



DANIEL MEGES, SENIOR MANAGING DIRECTOR, RESEARCH, CLEARSTEAD

## CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Administration team with Lauren Hughes, CPA.

Lauren recently joined Clearstead as Controller. She has held a variety of strong financial roles with leading Cleveland-area firms. Most recently, she was a Business Unit Controller at Avery Dennison after roles at First Brands Group including Financial Controller and Manager – Financial Planning & Analysis. Lauren began her career with Eaton in a variety of progressive finance and accounting leadership development positions at the plant and corporate level. Lauren earned her Masters of Accountancy and Bachelor of Science in Business at the Farmer School of Business at Miami University (Ohio).

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

## THE CASE FOR US SMALL CAPS – REMASTERED FOR THE 21<sup>ST</sup> CENTURY

BY DANIEL MEGES, SENIOR MANAGING DIRECTOR, RESEARCH, CLEARSTEAD

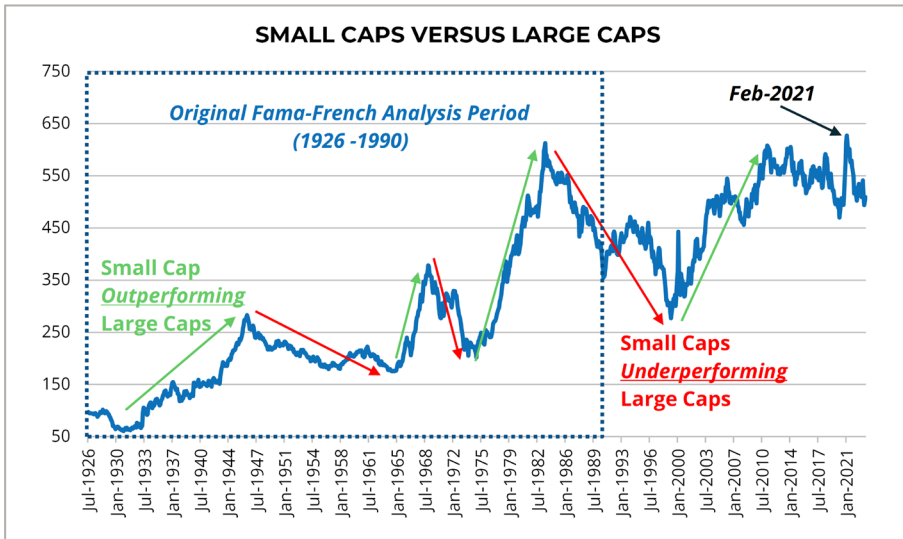
Clearstead has long advocated for a modest overweight allocation to small cap stocks. Periodically, we are asked why this is the case? Why do we advise our clients to have a permanent allocation to small cap equities? The simple answer is that, over the time periods discussed in this article, the risk-return proposition of small cap stocks is attractive from an absolute as well as a risk adjusted return framework. As shown in Figure 1 on the next page, while investors took on slightly more equity return volatility (generally thought of as equity “risk”) when investing in small cap stocks, they have historically been rewarded over the long run with higher returns as compared to their US large cap peers.

As evidence of this assertion regarding the attractiveness of small returns we turn to the Center for Research in Security Prices (CRSP) database which shows the returns of US equities of all cap sizes going back to 1927. That database has been analyzed by academics for decades, and in the early 1990s, two professors from the University of Chicago, Eugene Fama and Kenneth French, looked at categorizing the stocks into large cap and small cap categories as well as by their relative value—as measured by the price of a stock versus its book value—grouping them into expensive stocks and inexpensive stocks. One of the key findings in the Fama-French analysis is that if you had invested in the smallest third of US stocks versus the largest third, you would have realized greater returns over the course of the period they studied (1926 to 1990).

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Figure 1:



What Figure 1 shows is that, over nearly a hundred years, a \$100 invested in the smallest-third of the universe of US equities would be about 5.5x greater than if you had invested in the largest third of US equities. Also, while there are clear cycles of over and under-performance between small and large cap stocks, generally the trend is positive for small cap stocks and the patient investor has been rewarded by them over the long-run. However, Figure 1 also shows that since the late 1970s—when small caps had strongly outperformed for nearly a decade—the returns over the next forty years between US large cap and small cap stocks have been similar (see Figure 2). However, during that roughly forty-year period, small caps underperformed at times (1982 to 1999) and outperformed (2000 to 2010) at other times, before moving in a similar pattern during most of the past decade after the Great

