Quo Vadis, Small Cap Growth?

Key Takeaways

- Small cap growth stocks have outperformed small cap value stocks over the trailing 10 years. Over longer time periods, however, investment style performance has varied.
- Stronger earnings, growth characteristics attractive to strategic acquirers and price momentum have contributed to the current leadership of small cap growth companies.
- By many valuation measures, small cap growth stocks are no more expensive relative to small cap value stocks than in the past.

Small cap and growth stocks have outperformed this year for a variety of reasons. Chief among them have been the rising dollar compromising multinational earnings prospects, the implication of uncertain trade negotiations and tariffs and worries over cyclical fundamentals. Companies with secular growth tailwinds and disruptive business models have had a fertile environment in which to invest behind their opportunities – a growing economy and abundantly accommodative capital availability – leading to outsized growth metrics and concomitant stock market outperformance.

The concentration has been most pronounced in the large cap growth space, where the FAANG stocks have climbed a continual wall of market worry the past five years and frustrated naysayers. A recent Wall Street Journal article noted the changing portfolio complexion of traditional value managers, who have modified their style in line with the changing complexion of the market and now incorporate growthier stocks into their strategies to “keep up.”

We will defer to savvy technologists whether the rate of technological change is intensifying. Suffice it to say broad swaths of economic activity and consumer and business choices are in flux. Some examples include:

- Powerful computers now reside in the palm of every smartphone or tablet user, unleashing capabilities undreamt a decade ago. Want to bank, order food or price a new or used car? There’s an app for that.
The advantage of “the cloud” for many use cases has given rise to new industries (i.e., data centers, information security) and vendors.

Amazing medical innovations are on the brink of giving hope to patients with chronic conditions (i.e., hemophilia, diabetes) or poor likely outcomes (ischemic stroke).

Some investors are anxious about the sustained outperformance of smaller growth stocks (save for 2016) and whether growth valuations are overextended. So, to stay cognizant of our own growth investor behavioral biases, here are a few observations.

Is Small Cap Growth a Long-Term Outperformer?

The long-term performance of the small cap growth asset class versus small cap value has been variable. Growth has enjoyed a wide 1,070 bps margin over value over the last 12 months and a 60 bps annual advantage over the past three years. Growth has also enjoyed the upper hand over the past 10 years, with a 11.6% annualized return versus value’s 9.3% (Exhibit 1), while over the past 25 years, value has outperformed growth by about 200 bps per year.

We ascribe the decade of outperformance for small cap growth to several factors, principally earnings:

- Earnings and cash flow of the small cap growth universe have massively outperformed the value universe. Earnings have roughly doubled for the growth universe while earnings for the value universe are up about one-third.
- Very benign monetary policy was designed to re-inflate a severely traumatized economy after the 2008-2009 financial meltdown. As a result, the earnings of financial companies, a large component of the value benchmark, have been limited by the challenges of compressed credit spreads, lackluster traditional loan demand and heightened compliance and regulatory costs.
- Innovation-starved large cap companies have snapped up smaller growth companies, especially in the technology and health care sectors, both of which are big components of the Russell 2000 Growth Index.
- Outperformance begat outperformance with price momentum and revisions some of the strongest factors discriminating between top and bottom quintile performance in the small cap universe over the last year.

Exhibit 1: Russell 2000 Growth and Value Performance

Are Small Cap Growth Valuations Extended?

A persistent client concern, given the outperformance of small cap growth stocks over the past year and the leadership by smaller technology companies, is whether we are in a valuation “bubble” similar to 1999-2000.

There is no perfect way to quantify the differing valuations of small cap growth and value stocks. New business models have arisen with underlying economics calibrated with metrics significantly different than traditional success measures. Investors are far more likely today to look through reported GAAP earnings at the underlying and sustainable cash generation of the business.

Another changing element is the composition of the benchmark indexes. The annual Russell index rebalance generally reallocates companies between growth and value indexes based on a number of quantitative measures. This process “graduates” successful small cap companies into larger indexes while accepting struggling businesses (“fallen angels”) back into the small cap world. Comparability from one year to the next is suspect, especially this year when the growth indexes are experiencing significant sector changes.

We certainly acknowledge that in absolute terms, multiples have risen for both growth and value stocks, a function principally of low interest rate levels and recent corporate tax rate reductions (Exhibit 2).

That said, Exhibits 3 and 4 provide a snapshot of the relative attractiveness of small cap growth and value stocks. By many measures, such as forward price/earnings, price/cash flow and price/sales small cap growth stocks are no more expensive relative to small cap value stocks than in the past. Again, this speaks to
the earnings and cash generation of successful small cap growth stocks compared with the slower growth (historically) of the small cap value space.

Conclusion

Investors have asked repeatedly over the past six to 12 months whether small cap growth stocks can sustain their outperformance of value stocks. While valuations are not exalted for small cap growth compared to small cap value, we are mindful of the recent outperformance of select small cap growth stocks. We have kept an eye on the risk profile of the small cap growth portfolio through individual stock selection and position size management and have made many changes in our holdings to constantly recalibrate the portfolio’s potential risk/reward.

The past year has also been a fertile time to seed new investments guided by management teams facing large opportunities. Over 20 new investments have entered the portfolio as we pared back holdings that outgrew small cap status. This is a continual process that has been partly aided by an abundance of initial public offerings of appealing new businesses, and it is one we exercise with care to ensure we own companies with the resilience to perform regardless of the direction of market momentum.

About the Authors

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Exhibit 4: Relative Valuations of Russell 2000 Growth vs. Value

<table>
<thead>
<tr>
<th>Valuation Metric</th>
<th>Current</th>
<th>Long Term Average</th>
<th>% Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trailing P/E</td>
<td>1.31</td>
<td>1.38</td>
<td>-5.4</td>
</tr>
<tr>
<td>Forward P/E</td>
<td>1.40</td>
<td>1.39</td>
<td>1.0</td>
</tr>
<tr>
<td>Price to Book</td>
<td>2.20</td>
<td>2.43</td>
<td>-9.5</td>
</tr>
<tr>
<td>Price to Cash Flow*</td>
<td>1.48</td>
<td>1.55</td>
<td>-4.7</td>
</tr>
<tr>
<td>Price to Sales</td>
<td>1.52</td>
<td>1.79</td>
<td>-15.3</td>
</tr>
<tr>
<td>P/E to Growth</td>
<td>0.99</td>
<td>0.83</td>
<td>19.9</td>
</tr>
</tbody>
</table>

* Price to Cash Flow started in 2002.
Note: From March 31, 2016 forward Jefferies estimates.
Source: FactSet, FTSE Russell, Jefferies.