CLEARPOINT

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SMALL VS. LARGE COMPANIES: APPLES AND ORANGES

BY JOE NITTING, CFA, CAIA, ANALYST, RESEARCH

From January 1, 2017 to March 3, 2020, the Russell 2000 Index has underperformed the S&P 500 Index by 10.2% annualized[1], leading some investors to question the appropriateness of small companies in portfolios. In this month's edition of *ClearPoint*, we examine the qualitative differences between small and large companies, the drivers of small companies' underperformance, and our view on small companies' potential performance going forward.

SMALL AND LARGE: COMPANY-LEVEL VS. INDEX LEVEL

At a company level, the most apparent difference between small and large companies is size (quite obviously). In the stock universe, many investors define company size by "market capitalization" (market cap), which is the product of share price and shares outstanding. Generally, small companies have a market cap of less than $2 billion, while large companies typically have a market cap exceeding $20 billion[2].

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However, when observing small cap vs. large cap companies at an index level (Russell 2000 vs. S&P 500), we find more telling differences. As illustrated in the table below, the small cap universe has more exposure to financial and industrial companies and less to communication service and information technology companies.

Sector	Russell 2000	S&P 500
Communication Services	2.3	10.7
Consumer Discretionary	8.7	9.8
Consumer Staples	3.4	7.8
Energy	1.7	2.6
Financials	16.8	10.9
Health Care	21.3	15.4
Industrials	15.2	8.2
Information Technology	15.1	25.5
Materials	3.4	2.4
Real Estate	7.6	3.0
Utilities	4.5	3.6

Source: Morningstar, as of 3/31/2020.

When digging into these differences further, the types of companies in each sector in the Russell 2000 and S&P 500 are markedly different. In general, Russell 2000 companies are those in more regional or niche markets and have smaller business footprints, while the largest S&P 500 companies are household names with broad market reach, dynamic global supply chains, and massive business footprints. The table below shows the two largest companies (by weight) in the four previously discussed sectors across the Russell 2000 and S&P 500.

	2 Largest Companies (% Weight)	
Sector	Russell 2000	S&P 500
Communication Services	Cogent Communications (0.25%) Shenandoah Telecommunication (0.16%)	Alphabet/Google (3.24%) Facebook (1.88%)
Financials	First Financial Bank (0.21%) Community Bank System (0.20%)	Berkshire Hathaway (1.57%) JPMorgan Chase (1.20%)
Industrials	Generac (0.39%) Trex (0.33%)	Union Pacific (0.44%) Honeywell (0.41%)
Information Technology	Five9 (0.38%) Lumentum (0.37%)	Microsoft (5.68%) Apple (4.95%)

Source: Morningstar, as of 3/31/2020.

SMALL CAPS: RECENT UNDERPERFORMANCE

As previously stated, small cap companies have underperformed their large cap counterparts by a double-digit annualized margin since the start of 2017. Small caps have faced headwinds during that time including: (1) concerns about a contracting domestic economy, (2) unfavorable company characteristics relative to large caps in a potential recession, and (3) widening yield spreads between low and high quality debt, along with falling interest rates and a flattening yield curve.

