



Small Caps Compelling for Patient Investors

Key Takeaways

- ▶ The large cap Russell 1000 Index has outperformed the small cap Russell 2000 Index in nine of the past 10 calendar years, pushing valuation spreads between small and large cap stocks to historically extreme levels.
- ▶ However, valuation metrics and historical size-based leadership patterns suggests that now may be an opportune time for long-term investors to consider increasing the small cap allocation in their portfolio.
- ▶ Additionally, recent research has shown that combining valuation and quality factors in small cap selection proves a potent catalyst across various market conditions.

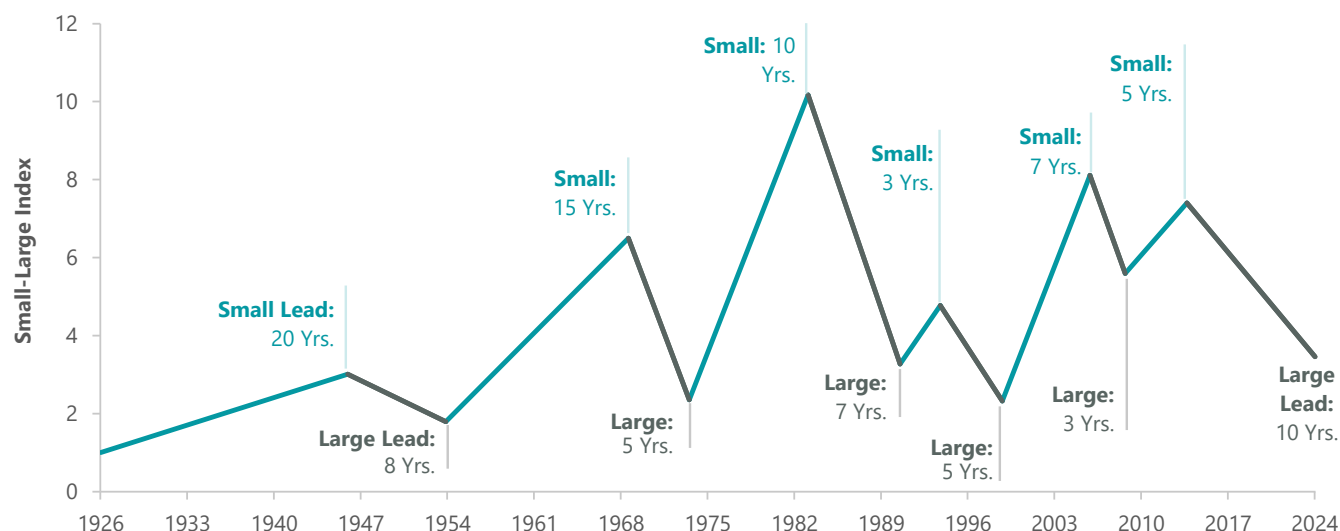
Small Caps Have Not Kept Pace with Large Caps

Over the past few years, the rapid rise of the Magnificent Seven¹ and concentration in the S&P 500 Index have dominated the headlines and, understandably, garnered significant investor interest. However, as this concentration of AI beneficiaries has absorbed market attention and investors' capital, it has often come at the expense of small cap stocks. In fact, the large cap Russell 1000 Index has outperformed the small cap Russell 2000 Index in nine of the past 10 years, with large caps returning approximately 106 percentage points more than small caps. Despite a sharp rally for small caps in July, it appears that 2024 is poised to follow a similar trajectory, with large caps extending their outperformance by 8.4 percentage points through the end of August. While this type of market-cap-based leadership isn't unprecedented, it has now pushed valuation spreads between small and large cap stocks to historically extreme levels. While it remains difficult to say when this trend will finally break, we believe that history has shown that all market cycles eventually end and that small caps will rotate back into market leadership, to the benefit of patient investors.

A Brief History of Market Capitalization Cycles

Equity markets are replete with market cycles, and the swinging pendulum of market leadership between large and small caps is a perfect example. Since the summer of 1926,

¹ Alphabet, Apple, Amazon.com, Meta Platforms, Microsoft, Nvidia and Tesla.

Exhibit 1: Historical Size-Based Leadership Favors Small Caps

As of June 30, 2024. Sources: Fama-French, ClearBridge Investments.

we have identified 12 distinct periods of at least three years where market-cap-based leadership was evident (Exhibit 1). This analysis, which is based on Fama-French data for the small-minus-big (SMB) universe, yields two noteworthy observations for small cap investors: 1) small has led large more than 60% of the time, and 2) the current 10-year run for large is the longest on record. While we believe that predicting the precise timing of such a rotation is a fool's errand, an eventual return to small cap leadership has history on its side.

