Small Cap Stocks Should Be In Your Portfolio

JUNE 2024

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KEY TAKEAWAYS

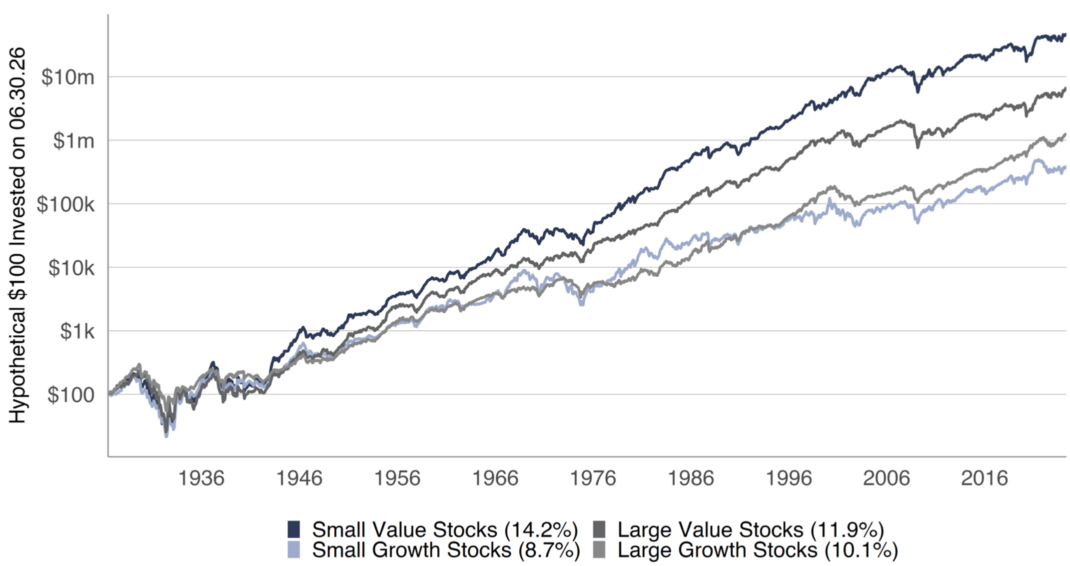
- **Historical Advantage**: Small Cap stocks have had better historical returns and offer diversification, reasonable valuations and generous dividend yields.
- **Opportunity**: Small Cap stocks have consistently grown faster than Large Cap stocks since 1995, while the valuation and performance gaps have remained wide.
- **Domestic Focus**: Sales are skewed towards the U.S. for small company stocks, which helps shield them against a strong dollar and currency volatility.

With Small Cap stocks stuck in neutral this year from a performance standpoint, we thought it was worthwhile to refresh last year's report on this still-undervalued subset of the stock market. Large Cap stocks have marched higher lately, propelled by a handful of A.I.-oriented companies like Nvidia and **Microsoft (MSFT)**. Smaller stocks, which are less concentrated around A.I. (and Technology overall), have not kept pace with the big-company advance. Of course, we aren't complaining about the A.I. megatrend; our broadly diversified portfolios have benefitted handsomely, but investor (and broad market index) allocations have shifted out of balance given the performance differences, meaning the historical performance advantage and diversification benefits from Small Cap stocks are likely to be underappreciated when the winds change.

HISTORICAL EVIDENCE

We continue to find value in all market-cap strata, but think it's worth focusing on the reasonable price metrics and generous dividend yields of smaller-cap stocks for at least part of one's overall allocation. To make for easier access to the pocket of value, we launched a Small-Mid Dividend Value strategy in 2015 with a dual mandate: capital appreciation and income generation.