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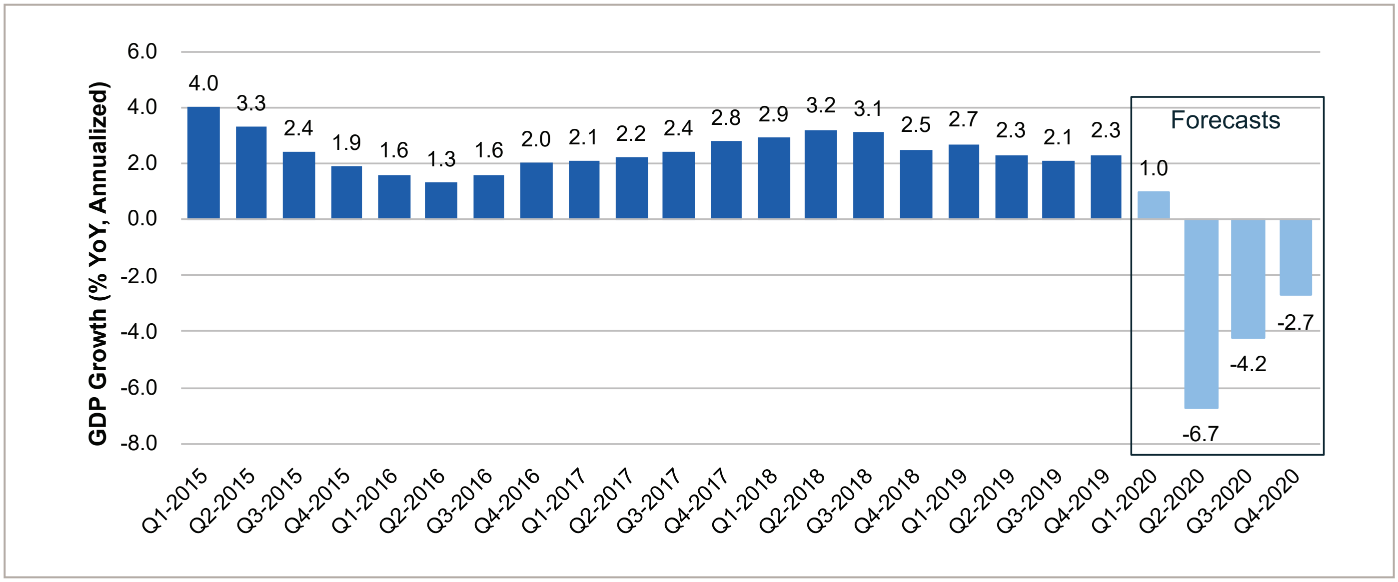
Beginning with concerns about a contracting domestic economy and seen in the chart below, the U.S. economy has been slowing since mid-2018. The impact of the coronavirus also has led many investors to believe the U.S. economy will enter a recession during 2020[1] (see chart below). Such concerns have weighed on small caps for multiple reasons. First, small caps are often domestically-focused businesses and could struggle more in a domestic recession than large caps. By comparison, the Russell 2000 generates roughly 77% of its revenues from the U.S. compared to just 62% for the S&P 500[2]. Moreover, the Russell 2000 also has more exposure to financials and industrials, both of which historically have been more cyclical in nature and could struggle more from a domestic economic slowdown.



Source: Bloomberg, as of 3/31/2020.

These headwinds for small caps have manifested themselves in performance from January 1, 2017 to March 31, 2020. During that time, small caps have, on average, underperformed large caps across all eleven sectors, in some cases by as much as nearly 20% annualized[2]. It is also worth noting that during that time, the exceptionally strong performance of six stocks in the S&P 500 (Facebook, Amazon, Apple, Netflix, Google, and Microsoft) has caused roughly a third of the relative underperformance of small caps[2].

	Annualized Returns (%)	
Sector	Russell 2000	S&P 500
Communication Services	-7.0	7.1
Consumer Discretionary	-9.5	9.2
Consumer Staples	-1.6	4.7
Energy	-41.0	-21.5
Financials	-8.4	-1.4
Health Care	9.2	10.0
Industrials	-4.3	-0.3
Information Technology	7.5	21.5
Materials	-12.3	-1.3
Real Estate	-6.3	3.7
Utilities	6.6	7.8

*Annualized returns since 1/1/2017.
Source: Morningstar, as of 3/31/2020. Past performance does not guarantee future results.

