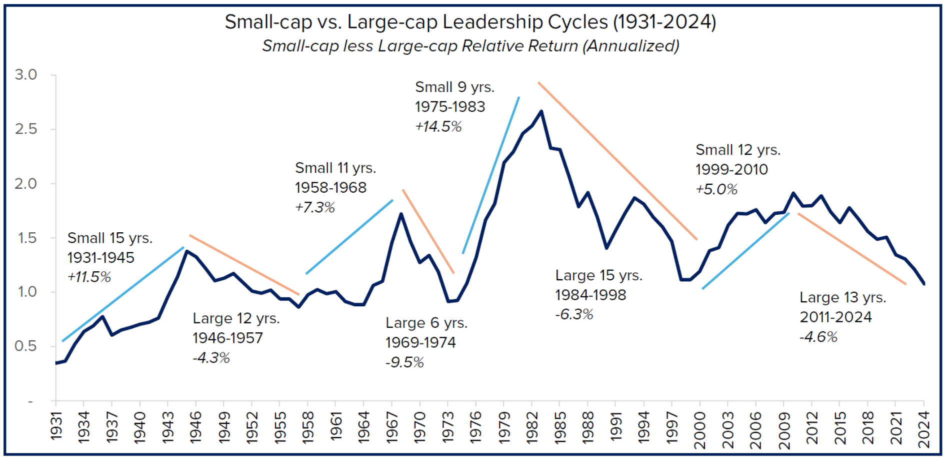
The relative valuation argument remains compelling. The market's leading technology stocks have had excellent growth but are trading at the upper end of their historic price/earnings multiples (P/E), driving large capitalization-weighted indexes to record heights. Dominated by technology leaders, the S&P 500®'s estimated P/E for 2025 is 22x. Meanwhile, the profitable components of the Russell 2000® are valued at a P/E of just 16x, a discount of nearly 30%.[1]

The S&P 500® remains highly concentrated, with the "Magnificent 7" technology leaders accounting for 31% of the index, down from 34% at its peak. Despite the recent weakness in leading technology stocks, the three giants of the S&P 500®— Apple, NVIDIA, and Microsoft— continue to boast market capitalizations of ~$3 trillion apiece. Each has a value greater than the entire market capitalization of the Russell 2000® Index. Combining any two of these technology leaders approaches the $6.6 trillion market value for the entire Russell 2500™ Index.[2] This starkly illustrates that a broad universe of U.S. companies in these indexes has been ignored and the true intrinsic value of these companies is not reflected in their stock prices.

Such disparity is the result of an extended period of small-cap underperformance. Since 2011, small-caps have lagged large-caps by 4.6% annualized through year-end 2024, worse than the 3.9% underperformance as of year-end 2023. This remains the second longest period of underperformance since 1932. The disparity between small- and large-cap returns was, perhaps, tied to subpar U.S. economic growth during a time that technology companies were able to stand out by growing above trend due to cloud computing, SaaS software product offerings, and other innovations. Today, the "law of large numbers" is impacting sales growth and there are growing questions about the durability of earnings estimates for these companies while their valuations remain high. The prior period of small-cap domination started in the last century coincided with the end of the technology capital investment cycle, enduring from the beginning of 1999 through 2010. We don't know if we are at the end of the technology investment cycle for Artificial Intelligence, nor whether that is a requirement for small/smid-caps to outperform large-caps, but a change in leadership is overdue.

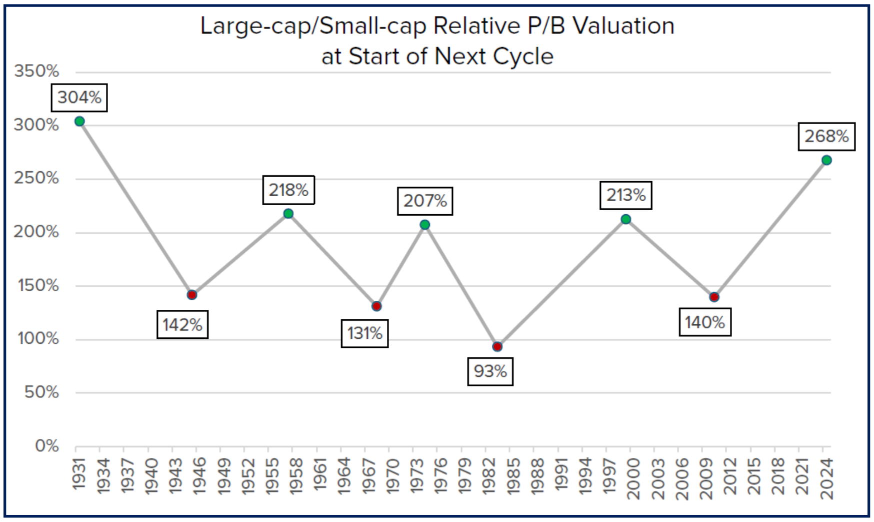
[1] As of February 28, 2025
[2] As of March 11, 2025

THE DARK BLUE LINE REPRESENTS THE SMALL-CAP TOTAL RETURN INDEX DIVIDED BY THE LARGE-CAP TOTAL RETURN INDEX, STARTING IN 1931. WHEN THE DARK BLUE LINE IS RISING, SMALL-CAPS ARE OUTPERFORMING LARGE-CAPS AND VICE VERSA. BOTH SERIES ARE INDEXED TO 1.0 AS OF 12/31/1925. SMALL-CAP INDEX EMPLOYS CRSP 6-8 DECILE INDEX RETURNS BEFORE 1979 AND RUSSELL 2000® INDEX RETURNS FROM 1979 TO PRESENT. LARGE-CAP INDEX EMPLOYS S&P 500® RETURNS FOR ALL PERIODS. THE LIGHT BLUE AND LIGHT ORANGE LINES INDICATE PERIODS WHERE PERFORMANCE IN ONE SIZE CLASS WAS DOMINANT OVER THE OTHER.