Figure 1: Ultra-Long-Term Performance since 1926



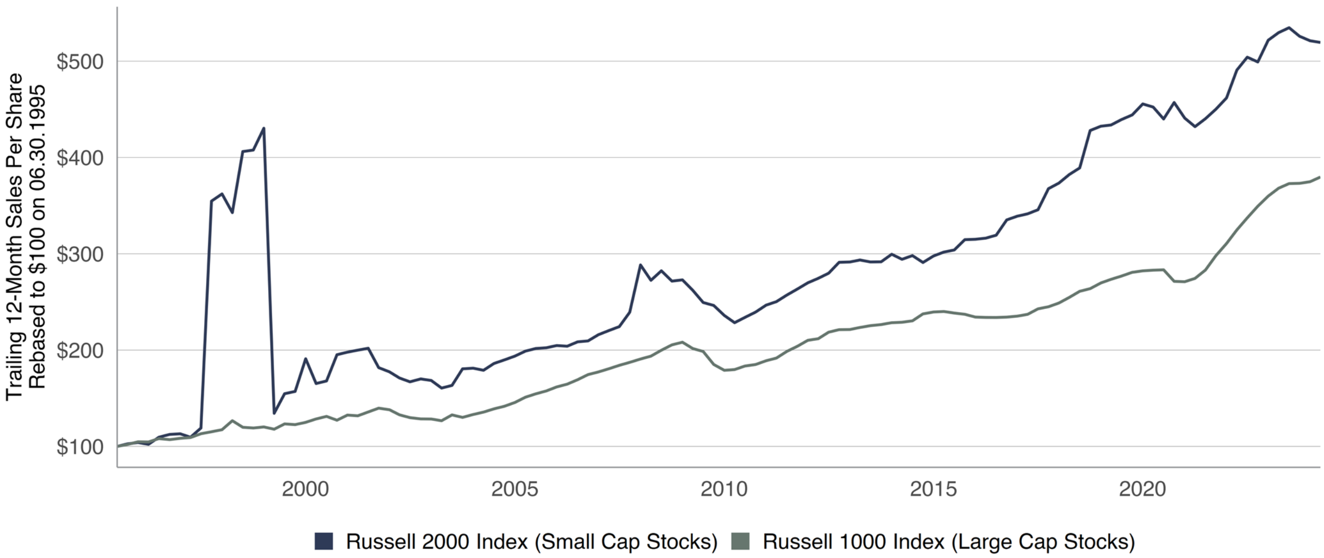
From 06.30.1926 through 04.30.2024. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Logarithmic scale. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French

REVENUE AND EARNINGS GROWTH

Large Cap stocks get a lot of fanfare. Microsoft, **Apple (AAPL)** and Nvidia each have market capitalizations in the $3 trillion range. Apple had $383 billion of revenue in 2023 and $97 billion of profit, the latter of which is larger than the entire market value for all but 96 companies in the Russell 3000 index. Such figures turn heads and garner grand headlines, but there is an entire subset of investable stocks that get far less attention but are potentially more valuable in a diversified portfolio.

