From Giants to Gems: Anticipating the Small Cap Leadership Cycle

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INTRODUCTION: LEADERSHIP CHANGE IN THE EQUITY MARKETS IS NEAR

The landscape of financial markets is always evolving and is characterized by cyclical shifts in leadership between different segments of the market. One such segment is size, defined as the market capitalization of a publicly traded company. Large caps have led the market since 2010. Based on a mosaic of evidence, we believe we are at the cusp of a small cap leadership cycle. Not just small cap in total but high-quality small cap to be more precise. It is useful to understand some of the underlying dynamics driving this transition. In this white paper, we present a data-driven, historical precedent-based analysis of why we believe the equity market is on the brink of a high-quality small cap leadership cycle. We'll step through the quality situation, leadership cycle duration, mega-cap concentration, large and small relative valuation, and earnings appreciation to build our case.

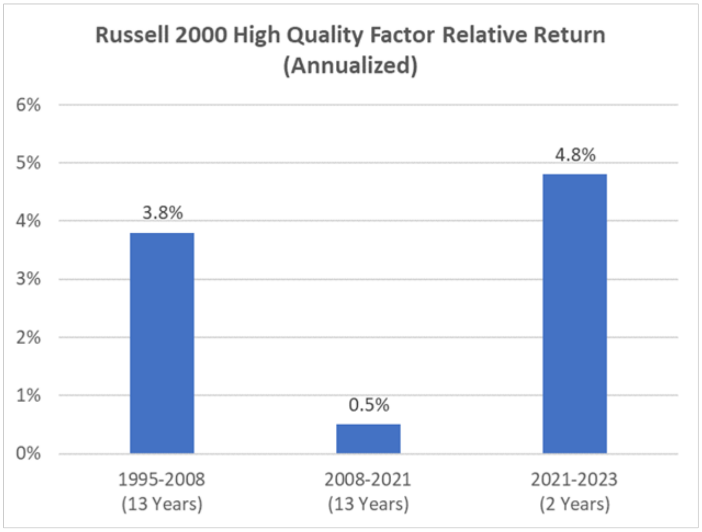
SITUATION: HIGH QUALITY SMALL CAPS RULE THE 2020'S AS LOW-QUALITY SMALL CAPS RULED THE 2010'S

Companies whose operations struggle to succeed because of being over-leveraged, having difficulty generating free cash flow, having scarce or non-existent profits, i.e., low-quality companies, performed well in the 2010s. With the Great Financial Crisis still at the forefront of the markets' operation, the government and the Fed promoted policies to keep the economy afloat. Quantitative Easing (QE) – the Fed's introduction of new money into the money supply by purchasing government bonds - made for easy money. A Zero Interest Rate Policy (ZIRP) where rates are nominally very low was the result. Inflation was not a hot point. Low-quality companies thrived in this low-risk environment.

What changed as we moved into the 2020s? Staying on our above points, too many dollars (money printing) began chasing too few goods (e.g., supply chain issues) in the early 2020s. This resulted in inflation levels unseen since the 1970s. ZIRP and QE became history as the Fed increased interest rates aggressively to fight inflation. QE became QT - Quantitative Tightening - the Fed began to shrink its balance sheet thus constricting the money supply. Rates and inflation are likely to remain higher for longer. Businesses that exhibit high operational efficiency, i.e., they are financially disciplined, are able to support their operations via free cash flow and generate profits to succeed in bad times (and good!), will return to their historically true winning ways. In other words, high-quality companies will thrive in this riskier, normalized environment.

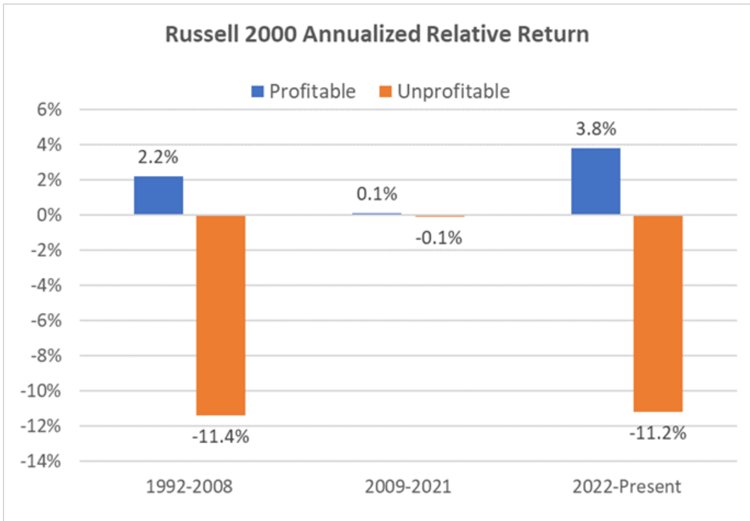
Figure 1 demonstrates how in times of normal or normalizing markets (1995-2008 and 2021-present), high quality outperforms low quality exceptionally well. Figure 2 demonstrates the same information by pitting profitable companies (high quality) versus unprofitable ones (low quality). High quality wins!