Interestingly, today's large cap leadership has been defined by a very narrow set of the largest large cap companies. From 2013 to 2023, the 10 largest stocks in the Russell 1000 Index nearly doubled in weight, from 14% to 27%, before surging to over 31% at the end of August — a level of market concentration not seen since the early 1960s. More astonishing, however, is the rate of increase in concentration over the last decade, which is the most rapid consolidation since 1950.² The annual rebalance of the Russell 2000 Index should have served to insulate small cap managers from such periods of concentrated performance, but it failed to do so for active managers that didn't own Super Micro Computer (SMCI) over the last two years, as SMCI reached the highest-ever weighting in the index in March 2024 by more than 100 basis points, for a total weight of 2.13%.

The last decade's large cap dominance has bled over into the universe of small cap managers. In fact, according to Lipper fund performance data, small cap active managers have migrated toward larger small caps, with the Small Core Lipper peer group carrying a

\$7.9 billion average market cap at the end of the second quarter of 2024, compared to the Russell 2000 average of \$2.6 billion.

Small Cap Valuations at Extreme Levels

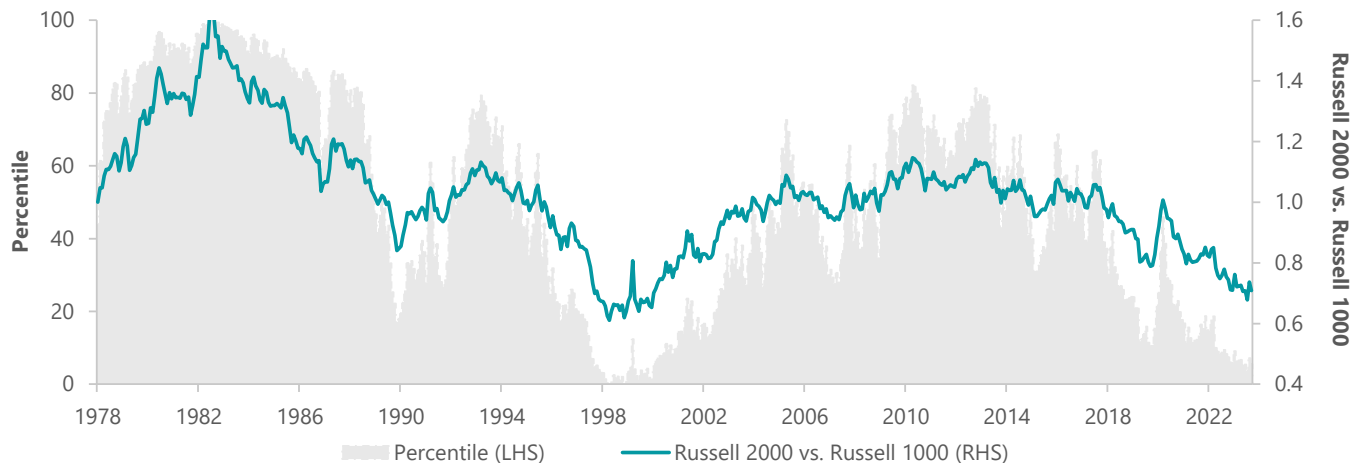
This extended run of large cap dominance has led to extremes, both in terms of relative performance and relative valuations, that the market has not seen in more than two decades. In fact, the Russell 2000 Index's performance relative to the Russell 1000 Index stands in the bottom decile since 1978, only slightly better than its relative performance during the Dot-Com era of the early 2000s (Exhibit 2). Similarly, relative valuation metrics such as price to book (P/B) and price to earnings (P/E) have also declined to their 2000s levels (Exhibit 3).

While this divergence between small and large cap performance and relative valuations are telling, they do not support a prediction for when a sustained rotation in market leadership to small cap stocks will occur. Rather, we believe these observations, juxtaposed alongside the pattern of historical size-based leadership cycles, suggest that current market conditions have created an excellent opportunity for investors to consider increasing the small cap allocation in their portfolio.