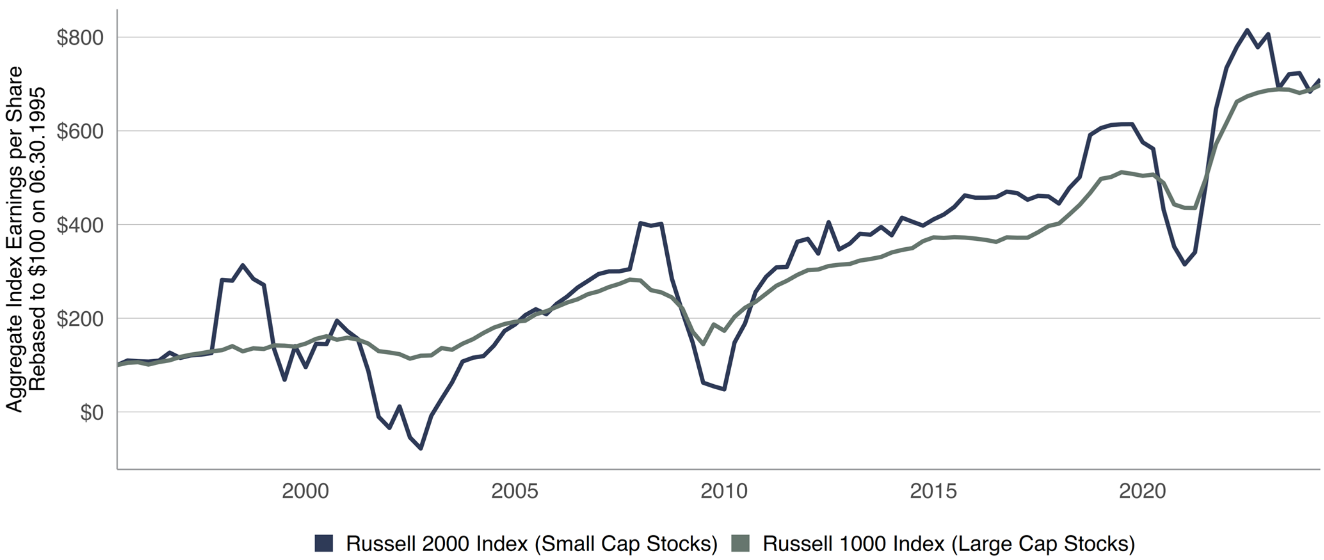
Figures 2 and 3 show Small Cap stocks have grown their sales and earnings at a faster clip than Large Cap stocks, at least since Russell started publishing index-level data in 1995. Admittedly, Large Caps have tended to be more profitable, which is reflected in the narrower gap between the indexes on the earnings chart (Figure 3) compared with the sales chart (Figure 2). Still, investors looking for corporate growth at reasonable valuations should take a hard look at Small Cap stocks, although a relative scarcity of data will make evaluating the Small Cap opportunity set a more challenging endeavor. As such, we rely on our quantitative framework to ensure we are fishing in the Value pond and regularly generating new ideas.

Figure 2: Small Cap Sales Growth Outpaced Large Caps



From 06.30.1995 through 05.31.2024. Trailing 12-Month Sales per Share. SOURCE: Kovitz using data from Bloomberg Finance L.P.

Figure 3: Small Cap Earnings Growth Has Kept Pace



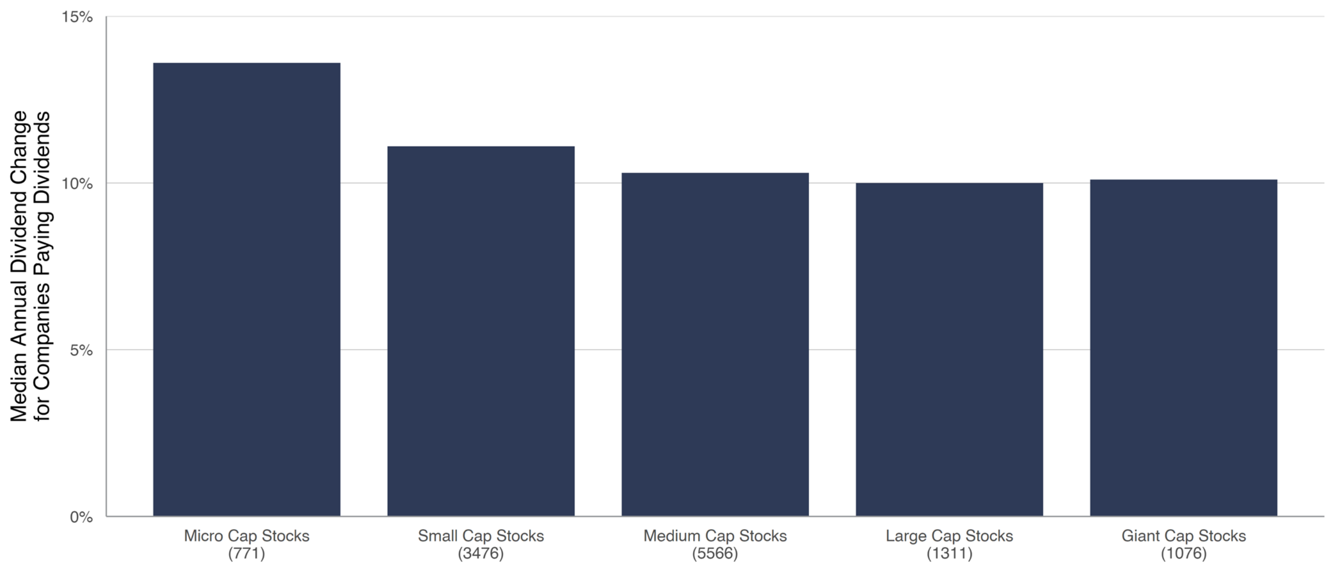
From 06.30.1995 through 05.31.2024. Trailing 12-Month Earnings per Share. SOURCE: Kovitz using data from Bloomberg Finance L.P.