Figure 1



Source: Furey Research Partners, FactSet at 6/30/2023; Returns measured from middle of each year

Figure 2



Source: Furey Research Partners, FactSet at 6/30/2023

DURATION: "IF SOMETHING CANNOT GO ON FOREVER, IT WILL STOP." -HERB STEIN

The current large cap leadership cycle is extended beyond the historical average of a size leadership cycle of 11½ years. It is currently in its 14th year. Small caps have given up nearly 300bp per annum to large caps since 2010. This prolonged cycle indicates that the dominance of large cap stocks may be nearing their end, paving the way for small cap stocks to take the lead.

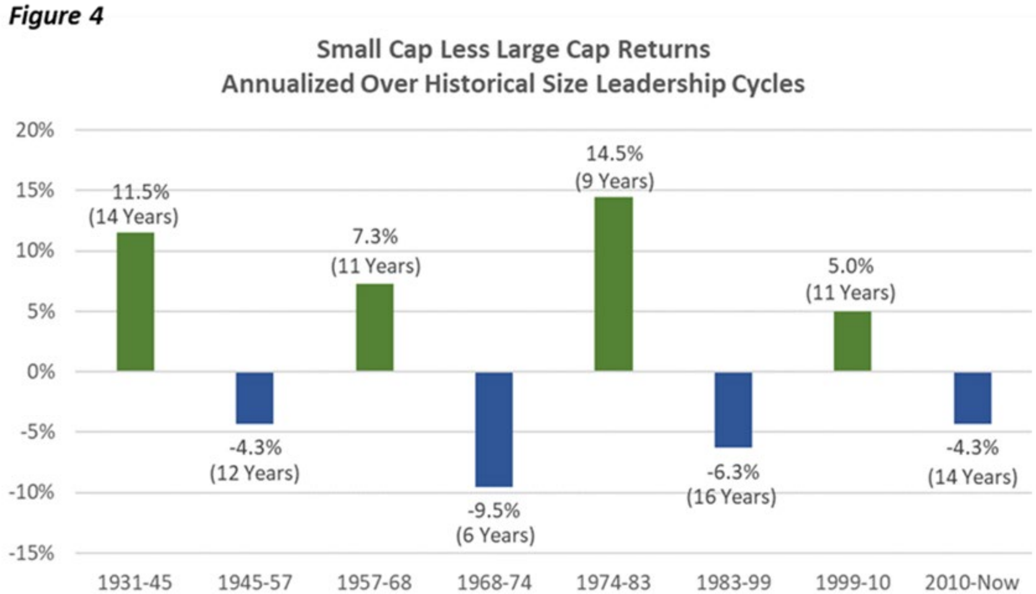
Whereas large cap leadership cycles often begin out of corrections, bear markets are often the pivot point when small caps move into a leadership cycle, for example, the bear markets of 1956-57 and 1973-74. The bear market that small caps ventured into on November 8, 2021, ended on October 27, 2023. The greatest beneficiaries out of a bear market are always small caps. Figure 3 illustrates how large caps lead small caps for a cycle followed by a cycle where small leads large. The data looks back to the 1930s.

Figure 3

Source: Furey Research Partners, FactSet

Looking at tabular data for the leadership cycles in the graph above indicates that when small caps lead, exceptional annualized returns follow. In the four small cap leadership cycles that occurred over the last near century, annual outperformance versus large caps has averaged nearly 10% (*See Figure 4*).