Source: Furey Research Partners. As of December 31, 2024.

The Federal Reserve may hold a key to the performance of small- and smid-cap stocks. Since the fall of 2024, we've dropped our expectations for rate cuts from four cuts to one cut in 2025, as persistent inflationary pressures are keeping the central bank from lowering rates further. Indeed, at its most recent policy meeting the central bank's Federal Open Market Committee chose to take no action on interest rates. The new administration is enacting a series of policy changes that are, at times, confusing, creating growth uncertainty and market volatility. We will see how the Federal Reserve incorporates these events into its interest rate policy. The last period of small-cap outperformance (1999-2010) coincided with a slowing economy, the Fed lowering interest rates, and a revaluation of the largest-cap leadership companies, especially the technology bellwethers of that period.

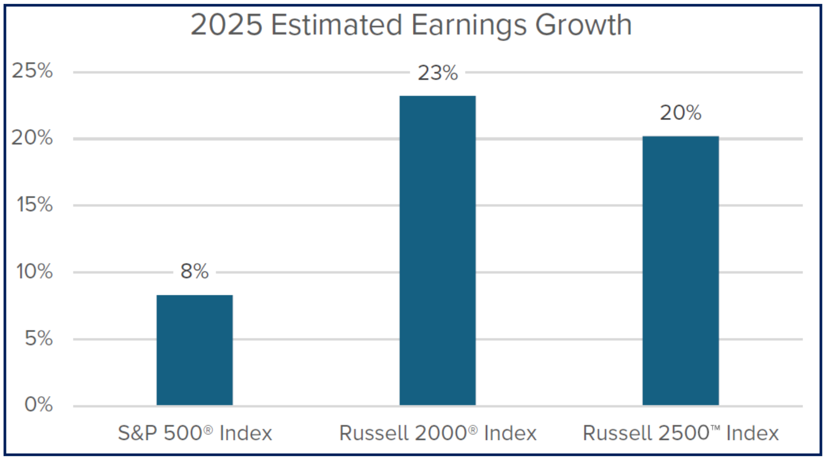


Source: Furey Research Partners. As of December 31, 2024.

On a price/book basis, the data also indicate we are near an inflection point for the market. Large-cap stocks historically trade at a premium over small-caps, but that premium is at the highest level since 1931, a price/book premium of 268%. We especially like this indicator for measuring relative valuations because a substantial number—more than 1/4—of Russell 2000® components are unprofitable.

Accentuating the valuation argument for quality small- and smid-caps is their strong expected earnings growth. 2025 expected earnings growth for the Russell 2000® is projected to outpace large-caps by almost 1500 bps. The 2025 expected earnings growth of 23.2% for the Russell 2000® and 20.2% for the Russell 2500™ is much higher than the S&P 500®'s 8.3% earnings growth forecast. In part, this reflects the ending of supply chain disruptions and other lingering post-Covid headwinds, to the benefit of smaller companies.

Helping to drive earnings growth for U.S.-based small- cap companies is the fact they generate the vast majority of their revenue domestically, about 77%, a far higher percentage than S&P 500® companies. Small and mid-sized companies are beneficiaries of the push to improve supply chain reliability and resilience by reshoring business to the U.S. Prominent among those companies are financial and industrial firms, which happen to comprise 38% of the Russell 2000®. Demand for data centers and microchip manufacturing, battery manufacturing for electric vehicles, and broader infrastructure investment is a long-term tailwind for small and mid-sized companies that specialize in providing the materials and services for these trends. It is early in this cycle and we believe it will take many years to play out.



Source: Furey Research Partners. As of February 28, 2025..

In conclusion, we believe the risk reward for small- and smid-cap stocks is favorable and positioned to finally attract attention from investors and strategic partners. The U.S. also has the opportunity to be a major beneficiary of supply chain reshoring which is a long-term trend that could benefit smaller domestically-focused companies. However, recent policy changes on trade have created uncertainty and concerns the economy could slow too much while inflation remains elevated has the potential to impact small/smid-caps. Over time, though, we believe these conditions will ease as policies become clearer. Deregulation, a cornerstone of the new administration, has yet to affect the economy and could positively impact small/smid-caps. Finally, the profitable, niche companies we focus on could become attractive takeover targets for bigger companies or private equity. M&A activity is beginning to pick up, which could provide a floor to current valuations. At a time when small/smid-caps are at record low levels of the total market value for U.S. companies, we believe the risk-reward remains favorable. The bottom line is that we continue to see a window of opportunity: this could be an especially good time to put money to work in small- and smid-cap stocks.

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The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2500™ Index measures the performance of the small- to mid-cap segment of the U.S. equity universe. It consists of approximately 2,500 of the smallest securities based on a combination of their market cap and current index membership.