Source: Clearstead, Fama-French Jul-1926 to Jun-2023; SMB (Small Minus Big) is the average return on the three small portfolios minus the average return on the three big portfolios.  $SMB = 1/3 (Small\ Value + Small\ Neutral + Small\ Growth) - 1/3 (Big\ Value + Big\ Neutral + Big\ Growth)$ , original paper Fama and French, 1993, "Common Risk Factors in the Returns on Stocks and Bonds," Journal of Financial Economics, covered 1963-1990, later extended to cover 1927-1963 and 1990 to the present. Past performance is not an indicator of future results. Clearstead, Bloomberg LP, Total returns of S&P 500 from 30-June-2011 to 30-June-2021 decomposed by primary return drivers: Annualized Real GDP, Annualized Core CPI, Average Dividend Yield, Change in Price-to-Earnings ratio over the ten-year period, and residuals or "unexplained".

Financial Crisis (2011 to 2021). Most recently, over the past two-years or so, investors have become more risk adverse—in large part due to the Federal Reserve’s efforts to raise rates and quell inflation—and small cap stocks have underperformed their large cap peers.

Figure 2:

Index	Asset Class	Annualized Returns Jan-1979 - Feb-2021	Annualized Returns Mar-2021 - Jun-2023
S&P 500 Index	US Large Cap	12.1%	8.50%
Russell 1000 Index	US Large Cap	12.2%	6.90%
Russell 2000 Index	US Small Cap	11.9%	-5.10%
S&P 600 Index*	US Small Cap	--	-0.70%

Source: Clearstead, Morningstar, Bloomberg; S&P 600 Index inception Dec-1993.

Figure 1 spurs several questions regarding the return profile of US small cap stocks. First, over the past 100 years, why did small cap stocks provide better returns over their large cap peers? Second, over the past forty years, small caps stocks have not provided a return advantage over large caps stocks, and so have the market dynamics that dominated the period of 1930 to 1980 fundamentally changed—particularly given the advent of private equity backed firms beginning in the mid-1990s—for today’s investor?

The answers to the first question as to why small cap stocks provide superior long-run returns lies in both their general risk-profile as well as the overall investment landscape. Small caps stocks are small—as defined by their market capitalization—

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but they are often growing faster than the overall market. As they grow, they likely carry greater debt loads, may experience wider swings in their earnings outlook, and may have less experienced management teams—all of which could increase their risk of default. Other risks could include less liquidity in trading their shares or more uncertainty about the competitive landscape in which they operate. Overall, each of these factors make investing in these firms riskier compared to investing in larger, more established, large cap firms where each of these risks are mitigated—hence you would expect the returns to be higher. Otherwise, why would you invest?

The investment landscape also matters for small cap stocks, in terms of the professional analyst and financial press coverage of a given stock. There are approximately 40 professional stock analysts currently covering Apple's stock and the average US large cap stock has at least 12 analysts covering the stock's price and earnings outlook. Every press release Apple publishes is dissected by the financial and mainstream media for its relevance to users and for its potential boost to Apple's sales. In contrast, the average small cap stock has less than 8 analysts covering it, and approximately 10% of index has no analysts covering their stock at all. Needless to say, most press releases by small cap companies go unnoticed by most media outlets. Similarly, most investors have known biases, which can be amplified in stocks with limited analyst coverage and whose shares are thinly traded. Given the well-documented loss-aversion present in most investors, small cap stock prices are likely to over-react to unexpected bad news, but due to anchoring biases may under-react to unexpected good news. The lack of analyst coverage and these well-documented biases suggest that small cap investors are likely operating in an inefficient market. Furthermore, active small cap managers, with a disciplined process grounded in fundamental research should be able to exploit this inefficient environment to generate returns in excess of a small cap index.

Regarding the second question as to whether the likelihood of small cap stocks outperforming large caps has diminished or vanished over the past forty-years, one needs to examine how the universe of small cap stocks has evolved over the past few decades. There have been three major developments over this period that have changed the nature of the small cap universe.