Figure 4

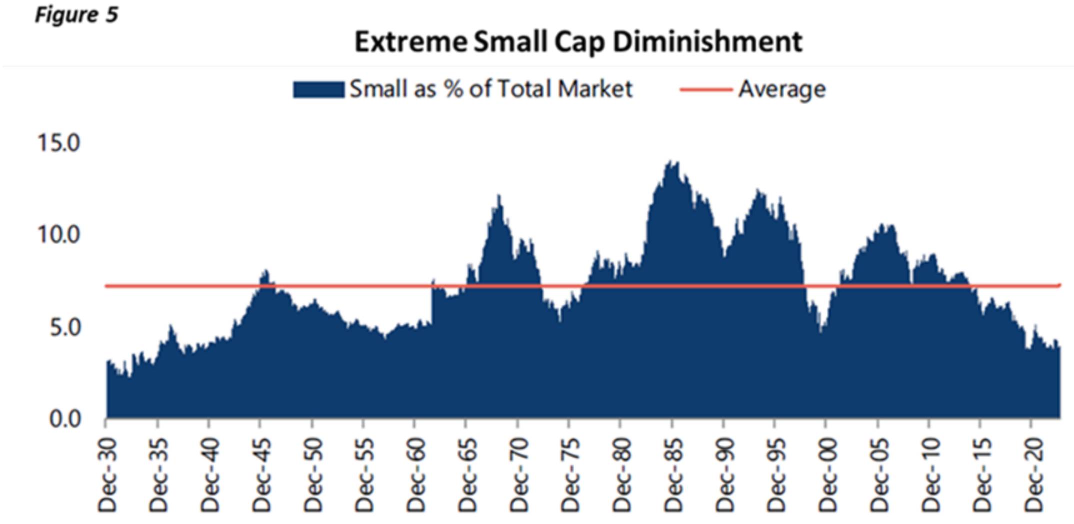


Source: Furey Research Partners, FactSet as of 3/28/2024

CONCENTRATION: WHEN THE LARGEST OF THE LARGE CAPS CONCENTRATE, A LEADERSHIP SWITCH IS NEAR

At first quarter end 2024, small caps represented as little a portion of the total U.S. equity market since the Great Depression. The only similar data point occurred in the summer of 2020 as the markets began their ascent from the depths of the pandemic crash. Outflows from mega caps can be the fuel needed to ignite small cap leadership.

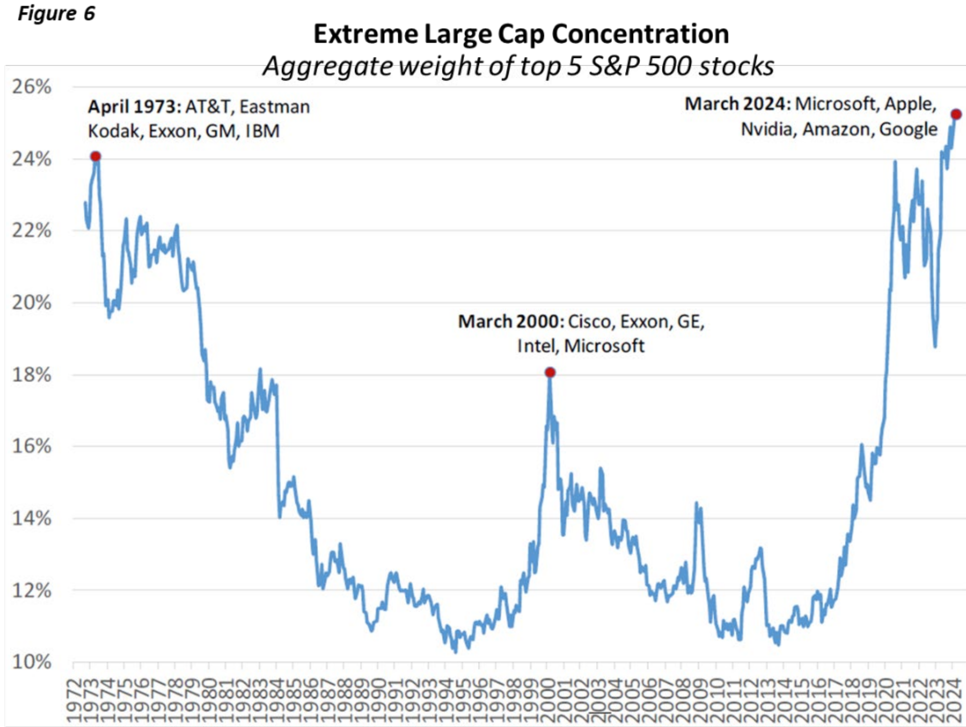
Figure 5



Source: Center for Research in Security Prides (CRSP®); University of Chicago Booth School of Business; Jefferies