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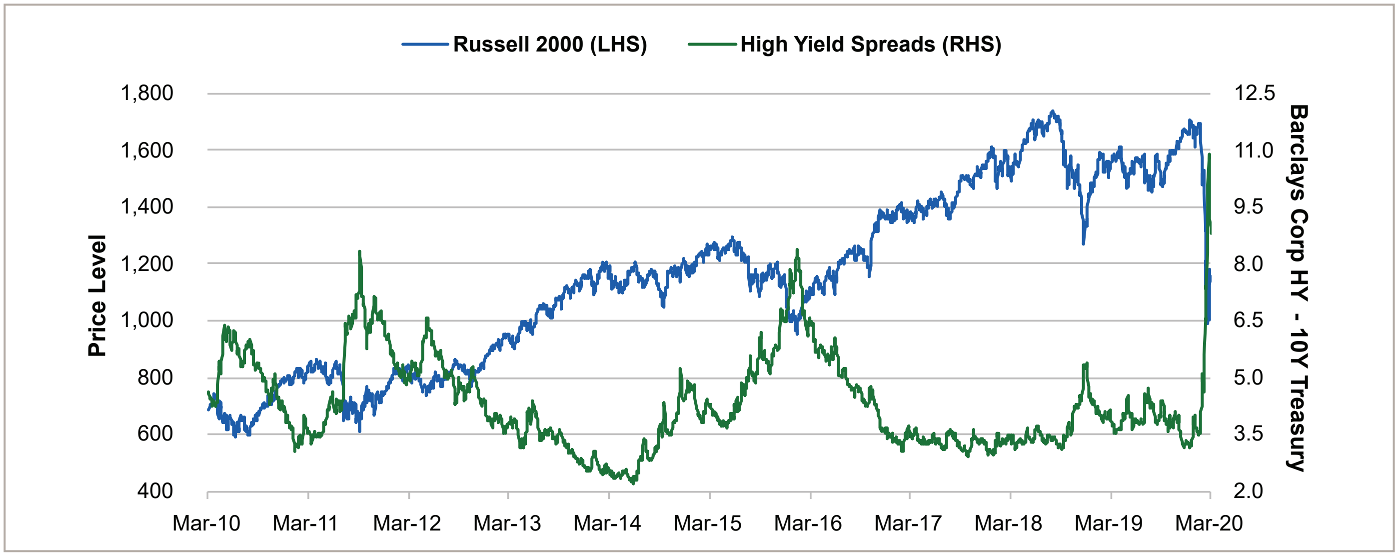
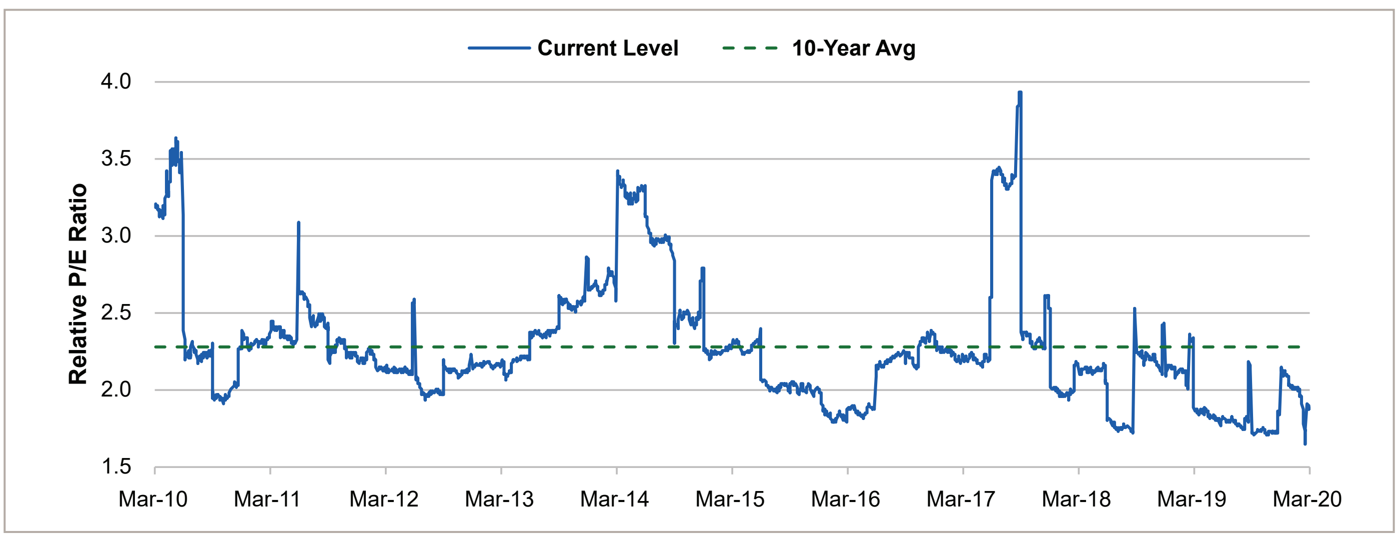
Expectations for a recession in the U.S. have also led to a significant divergence between interest rates of high-quality (investment grade) and low-quality (high yield) debt, sparking concerns about small caps and their access to potentially expensive credit. In the event of a recession, small cap companies could need loans, which could be more costly amid rising high yield interest rates, further exacerbating an already-struggling business environment. Additionally, falling high-quality interest rates and a flattening yield curve have weighed on regional banks in the Russell 2000. Banks often borrow on a short-term basis and lend on a long-term basis to make money. If interest rates are comparably low across time horizons, it could be difficult to borrow on a short-term basis and lend on a long-term basis to make money if interest rates are broadly low and at similar levels. Historically, these small cap regional banks have also not had as diverse businesses as their large cap peers, which can also make money through investment banking, trading, and asset management in the event of broadly low interest rates.



Source: Bloomberg, as of 3/31/2020. Past performance does not guarantee future results.

LOOKING AHEAD

Despite small caps' underperformance relative to large caps, they now appear more attractive on a relative valuation. The chart below shows the Russell 2000's trailing 12-month P/E ratio (excluding negative earning companies) divided by the S&P 500's trailing 12-month P/E ratio and indicates small caps are trading at a discount relative to large caps compared to the trailing ten-year average.



