

Despite lackluster years, small-cap value stocks may be the way to go

Small-cap value stocks have been uniquely poor performers recently. They posted strong returns in 2016, but otherwise, each of the past seven years small-cap value stocks have either significantly lagged or just barely beaten large-cap growth stocks.

The argument for small-cap value stocks is that they generate strong returns over the long term. However, they have posted almost the same returns as large-cap growth stocks since 2005. That is almost thirteen years with no significant return premium.

All of this has created an environment in which small-cap value stocks are largely unloved. The difference in valuation, as measured by the price-to-earnings ratio, between large-cap growth stocks and small-cap value stocks is over 14 points. This is among the highest readings since the technology boom of the late 1990s, making small-cap value stocks unusually cheap compared with past periods.

Valuation alone may not be enough of a reason to buy these stocks, but over very long time periods, they have significantly outperformed every other segment of the stock market. A high-performing investment trading at historically low prices starts to look awfully attractive.

Indeed, since 1927, which is about as far back as robust stock market data is available, small-cap value stocks have returned an annualized 13.6 percent. This compares with 10.1 percent for the overall stock market. An extra return of 3.5 percent may not sound like much, but compounded over 10 years, a \$1 million portfolio would generate more than \$950,000 in additional wealth. The difference over 20 years would be almost \$6 million. Clearly, there has been a benefit to owning these riskier stocks.

Though, with higher return potential comes higher risk. Annualized standard deviation, a measure of year-to-year price fluctuations, has been over 29 percent for small-cap value stocks versus around 18 percent for the overall stock market.

This is not just an academic statistic. Looking at past periods of market duress, small-cap value stocks have generally fallen more than the rest of the stock market. During the 2007-09 financial crisis, the overall stock market declined 47 percent, but small-cap value stocks lost 58 percent. The same is true in many other historical market drawdowns.

However, just because the overall stock market declines, it does not necessarily imply small-cap



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value stocks will fall further. In the wake of the dot com boom of the late 1990s, the opposite happened. More on this later.

Another reason to consider small-cap value stocks now is that they tend to outperform the most just after periods when they have been at their worst.

It also doesn't hurt that these stocks appear to be a bargain at the same time many other parts of the stock market are trading at historically high levels. The overall stock market, by some measures, is trading at the second highest level on record. The long-term price-to-earnings ratio shows that the stock market is now even more richly valued than just before the Great Depression.

During the later stages of stock market expansions, it is not unusual for investors to chase the returns of companies posting strong corporate profits, such as large-cap growth stocks. Additionally, higher overall stock market valuations,

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as we have today, can lead to investor unease, and riskier segments of the stock market, such as small-cap value stocks, are often shunned. Valuation becomes secondary to earnings growth, leading to disparities in which more reasonably valued stocks are ignored.

This is exactly what happened during the technology bubble of the late 1990s. It looks as if we're experiencing some of the same today. That is not to say that we're on the verge of another "tech wreck" that will drag the market down 50 percent like it did in the early 2000s. Things are different today. Technology companies have

very high valuations, but today's tech firms are real companies. They have viable products and positive earnings. Back in the 1990s, companies often went public with little hope of ever making money.

Still, the valuation disparity between large-cap technology companies and much of the rest of the market today is similar to the late 1990s. When the tech bubble burst, and the market declined from 2000 through 2002, large-cap growth stocks suffered the worst of the fall.

Small-cap value stocks actually fared pretty well. They declined in both 2000 and 2002, but still outperformed large-cap growth stocks by more than 10 percentage points each year. And, in 2001 when large-cap growth stocks fell 21 percent, small-cap value stocks posted a gain of over 40 percent.

Today, technology stocks are starting to show signs of fatigue. Volatility has picked up in these shares as the threat of stricter government regulation looms, future growth prospects are less rosy as many of the largest tech firms reach market saturation, and security breaches weigh on the public's trust in big data. The largest tech stocks have declined significantly more than the overall market since the market's peak in late January.

Meanwhile, small-cap value stocks have held their value better. They are still off their highs from earlier in the year, but by less than the overall stock market. The fact that small-cap stocks tend to be less globally exposed also helps position them favorably. Talk of a trade war has spooked companies that rely on exports for a significant portion of their revenue. Smaller companies are less apt to be doing as much business abroad.

Their domestic focus, favorable relative valuations, and recent underperformance are all reasons to take a harder look at small-cap value stocks. We certainly don't advocate timing the market, but for investors with no exposure to small-cap value, now may be the time to consider adding a strategic allocation to this sector.

Small-cap value stocks have taken investors on a wild ride historically, but for those willing to bear the high level of volatility, and are able to remain patient during periods of underperformance, strong returns can be the reward.

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