Mega-cap concentrations have proven to be apex events historically regarding size leadership, i.e., distributions out of mega-caps begin to occur and small caps become the years-long beneficiary. Like occurrences in 1973 and 2000, these stocks have become highly concentrated as a percentage of the total capitalization of the equity market again. During this large cap leadership cycle, Microsoft, Apple, Nvidia, Amazon and Google, are the mega caps capturing the attention plus a huge amount of flows. Figure 6 demonstrates the aggregate weight of those top 5 S&P 500 stocks.

Figure 6



Source: Furey Research Partners, FactSet as of 3/28/2024

Excellent performance does not guarantee flows but small caps have been virtually ignored in favor of much lower returning asset classes since 2010. Small caps have averaged 10% price appreciation annually while receiving inflows of just $11 billion. Taxable bonds, money markets, and international equities have captured the greatest amount of inflows while generating average annual price appreciation of ~0%, ~0% and ~4% respectively. However, taxable bonds received 321x the asset flows of small cap, money markets received 170x the asset flows and international equities received 120x those of U.S. small caps.

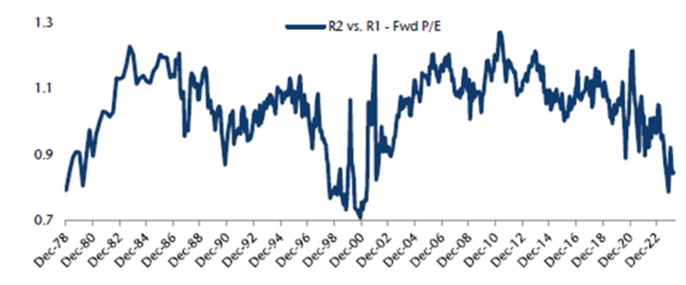
VALUATION: WHEN THE LARGE CAPS DEVELOP EXTREME RELATIVE VALUATIONS, A LEADERSHIP SWITCH IS NEAR

Perhaps the primary fulcrum for durable leadership handoffs between size categories is valuation. Relative valuations for small caps in comparison to large continue to be near historical lows; the asset class is as attractive valuation wise as it has been since the Internet Bubble of 2000 regarding earnings and book value. In regard to cash flow, small caps are more attractive now than they've been since the inception of the Russell indices, i.e., looking back "only" looks back to 1978. The valuation gap that exists between small caps and large suggests an attractive opportunity for small cap stocks to outperform in the near term. Figures 7.1 through 7.4 indicate how compressed small caps valuation measures are versus large caps.

Figure 7.1
R2 vs R1 – Relative Trailing P/E (Non-negative)

