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Is It Time Again for Small-Cap Value?

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There's no question that small-capitalization value (bargain-priced) stocks, as represented by the Russell 2000 Value Index, have been in the doldrums. Year-to-date through the end of May, due in good part to a 36% plunge in the first quarter, small-cap value trailed small-cap growth (Russell 2000 Growth Index) by 19 percentage points, and lagged large-cap growth (Russell 1000 Growth Index) by a cavernous 31 points. Yet our research shows that it may be time to consider adding an allocation to this beaten-down asset class.

Small-Cap Value Shunned

Small-cap value's slump has been a prolonged one. In the 10 years ending May 31, 2020, the Russell 2000 Value Index returned just 6.5% annualized, behind its small-cap growth counterpart by five percent. And it underperformed the large-cap growth cohort, which contains market darlings such as Apple, Amazon, and Facebook, by a whopping 10 percent.

Not surprisingly, during the same time frame, the valuation discount of small-cap value relative to small-cap growth widened dramatically—which alone should pique the interest of value-oriented investors. For instance, during the past decade, the price-to-book discount of Russell 2000 Value widened from 61% to 73% (small-cap value now trades right around book value, compared to small-cap growth's 4x book); on a price-to-sales basis, the discount was 60% at the end of May; and the price-to-cash flow discount opened up to 69%. Based on these three metrics in aggregate, value's discount to growth is the widest it has been in the past 10 years.

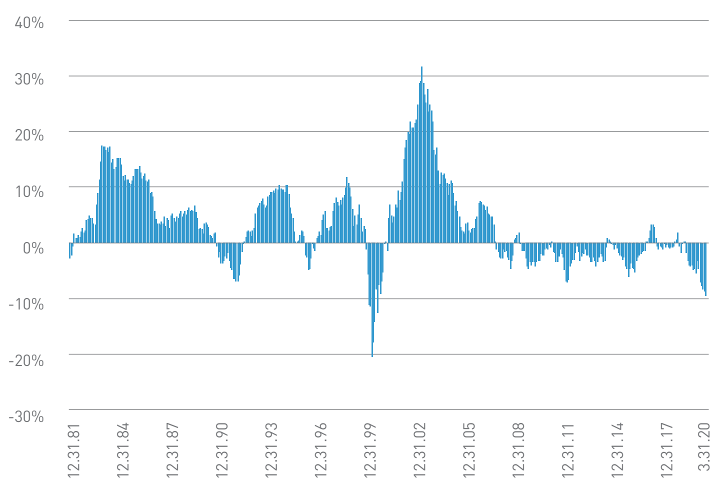
Yet, the long-term performance of small-cap value has been solid. If we expand our horizon to the four decades from January 1980 through May 2020, Russell 2000 Value returned 11.7% annualized, compared to 9.6% for Russell 2000 Growth. And small value's higher return came with 20% less volatility, resulting in a Sharpe ratio (a commonly used measure of risk-adjusted return) of 0.49 vs. only 0.29 for small-cap growth. And so the past decade's pattern of growth crushing value is something of an anomaly.

Poised for a Turnaround?

On a rolling basis during the same 40-year period, small-cap value bested small-cap growth in 61% of the three-year rolling periods, two-thirds of the five-year periods, and an impressive 73% of 10-year periods (**Figure 1**). If you're a long-term investor, you probably like those batting averages. It's a logical pattern, since investors have demanded higher return over time for taking the higher risk of owning small, out-of-favor companies.

We can't predict with any certainty when small-cap value stocks will find their place in the sun again. But today's extreme discounts and small-cap value's strong long-term history may be good signs. Finally, small-cap value has tended to perform relatively well when the economy is pulling out of a recession, which may be where we are now. Finance theory teaches that investors demand a higher return from small-cap value as compensation for taking higher risk in businesses with very low expectations and often elevated indebtedness. When the economy recovers and the cost of borrowing for riskier businesses declines (i.e., the high-yield interest rate spread over Treasuries narrows), the perception of risk lessens and many of these stocks can beat low expectations and mean-revert in value. We can't promise that this will happen or that it will turn into a long run change in leadership from growth to value, but at least over the short term, small-cap value looks to us like an investment opportunity.

FIGURE 1: OVER THE LONG TERM, SMALL-CAP VALUE HAS BEEN A WINNER
ROLLING 3-YEAR EXCESS RETURN OF RUSSELL 2000 VALUE VS. RUSSELL 2000 GROWTH



Sources: People's United Advisors Research, Bloomberg

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