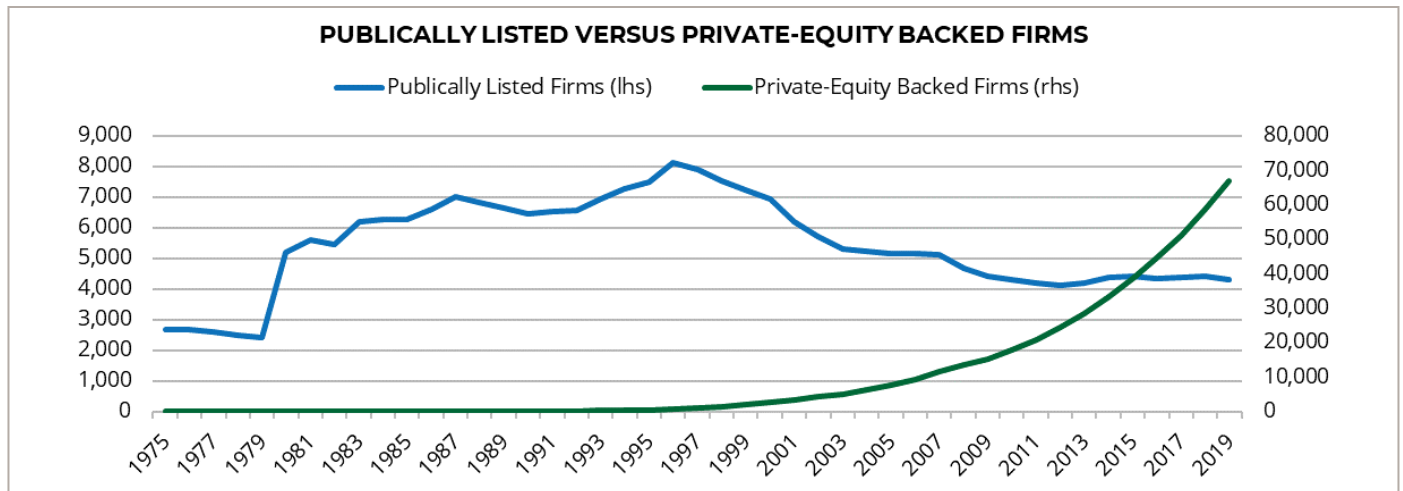
The first two are similar in their impact, although their timing is different. Beginning in the late 1970s, and then really taking off in the 1980s, was the US biotech industry, which promised asymmetric rewards for investors if their new drug technology worked but could easily trade down to the cash levels of these firms if their drug trials failed. The emergence of biotechs in the 1980s meant that a growing portion of the small cap universe would have little to no profits and the outcome for the stocks was binomial in nature—either trading up sharply if the drug worked or crashing if the new drug did not work. Similarly, many software companies began to go public in the 1990s and many of these firms have very little profits but are growing sales very quickly. As a result of these two new sectors to the small cap universe—biotechs and software firms—an increasing portion of the small cap space had little to no earnings, higher leverage than many peers, and a higher propensity to fail. The net result was the “quality” of the overall small cap space began to decline beginning in the mid-to-late 1980s.

The third development impacting small cap stocks in this period was the rise of private-equity backed firms, which dramatically altered the number and size of the US public equity universe (see Figure 3). These private-equity backed firms are not publicly traded, but rather held by private ownership until they are sufficiently large and profitable enough to go public. In decades past, many of these firms would have gone public via an IPO at an earlier point in their existence and likely become part of the US small cap universe. However, now they are more likely to delay their IPO and, when they do emerge from private ownership, they are likely to be appropriately classified as a mid-cap or even large-cap firm. Thus, a portion of the would-be small cap universe is skipping the small cap stage altogether. Today, there are over 70,000 private-equity back firms—a 70x increase over the past two decades—while there are just over 4,000 publicly traded firms in the US—down from over 8,000 in the late 1990s, according to data by US Federal Reserve of St. Louis and Pitchbook (see Figure 3). What is more, private-equity investors are highly incentivized to back only those firms that have the best growth prospects, the highest quality (stable) earnings potential, and the strongest management teams—thus some might argue that many of the most attractive small cap firms never go public as a small cap stock.