Source: FactSet; FTSE Russell; Jefferies

Figure 7.2
R2 vs R1 – Relative Forward P/E

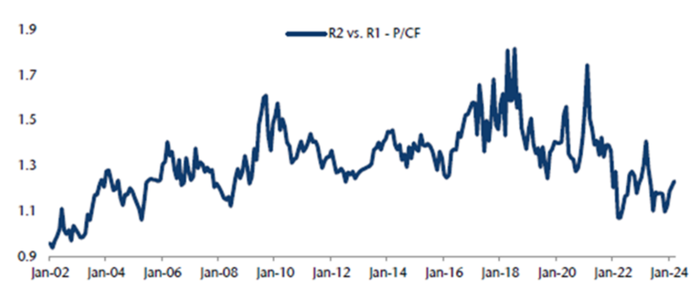


Source: FactSet; FTSE Russell; Jefferies

Figure 7.3
R2 vs R1 – Relative Price to Book

Source: FactSet; FTSE Russell; Jefferies

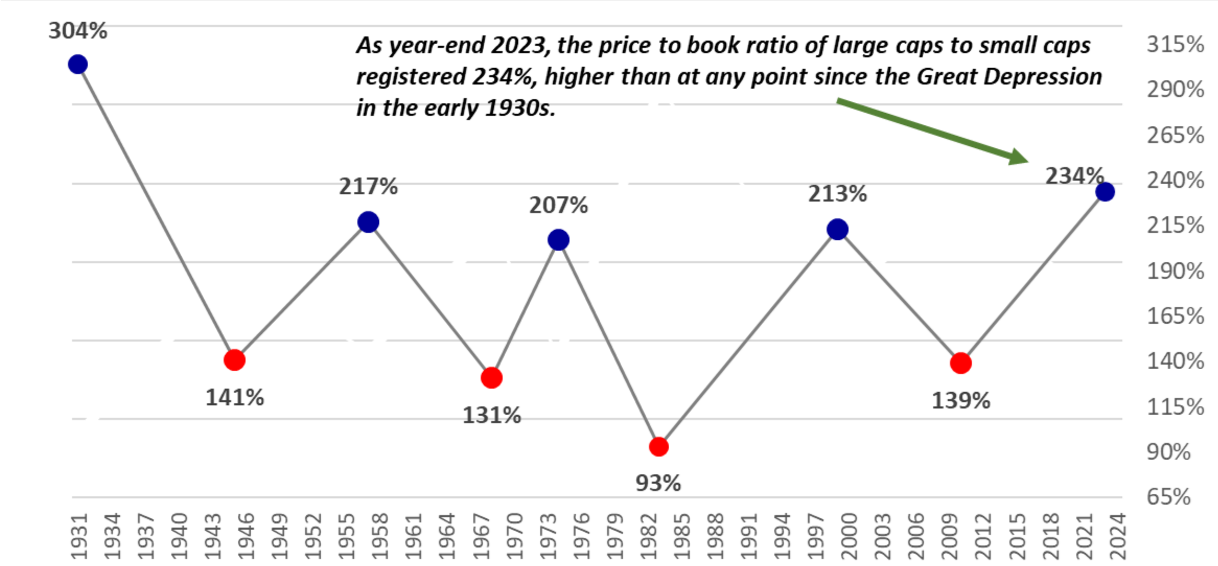
Figure 7.4
R2 vs R1 – Relative Price to Cash Flow



Source: FactSet; FTSE Russell; Jefferies

The argument can be strengthened by considering relative valuation data between large caps and small caps reaching back into the 1930s.

Figure 8



Source: Furey Research Partners

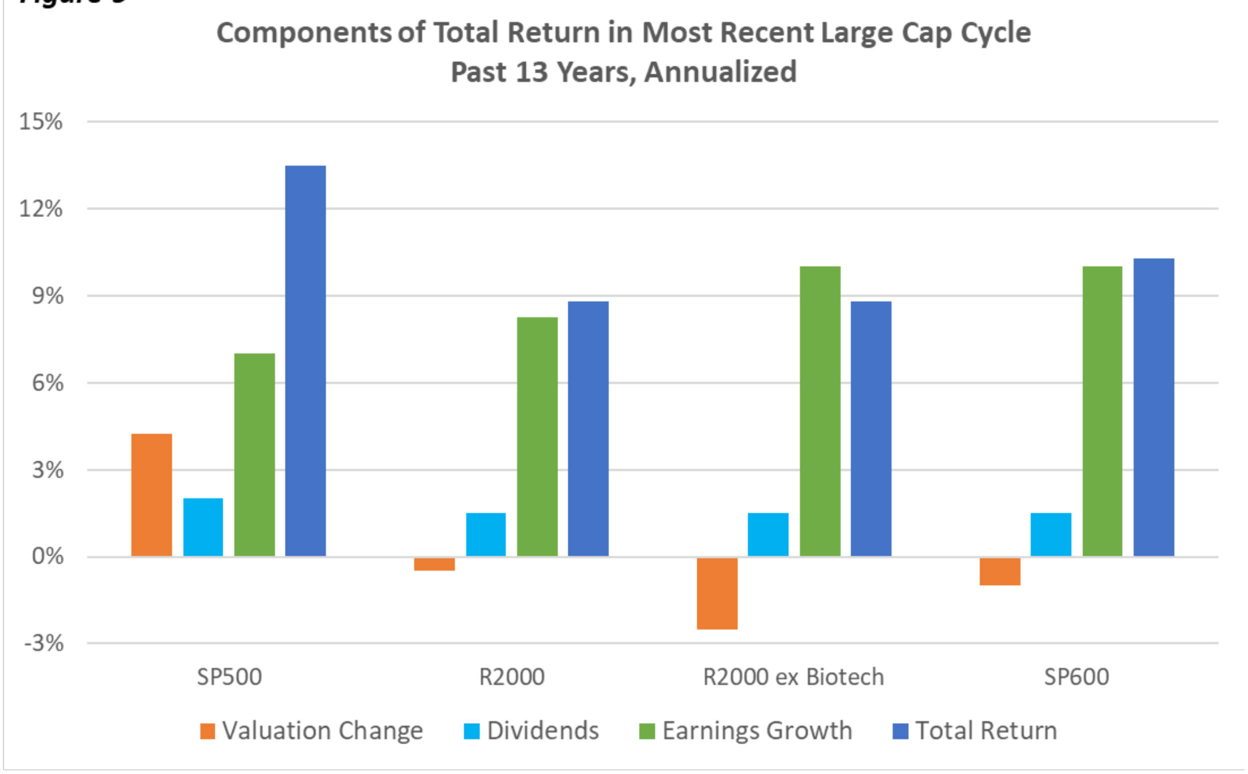
The longer-term chart, Figure 8 above, shows that the relative valuation of price to book ratios between large cap and small cap tends to become stretched above 200% with an average reversal valuation of 235%. The ratio ended 2023 at 234%.