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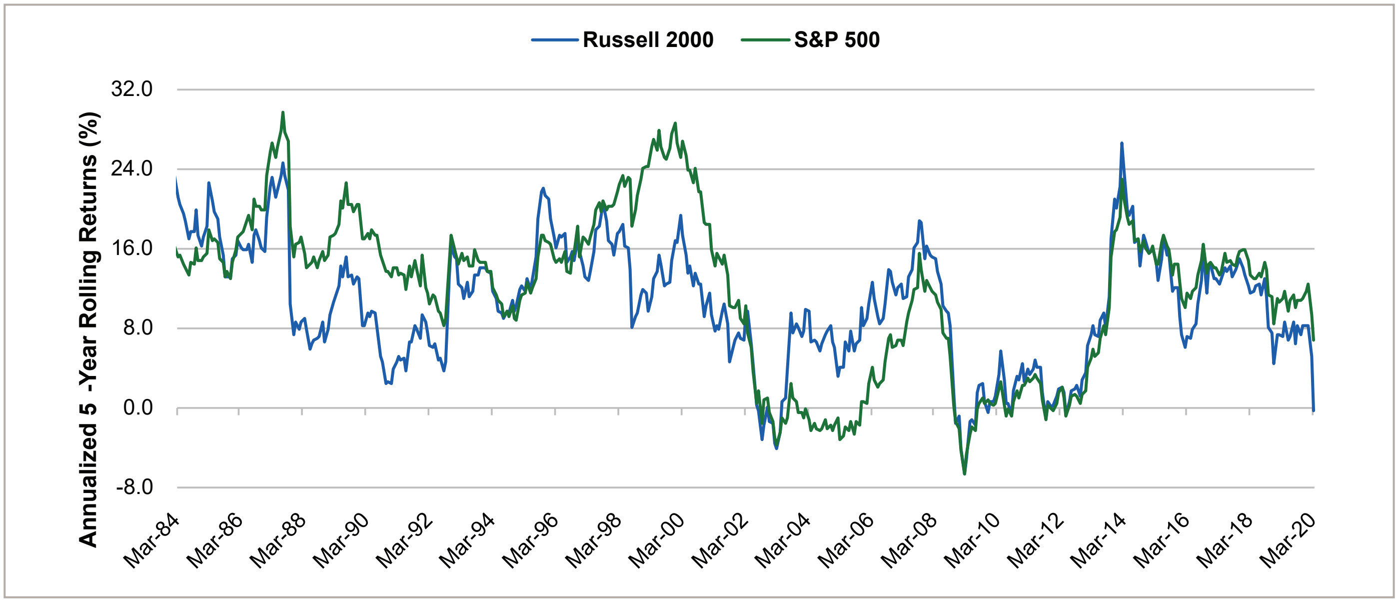
While small caps are becoming more attractive, several events need to take place before they begin to outperform. First, the domestic economy needs to stabilize to provide investors with more clarity around its growth trajectory. Concurrently, Clearstead believes high yield spreads need to tighten to more normalized levels and stay there to reduce fears about small caps' access to credit facilities in an economic downturn, while the yield curve also needs to steepen. If these events take place, we believe small caps and the sector composition of the Russell 2000 will return to favor. However, we acknowledge it could be a bumpy ride in the interim and continue to recommend staying invested and rebalancing regularly where appropriate.



Source: Morningstar, as of 3/31/2020. Past performance does not guarantee future results.

Sources:

(1) Bloomberg: 3/31/2020.

(2) Morningstar: 3/31/2020.

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

MARKET BENCHMARK RETURNS

April 30, 2020		1M	3M	12M	YTD
US Large Cap	S&P 500	12.8%	-9.3%	0.9%	-9.3%
US Small Cap	Russell 2000	13.7%	-18.5%	-16.4%	-21.1%
Developed Intl	MSCI EAFE	6.5%	-16.1%	-11.3%	-17.8%
Emerging Intl	MSCI Em Mkt	9.2%	-12.5%	-12.0%	-16.6%
Real Estate	NAREIT	9.1%	-19.8%	-10.7%	-18.7%
Core Fixed	BarCap Agg	1.8%	3.0%	10.8%	5.0%
Short Fixed	BarCap 1-3Yr	0.6%	1.8%	4.9%	2.3%
Long Fixed	BarCap LT G/C	4.5%	5.5%	25.2%	11.0%
Corp Debt	BarCap Corp	4.6%	-1.0%	9.4%	1.3%

Source: Bloomberg

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