DIVIDEND GROWTH

Larger companies tend to be given credit for their business' maturity, allowing them to build up balance sheet cash to fund growth projects, buy back common shares and pay dividends to investors. Smaller companies are not necessarily knocked for their dividend payment programs or strong balance sheets, but investors often jump to conclusions about corporate stability by looking at a company's size.

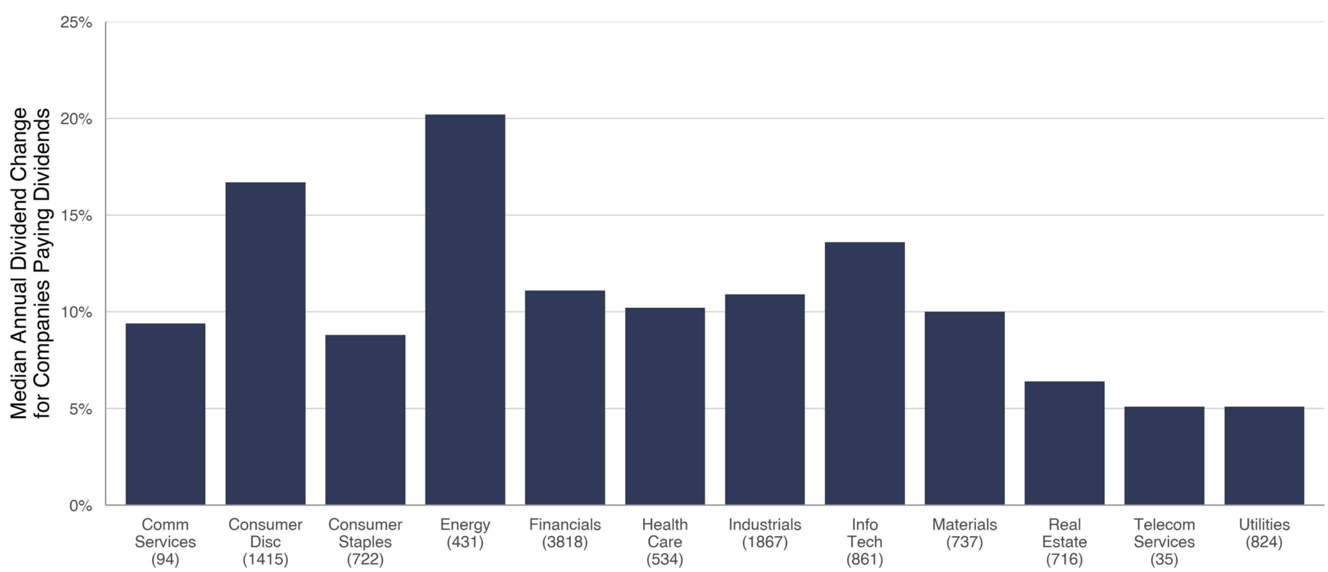
In Figures 4 and 5, we crunched numbers for nearly 2,500 dividend-paying companies between 2009 and 2023 and found that dividend hikes in Small Cap and Micro Cap stocks outpaced Large Cap and Giant Cap hikes, while increases in payouts vary by Sector, indicating that well-selected smaller companies are a great place to search for yield growers. The theme carries over to the broad index level. The average yield for dividend-paying Small Caps is 4.2% (Russell 2000 index), 2.6% higher than that of dividend-paying Large Caps (Russell 1000 index). We also note the broad indexes do not target dividend-payers specifically. As of May 31, 76% of Large Cap and 50% of Small Cap constituents paid a dividend over the past year.