APPRECIATION: SMALL CAP STOCKS OFFER BETTER EARNINGS POTENTIAL THAN LARGE CAPS

How can this be true in light of the price performance trouncing small caps have taken in relation to large caps? If GAAP earnings are used, it does appear that small caps have trailed large caps regarding earnings growth since early in the large cap leadership cycle. However, unusual expenses, write-downs, and stock compensation expenses all affect small companies to a greater degree than large companies. If those expenses are incorporated into the analysis, the picture changes. Using non-GAAP earnings – whose methodology aligns data more closely with cash flows - reveals that small caps (represented by the high-quality S&P 600 index) have outperformed large caps (represented by the S&P 500 index) since 2011.

Non-GAAP earnings are calculated as last twelve months net income plus last twelve months non-cash items excluding debt and amortization. Using this data (*Figure 9*), we find that valuation expansion has been responsible for the outperformance of large versus small, not superior earnings growth.

Figure 9

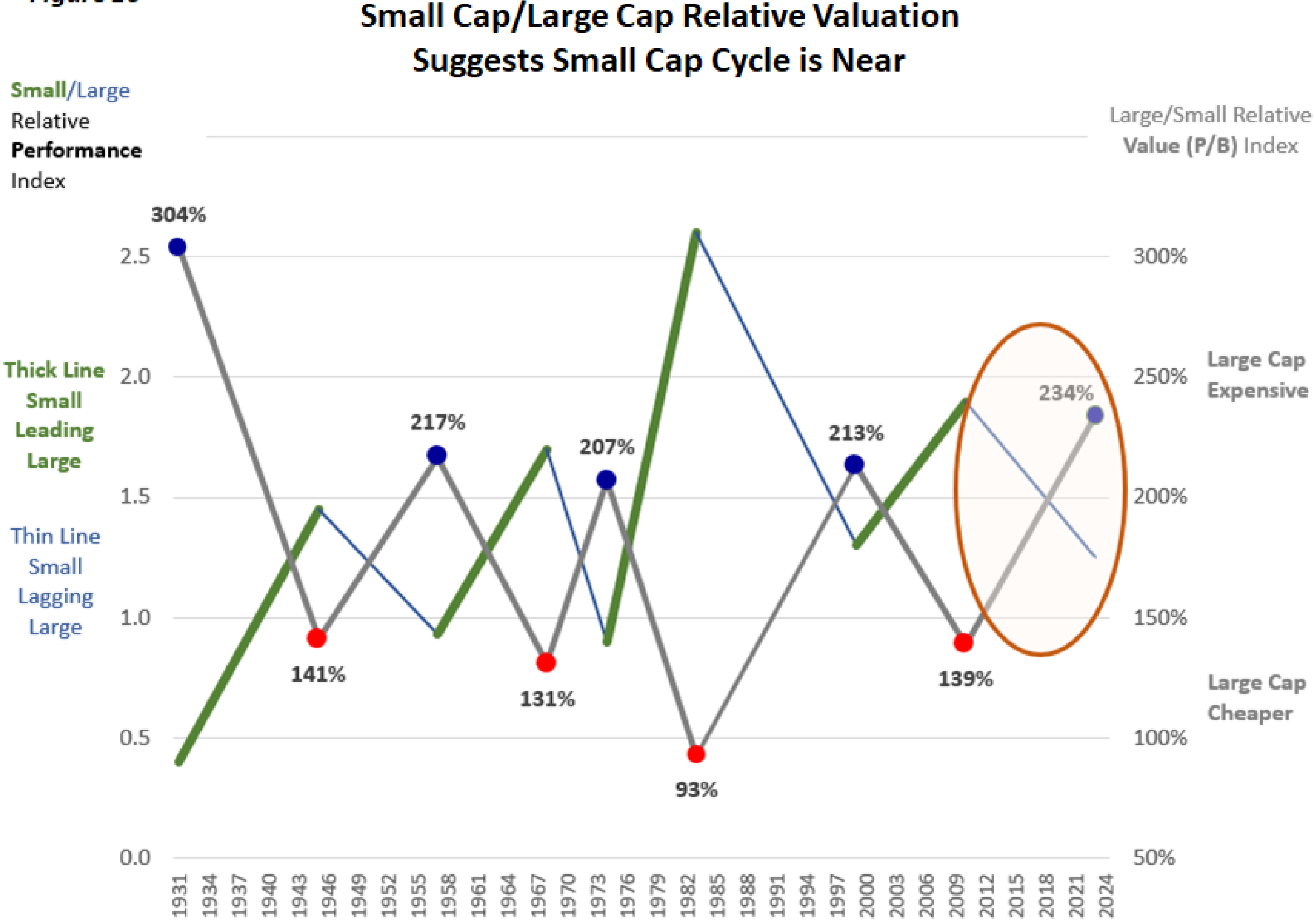


Source: Furey Research Partners

VALUATION AND LEADERSHIP CYCLES HAVE A STORY TO TELL

Combining the relative price/book of large caps to small caps with size leadership cycles (*Figure 10*), the indication is that not only is the large cap leadership cycle well-extended in years (thin blue descending line at far right), but it also coincides with a valuation disparity that has been seldom reached (gray line with blue dot at far right). Another data point suggesting small cap leadership is near.

Figure 10



Source: Furey Research Partners

CONCLUSION

High-quality small cap stocks are poised to benefit from a normalizing economic environment of higher for longer interest rates and inflation. These markers often signal economic strength which tends to favor smaller, more nimble companies with higher growth potential. In addition, a normalizing rate environment enforces discipline on low quality/unprofitable companies. In a normalizing rate environment, high quality companies thrive.