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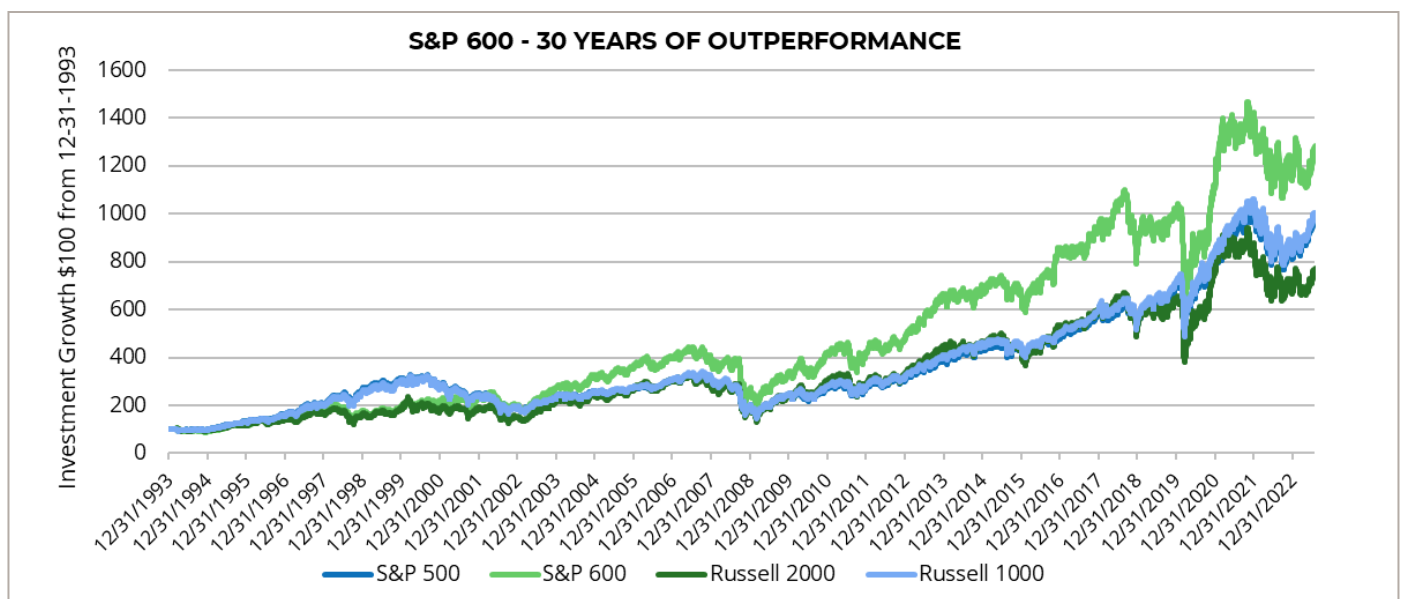
Figure 3:



Source: Clearstead, St. Louis Federal Reserve, Pitchbook Data 1975-2019.

So, what does this mean for US small cap investors? Well, there are two dynamics that provide compelling evidence that small cap investors should continue to have confidence that these investments provide a positive risk-return profile. First, in December 1993, Standard & Poor’s introduced the S&P 600 (small cap) Index. The S&P 600 differs from the Russell 2000 in several aspects—a liquidity requirement, larger public float requirement—but the most significant difference is that S&P 600 Index includes a profitability criterion. To be part of the S&P 600, the sum of the profits over the previous four quarters has to be positive. This criterion excludes many of the low-quality small cap names found in the Russell 2000 Index and this has been shown to be a key factor impacting the long-run returns of the two indices. This can be seen in Figure 4, which shows the long-run returns of the S&P 500, Russell 1000, Russell 2000, and S&P 600 since January 1994. Over this period the S&P 600 has outperformed the S&P 500 and Russell 1000 by about 10 to 20 basis points annualized, with similar amounts of risk. Furthermore, over this same 30-year period, the S&P 600 has outperformed the S&P 500 over 66% of all rolling 3-year periods, while the Russell 2000 has only accomplished this feat 44% of time over the same period.

Figure 4:



Source: Clearstead, Bloomberg, Morningstar December-1993 to July-2023.

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The key factor that can vastly improve the odds of success in US small cap investing is ensuring your small cap portfolio contains a quality bias. This can be accomplished by identifying active managers that eschew low quality firms and are highly selective in their holdings of biotechs and newly IPOed tech firms. This is why Clearstead's due diligence of US small cap strategies focuses on how these firms and teams evaluate those sectors and how they incorporate quality metrics related to profitability and stable cash flows into their fundamental analysis.

All this analysis shows that small cap investing has changed over the past few decades, but the asset class remains an attractive area for the patient investor to reap robust long-run returns.

## Sources:

(1) S&P Global "A Tale of Two Small-Cap Benchmarks: 10-Years Later" 27-Sep-2019.

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*Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.*

## MARKET BENCHMARK RETURNS

August 31, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	-1.6%	8.3%	15.9%	18.7%
US Small Cap	Russell 2000	-5.0%	9.0%	4.7%	9.0%
Developed Intl	MSCI EAFE	-3.8%	3.8%	17.9%	10.9%
Emerging Intl	MSCI Em Mkt	-6.2%	3.5%	1.3%	4.6%
Real Estate	NAREIT	-3.3%	4.4%	-7.6%	1.9%
Core Fixed	BarCap Agg	-0.6%	-1.1%	-1.2%	1.4%
Short Fixed	BarCap 1-3Yr	0.4%	0.4%	1.6%	1.9%
Long Fixed	BarCap LT G/C	-2.3%	-2.6%	-5.1%	0.9%
Corp Debt	BarCap Corp	-0.7%	-0.1%	0.8%	2.7%

Source: Bloomberg

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