From Obscurity to Opportunity: The Small-Cap Advantage

In recent years, stock market returns have been increasingly dominated by a handful of large-cap growth-oriented companies while small-cap stocks have struggled. This phenomenon is not new. In this paper, we explain why an allocation to actively managed small-cap equities should be part of a well-balanced investment portfolio.

The Large-Cap Phenomenon

In the late 1960s and early 1970s, investors fell in love with a group of large-cap, blue-chip businesses dubbed the Nifty Fifty. The Nifty Fifty were regarded as stocks that investors could buy and hold forever and included household names like IBM, General Electric, and Kodak. While IBM and General Electric remain in business today, their reign as the two most valuable companies in the world ended long ago.

In the late 1990s and early 2000s, investors once again crowded into the largest, most popular companies such as Cisco, AOL, and Nortel. While Cisco survived the dot-com crash, it has fallen far from its position atop the market leadership board where it peaked in March 2000.

Today, we are seeing a similar pattern, with investors crowding into a handful of mega-cap stocks hailed as the Magnificent Seven: Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla, and Meta Platforms.

In the Nifty Fifty era, the dot-com bubble, and again today, potential opportunities in the small-cap segment of the market are overshadowed by the attractiveness of the largest, growth-oriented companies. The ironic reality is that the most popular companies today started out in the shadows of the small-cap universe.

While it is never easy to compete with what is fashionable, new leaders eventually do emerge. Investing in the small caps of today offers the opportunity to potentially own the leaders of tomorrow. With investors once again crowding into a small number of large-cap companies, we believe small-cap equities have an increasingly important role to play in the search for value-added returns.

The Small-Cap Advantage

There are three compelling reasons why investors should consider an allocation to this often-overlooked asset class.

1. **The small-cap universe is much more diversified than the broader equity market.** As noted earlier, the large cap universe is increasingly dominated by a handful of mega-cap stocks. While the global large-cap universe has enjoyed outsized returns in recent years, much of this performance can be attributed to the Magnificent Seven, which represented 21% of the weight of the MSCI World Index at the end of 2023 and yet contributed 45% of the overall index return that year. By contrast, the top seven companies by market value in the MSCI ACWI Small-Cap Index represent less than 1% of the overall index. A less concentrated universe gives investors more flexibility to build meaningful positions in companies they believe offer the highest potential return, while assuming relatively less concentration risk.

2. **The small-cap market is less followed and therefore more inefficient than large caps.** Smaller companies have a smaller following among research analysts. According to S&P Capital IQ, on average, there are almost four times more sell-side research analysts covering a U.S. large-cap company than a global small-cap company. With fewer research analysts following small-cap companies, the likelihood of the market mispricing these companies increases. Astute investors can take advantage of these pricing discrepancies to purchase great companies at a discount to their fair value and sell companies trading at a premium.

3. **Small-cap stocks have delivered superior risk-adjusted returns over longer time horizons.** Perhaps the most compelling reason to invest in this underfollowed asset class is that small-cap stocks have historically enjoyed superior risk-adjusted returns relative to broader global equity benchmarks. While small-cap returns have lagged the large-cap market in seven of the last 10 years, small caps returned 8.3% over the past 25 years, outperforming the broader market's return of 6.0%.[1] It is true that higher returns for small-cap stocks are often accompanied by higher volatility as these companies tend to be more sensitive to swings in economic cycles. However, the small-cap market has rewarded long-term investors with a higher return per unit of risk compared to the broader global equity market – a 0.46 reward-to-risk ratio for the small cap index compared with a ratio of 0.39 for the world index in the 25 years to December 31, 2023.

Case Study: Booking Holdings

Booking Holdings is the largest online travel agency in the world and a great example of the benefit of investing in companies that are less widely followed. As a small-cap company in 2005, Booking had a following of 13 sell-side research analysts. By 2009, Booking had graduated to the large-cap universe, but it was still relatively underfollowed, at just 17 analysts. As the company continued to grow so did its analyst following, which more than doubled from the time it was a small cap in 2005 to its peak at 27 analysts in 2013. An investor who purchased Booking at its peak popularity in 2013 and held it to December 31, 2023, would have earned a respectable return of 205% in U.S. dollars in the 10 years to December 31, 2023. However, purchasing Booking just four years earlier in 2009, when it was less popular among sell-side analysts, would have generated a return of over 1,500% to the end of 2023. Booking is a great example of how the relatively low level of analyst coverage in small caps can create opportunities for patient, long-term investors.

For these reasons, small caps are not only an essential part of a well-diversified investment strategy but allocating even a small portion of your overall portfolio, say 10% of your equity allocation, can potentially increase returns over the long term.

The Current Opportunity: Big Upside from Small Companies

Small-cap stocks were out of favour in 2023. Large-cap stocks, on the other hand, outperformed their small-cap peers by a wide margin. In 2023, global large caps gained 23.5%, while global small caps returned 16.8%.[2]

Small-cap stocks are historically cheap relative to their large-cap peers. In the last 20 years in Canada, small caps traded at an average premium of 232% relative to large caps. In December 2023, small caps traded at a premium of only 15% compared with large caps. The situation is similar in the U.S. where the average premium was 94% over the last 20 years while the December 2023 premium was 48%.[3] We believe the valuation multiples of small caps are at levels that are too attractive to ignore and that the valuation premium over large caps has fallen to an unsustainable level. Yet many investors are under allocated to this segment of the equity market. The question is, why?