Large cap stocks have outperformed small caps for 14 years. Whether performance is measured from the beginning of the leadership cycle, the last decade or since the mega-caps took over, their annualized return has been well in excess of historical norm. These returns will mean revert. The average size leadership cycle lasts 11½ years; this leadership cycle is extended at 14+ years. Additionally, mega-caps have become concentrated in regard to their weighting in the market. Concentrations have proven to be apex events in the past with small caps becoming the years long beneficiary.

Small cap relative valuations have become compressed to the point where they are at or near historical lows. The compression is not due to inferior earnings of the segment – small cap earnings are actually superior to large caps - but due to the valuation expansion of their large cap brethren. Valuation disparities have always corrected regardless of asset type. Once again, small caps will be the beneficiary.

This paper has presented evidence suggesting that the market is on the brink of a high-quality small cap leadership cycle. Investors who recognize the signs and position themselves accordingly stand to benefit from the potential outperformance of small cap stocks in the coming years.

Sawgrass's Genesis Small Growth Equity product, built with high quality stocks exhibiting lower price volatility; stable, consistent growth; and attractive valuations is made for this environment.

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33 Years of Investment Experience

26 Years with Sawgrass

Mr. Riley is a Partner at Sawgrass Asset Management and is the lead portfolio manager for the well-diversified Genesis Small Growth Equity and SMid Core Equity portfolios. He is responsible for quantitative and fundamental analysis and research, idea generation and portfolio construction. He serves on the firm's equity research committee. Prior to Sawgrass he spent seven years at Barnett Capital Advisors, Inc., as a senior analyst and assistant portfolio manager for the firm's Small Cap Growth Equity product. His educational accomplishments include a M.B.A with a concentration in Finance from Auburn University, a B.B.A. with a major in Marketing from Marshall University and, earning the Chartered Financial Analysts (CFA) designation. He is a member of The CFA Institute (formerly AIMR) as well the Jacksonville Financial Analysts Society.

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