Figure 4: Dividend Growth by Market Capitalization



From 12.31.2009 through 12.31.2023. Includes only companies that paid a dividend in the Russell 3000. Total annual dividend payments were assigned by pay date. Companies that stopped trading mid-year were excluded for that year. Market capitalization buckets were determined by the value at the end of each year. Source: Kovitz using data from Bloomberg Finance L.P.

Figure 5: Dividend Growth by GICS Sector

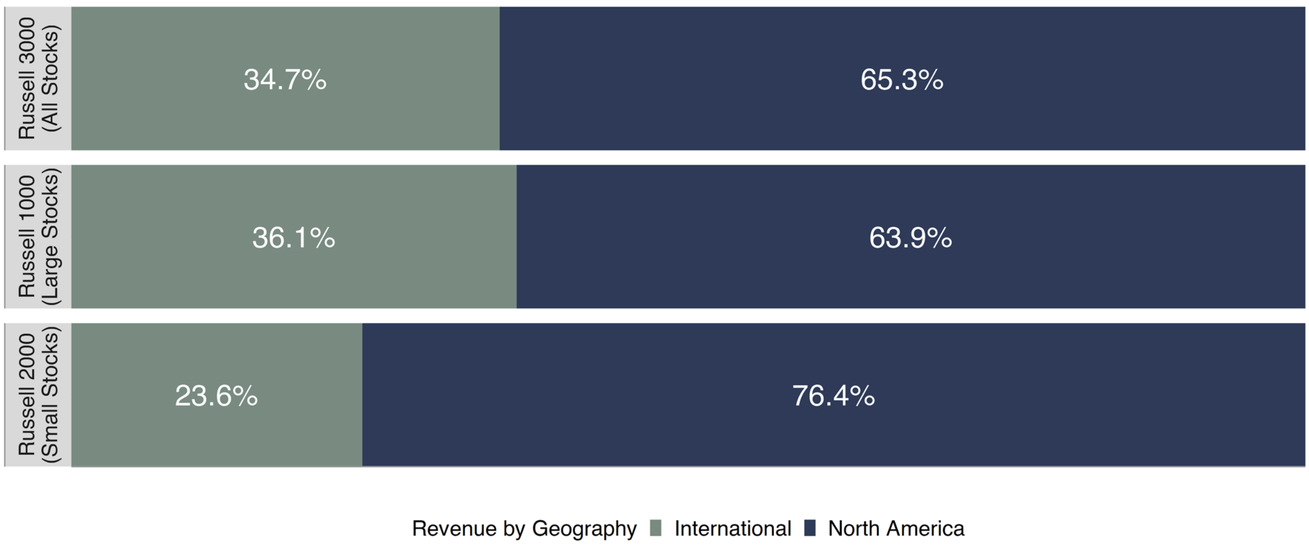


From 12.31.2009 through 12.31.2023. Includes only companies that paid a dividend in the Russell 3000. Total annual dividend payments were assigned by pay date. Companies that stopped trading mid-year were excluded for that year. Sectors were determined by the company's GICS classification at the end of each year. Source: Kovitz using data from Bloomberg Finance L.P.

DOMESTIC FOCUS

A strong U.S. dollar has been cutting into revenue and profitability figures for larger U.S.-based companies as the value of sales and earnings made in euros, pounds and other currencies are worth less after translations back into greenbacks. With persistent inflation also a headwind in many global markets and corporate profit margins for many multinational companies under pressure, the inclusion of exposure to U.S.-centric companies would seem to be of particular interest.

Figure 6: Currency Impacts Are Likely to Vary by Index



Fiscal year 2023. Source: Kovitz using data from Bloomberg Finance L.P.