Small-cap stocks struggled in 2023 amid investor concerns over an impending recession. It is true that small caps tend to underperform large caps in weaker economic environments. However, despite higher interest rates, there has been no sharp decline in economic growth so far. In fact, some economic data would suggest quite the opposite. Either way, the small-cap market appears to already have factored in the risk of recession given the historically steep discounted valuation of this segment, both on an absolute basis and relative to its larger counterparts. This strengthens the case for allocating to small caps because, in the event that the economy does slow, small caps should provide better valuation support, acting as a cushion to provide downside protection in a market correction.

[1] Figures are in U.S. dollars. Small caps are represented by the MSCI ACWI Small-Cap Index. The broader market is represented by the MSCI World Index.
[2] Figures are in U.S. dollars. Global large caps are represented by the MSCI ACWI Large-Cap Index. Global small caps are represented by the MSCI ACWI Small-Cap Index.
[3] Canadian small caps, Canadian large caps, U.S. small caps, and U.S. large caps are represented by, respectively, the S&P/TSX Small Cap Index, the S&P/TSX Composite Index, the Russell 2000 Index, and the S&P 500 Index.

Recent economic data suggests that we have seen the last of the interest rate hikes by central banks. Thus, while there are signs the market is gradually becoming more responsive to valuations, there have yet to be meaningful inflows into smaller companies, indicating that we are still in the early innings of a rotation into small-cap equities. However, timing the market is a fool's errand. Shifts in investor sentiment from bearish to bullish can be very sudden. Allocating even a small portion of a balanced portfolio to small-cap equities enables investors to fully participate in the early phases of bull markets and the subsequent rallies. As FGP Global Smaller Companies Portfolio Manager Ray Szutu likes to remind investors, "Time in the market is better than timing the market."

Inefficiencies Create Opportunities for Active Management

While inefficient markets present opportunities to generate outsized returns, it is critical to understand that the internal risk/reward profile of individual small-cap companies can vary considerably, even between companies in the same industry. Therefore, we believe small-cap investing favours a disciplined active management approach that is firmly rooted in fundamental analysis.

We find the best approach to protecting your capital is by investing in companies that are resilient and stable. These are companies that have a strong financial position, clear competitive advantages, and/or a high amount of recurring, predictable earnings.

There are about 10,000 companies in the global small-cap universe, many of them unprofitable. Debt magnifies a company's profit growth in good times and its profit decline in bad times. Many companies recently opted for fixed rate debt, so they haven't yet been hit by higher borrowing costs. If rates remain high when it is time to refinance, these companies won't be immune to increasing interest payments. This is true for businesses of any size. However smaller companies tend to rely more on borrowing to grow their businesses compared with their large-cap peers. Higher interest rates, therefore, disproportionately impact the small-cap universe. Allocating to a passive small-cap index fund exposes investors to unnecessary interest rate risk.

Case Study: Winpak

Winpak is a leading North American manufacturer of specialty, flexible, and rigid packaging and an excellent example of a high-quality small-cap company. Winpak has no net debt and nearly $11 per share in cash on its balance sheet. Over the past seven years, Winpak grew its revenues and earnings by 43% and 39%, respectively, and amassed a war chest of cash on its balance sheet, yet its share price declined 11% in Canadian dollars over this period. At the end of 2023, Winpak's shares traded at an attractive valuation multiple of less than six times EV/EBITDA, which is 50% cheaper than what an investor would have paid seven years ago.

Active managers can significantly reduce the risks associated with higher interest rates by owning only those small-cap companies that have little or no debt because, as Ray Szutu says, "You're unlikely to go bankrupt if you don't owe anyone money." Furthermore, companies with under-levered balance sheets can opportunistically deploy capital in times of broad economic stress. They have the capacity to buy back their own shares or acquire competitors at discounted prices, or they can invest in strengthening their businesses while indebted competitors are retrenching.

When astute investors find companies with the above characteristics that are well-run and have strong competitive positions, it is crucial that they not overpay for them. Even the perfect company can be a terrible investment if the entry price is astronomical. The same can be said of defensive companies. When investors are worried and crowd into the very largest and best-known companies at high prices, it can be a self-defeating proposition.

Conclusion

The small-cap equity market provides investors with exposure to companies that offer good risk-adjusted returns and relatively low correlation to the large-cap universe. Yet many investors are underinvested in this segment of the equity market. In today's market, investors are more inclined, perhaps than ever before, to favour the very largest and best-known companies, which are often perceived as being lower risk. However, the greater inefficiencies in the smaller cap market provide ample grounds for successful active managers to generate strong risk-adjusted returns.

It is no coincidence that we have two active small-cap strategies – the FGP Small Cap Canadian Equity Fund and the FGP Global Smaller Companies Fund - led by different portfolio managers, invested in different geographies, applying the same disciplined investment process.

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