The Potent Power of Valuation and Quality

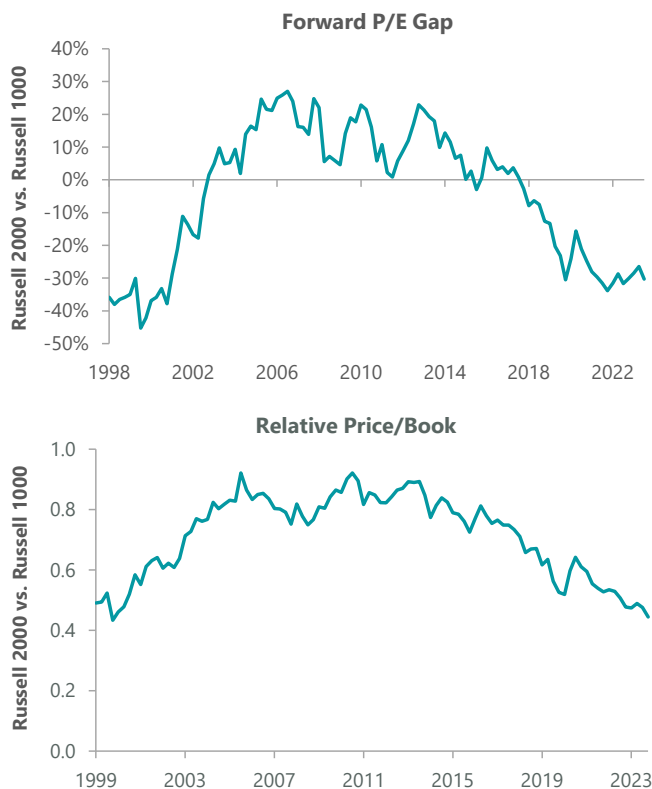
While small caps in general will benefit from a cyclical rotation out of large caps, we believe that betting on the size factor is not enough to generate

Exhibit 2: Small Relative Performance Near Historic Lows



As of Aug. 31, 2024. Sources: FactSet, Russell.

Exhibit 3: Small Cap Metrics at Multi-Decade Lows



As of June 30, 2024. Source: FactSet, ClearBridge Research

consistent outperformance by active managers. Rather, generating sustained outperformance requires a focus on both valuation discipline as well as a portfolio constructed of high-quality companies.

Quality appears to be the key ingredient, not only for teasing out the size factor, but also for generating excess returns within the small cap universe. When Eugene Fama and Kenneth French (namesakes of the Fama-French three-factor model) first found that small cap companies have higher risk-adjusted returns than larger cap companies, it was considered revolutionary and groundbreaking — enough so to be one of the first major challenges to the capital asset pricing model (CAPM). However, since then, this size premium has consistently failed to materialize, casting doubt on both practical implementation and even on its theoretical existence. However, more recent research has shown that a strong and distinct size premium emerges when quality factors are incorporated.³ This is primarily a function of the disparity in quality between small and large, which is to say that small cap companies are of generally lower quality than their large cap peers. Additionally, research has shown that the size factor is almost exclusively driven by the small cap quality. In other words, to truly capitalize on the size factor, investors must also avoid low-quality small caps.⁴

We believe that avoiding these low-quality small caps has become even more paramount given the secular decline in the overall quality level of the Russell 2000 Index since the turn of the century. At present, 44% of the names in the Russell 2000 benchmark are unprofitable over the last 12 months, while the return on invested capital spread of large and small companies has swelled from an average of 80 basis points in the 1990s to 410 basis points by the end of 2023.⁵ This suggests that the quality gap between small and large

³ Asness, Clifford, et al. "Size matters, if you control your junk." *Journal of Financial Economics*, vol. 129, no. 3, Sept. 2018, pp. 479–509.

⁴ Blitz, David and Hanauer, Matthias Xaver, *Settling the Size Matter* (September 4, 2020).

⁵ Mauboussin, Michael and Callahan, Dan, "Stock Market Concentration: How Much Is Too Much?" *Counterpoint Global Insights*, Morgan Stanley Investment Management, 4 June 2024.

cap stocks is widening, but it is worth asking: is avoiding low-quality small caps enough to generate superior risk-adjusted returns versus the Russell 2000?

ClearBridge's quantitative research team tested this question and found that a portfolio composed of small cap stocks with top-two quintile rankings in both value and quality factors not only generates superior risk-adjusted returns, but it also does so without sacrificing absolute upside. Specifically, this "high-quality value" (HQV) portfolio has generated a compound annual growth rate of 14.5% compared to the Russell 2000's 8.5%, with annualized volatility of just 21%. In back testing the HQV portfolio over the last 28 years, the portfolio outperformed the benchmark in 23 years over the period, an 82% success rate. This data suggests that the value factor alone can't produce these results, but rather that this strategic combination of value and quality not only enhances overall portfolio performance but also lowers volatility, thus achieving superior risk-adjusted returns. Thus, we believe that small cap investors that build a portfolio of stocks with high value and quality factors can get the best of both worlds.

Exhibit 4: Quality and Value Factors Combine to Outperform (1996 — 2024)

	High Quality Value	Russell 2000 Index
CAGR	14.5%	8.5%
t-stat (1M>0)	4.0	2.7
Annualized Volatility	21%	20%
Mean-Volatility Ratio	0.7	0.4

As of Aug. 31, 2024. Source: FactSet.