RECENT HISTORY - SMALL VS. LARGE RETURNS

Pivoting to the Value version of the Russell 2000 index, investors have seen the performance gap between the Small Cap Russell 2000 Value index (with market caps between $11 million and $19.3 billion on May 31) and the Large Cap S&P 500 index widen over the past six-plus years. The tide started to turn in Q4 2020, but has expanded again recently, offering new opportunity to add Small Cap exposure to one's asset allocation.

Figure 7: Small Cap Value Returns Have Lagged Large Cap

From 01.31.2017 through 05.31.2024. SOURCE: Kovitz using data from Bloomberg Finance L.P.

DIFFERENTIATED EXPOSURE

Exposure overlap can be problematic for investors and often goes unnoticed. Diversification, often referred to as the only free lunch in investing, refers to the practice of spreading out investments across multiple assets, such that the bumps along the path to investment success are smoothed out. We have long found the diversification juice is worth the squeeze and we can see why an investor might consider themselves to be more diversified holding both a S&P 500 ETF and a Russell 1000 ETF, rather than picking one. After all, they are different vehicles covering different indexes.

However, Figure 8 shows the sector-level exposures are effectively the same. An investor would find a much larger diversification benefit holding an S&P 500 ETF plus a Russell 2000 ETF or Russell 2000 Value ETF because of the reduction in overlap. The additional diversification, in conjunction with fundamental and total return benefits, leads us to believe that Small Caps serve as an attractive slice of an investor's overall allocation.

Figure 8: Indexes Can Look Alike or Very Different

Index-Level Sector Exposures					
Sector	S&P 500 Index	Russell 1000 Index	Russell 1000 Value Index	Russell 2000 Index	Russell 2000 Value Index
Communication Services	9.3	9.0	4.5	2.2	2.4
Consumer Discretionary	9.8	10.0	4.8	10.5	10.6
Consumer Staples	6.0	5.8	7.9	3.5	2.3
Energy	3.9	3.9	8.0	7.6	10.4
Financials	12.9	13.6	22.7	15.9	25.7
Health Care	11.2	11.9	13.8	14.8	8.6
Industrials	8.5	9.4	14.4	17.4	14.7
Information Technology	30.5	29.2	9.1	15.0	6.3
Materials	2.3	2.5	4.8	4.8	5.3
Real Estate	2.2	2.5	4.5	5.5	9.6
Utilities	2.5	2.4	5.2	2.6	3.9

As of 05.31.2024. May not sum to 100 due to rounding. SOURCE: Kovitz using data from Bloomberg Finance L.P.

SMALL CAPS DESERVE A SPOT IN YOUR PORTFOLIO

We think there's a lot to like about Small Cap stocks, especially those that reside in the Value camp and pay dividends. While the preceding analysis uses broad indexes to cast the widest possible net, we do sleep better at night with the knowledge that the metrics on our managed account portfolios generally are far less expensive than those of the major market averages and are even priced more favorably than nearly all the Value indexes. The Small-Mid Dividend Value (SMID) strategy's forward P/E is 11.6x, compared to the 21.2x figure for its Russell 2000 Value benchmark and the 21.8x multiple for the S&P 500. What's more, SMID's estimated dividend yield is 2.9%, compared with the benchmark's 2.3% yield and the S&P 500's 1.4% figure.

Efforts to augment our comprehensive wealth management services frequently turn up valuable investment opportunities for our clients and future clients. The Small-Mid Dividend Value strategy is a product of such research, and it has been a live portfolio for nearly a decade, endeavoring to offer the benefits we've highlighted in this report when included as part of an investor's asset allocation.

For more than four decades, we have collaborated with our clients in their investment decision-making process as they pursue their long-term financial goals. We are committed to keeping your goals, concerns and attitude about investing at the heart of your plan. If you're ready to experience our personalized investment approach and exceptional client service, contact Jason R. Clark, CFA at 949.424.1013 or jclark@kovitz.com.

For additional information about subscribing to the *The Prudent Speculator* newsletter, please call Phil Edwards at 800.258.7786 or email pedwards@kovitz.com.

For more details about our wealth management and asset management services, kindly reach out to:

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The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The Standard & Poor's 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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