The quantitative testing that produced this result selected publicly traded stocks in 1996 that were constituents of the Russell 3000 Index with market caps below the 20th percentile and a trailing three-month average daily volume above the 25th percentile, in order to create a sample set of stocks that we believe best represents a truly investible U.S. small cap universe. Using this sample set, the team constructed six portfolios based on our proprietary quality and value factor models (Exhibit 5). The portfolios were then tested with both equal- and value-weighted structures, which showed little impact on overall results.

The results of the test showed that not only did the HQV portfolio outperform the Russell 2000 Index, but that is also outperformed each of the other five portfolios on both an absolute and risk-adjusted bases over the 28-year period (Exhibit 6). Additionally, the results showed similar outperformance over most multiyear periods within the overall 28-year test, suggesting that valuation and quality are a potent combination across various market environments.

Positioned for Small Value and Quality Outperformance

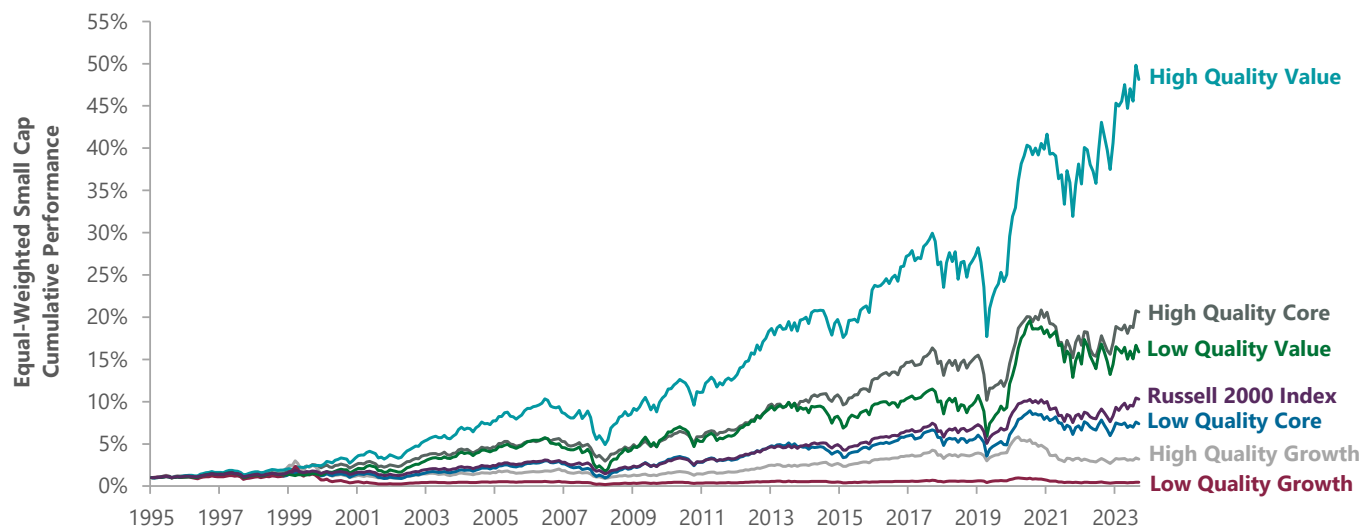
We believe that the combination of these findings, along with historical precedent on size-based market leadership cycles and the current market extremes in small cap relative valuation levels point to a favorable setup for patient small cap investors. However, we believe that an eventual rotation to small cap leadership will prove particularly beneficial to the ClearBridge Small Cap Strategy, as our rigorous investment process favors high-quality companies trading at a significant discount to their intrinsic business value. This results in a portfolio that maintains a generally positive tilt to both quality and value factors relative to our Russell 2000 benchmark, which we believe will provide added tailwinds when this long-anticipated rotation finally occurs.

Exhibit 5: Six Portfolios Constructed to Represent a Range of Factors

	High Quality Core	High Quality Growth	High Quality Value	Low Quality Core	Low Quality Growth	Low Quality Value
Average Number of Securities	104	125	262	91	263	131
Quality Ranks (1 to 5)	1,2	1,2	1,2	4,5	4,5	4,5
Value Ranks (1 to 5)	3	4,5	1,2	3	4,5	1,2

Value ranks 1 and 2 represent value stocks, rank 3 represents core, and ranks 4 and 5 represent growth. Quality ranks 1 and 2 denote high quality, while ranks 4 and 5 indicate poor quality.

Exhibit 6: High-Quality Value Proves Dominant



As of Aug. 31, 2024. Source: ClearBridge Investments, FactSet.

About the Author



Erich Frey, CFA

Director, Portfolio Analyst

- 19 years of investment industry experience
- Joined a predecessor organization in 2005
- BS in Business Administration and Psychology from Washington and Lee University

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com

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