U.S. Strategy Snapshot

Digging Deeper into Our December Small Cap Upgrade

Summary

(Note: This week's Strategy Snapshot is a follow-up to the mid-December 2020 Small Cap upgrade published as part of the *1Q21 Asset Allocator's Guide.*) Small Caps struggled to keep pace with the biggest Large Caps over the last decade. Mega Cap Tech companies, such as MSFT, AMZN, APPL, FB, and GOOG, powered the NASDAQ 100 higher (**Figure 1**) and boosted Large Caps' fundamentals (**Figure 2**). The result was a concentrated pack of companies that dominated the stock market and accounted for a growing share of the index (**Figure 3**). With markets trading at all-time highs, the risk is Mega Caps' sky-high valuations already price in future growth expectations. If so, Mega Caps could act as headwinds to Large Caps' future performance.

In our view, Large Caps' concentration risk and a combination of catalysts support a Small Cap upgrade to OW. From a valuation perspective, Small Cap's trade at the biggest NTM P/E discount vs Large Caps since the dot-com bubble (**Figure 7**). Small Caps' higher relative earnings yield compared to 10Y U.S. Treasuries also suggest Small Caps are undervalued, especially when factoring in NTM EPS estimates (**Figure 8**). From a thematic perspective, S&P 500 companies sit on large cash piles, which could be used to fund M&A growth (**Figure 9**). However, a Small Cap OW is not without risk. Small Caps face serious quality issues, including a high percentage of money-losing companies and high leverage (**Figures 4 & 5**). Despite the risks, we believe low interest rates, fiscal stimulus, and pent-up consumer and business demand can level the playing field for Small Caps.

Main Points

- ► The Russell 2000 / NASDAQ 100 trading price ratio recently bounced off an extreme low from the dot-com bubble (**Figure 1**).
- ► Tech's dominance in the 2010s improved Large Caps' fundamentals and growth potential relative to Small Caps (**Figure 2**).
- ► The S&P 500's top five holdings accounted for 22% of the index as of 12/31/2020 vs the twenty year average of 14% (**Figure 3**).
- ► 47% of the Russell 2000 Index generated negative earnings during 2020, up from the 38% peak during both the dot-com bubble and 2008 financial crisis (**Figure 4**).
- ► Small Caps' leverage soared following the 2008 financial crisis, which further intensifies Small Caps' risk profile (**Figure 5)**.
- ► Replacing the Russell 2000 with the S&P 600, which screens for a profitability factor, is our preferred way to emphasize quality (**Figure 6**).
- ► Small Caps traded at a -3.5x NTM P/E relative valuation discount vs Large Caps as of 12/31/2020 compared to a +1.3x average premium over the last two decades (**Figure 7**).
- ► Small Caps' higher relative earnings yield against 10Y Treasuries suggests Small Caps are undervalued (**Figure 8**).
- ► Management teams and corporate boards will likely search for ways to deploy large cash reserves and generate growth, which could boost Small Cap M&A (**Figure 9**).

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U.S. Factor Ratings

12-18 Month Investment Horizon

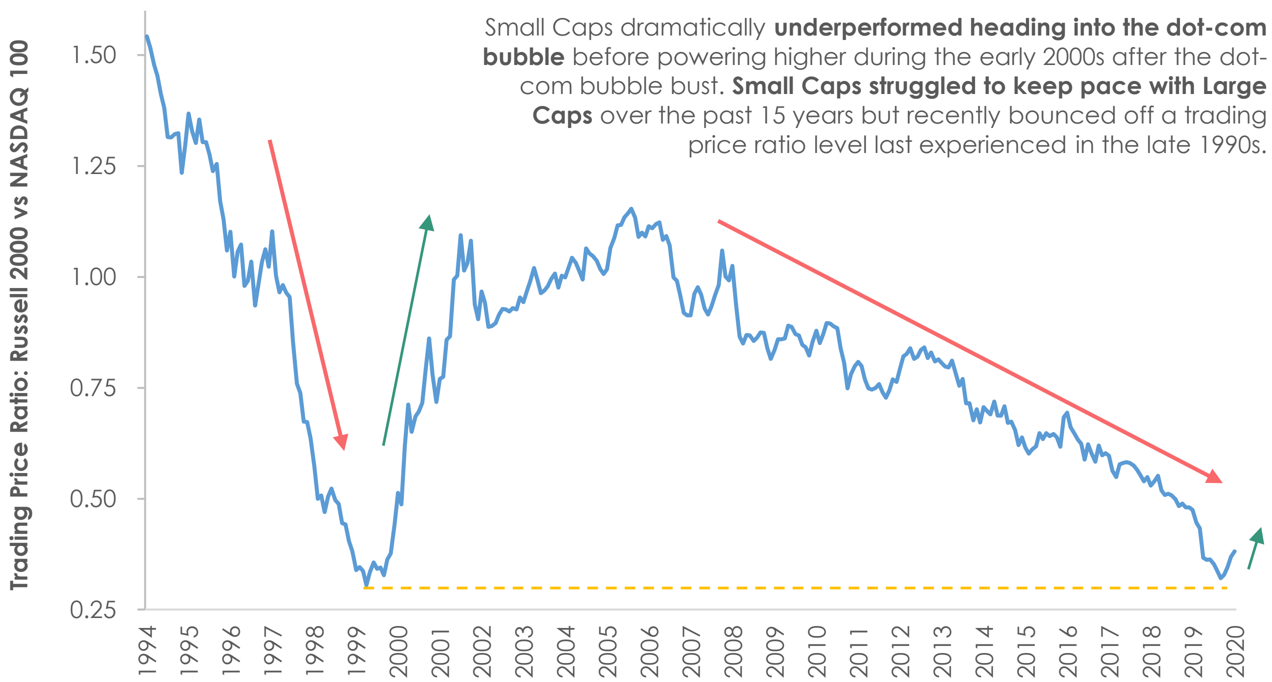
Factor	Our View	Last Chg
Growth	OW	Dec-19
Size - Small	**OW**	**Jan-21**
Low Volatility	OW	Aug-20
Momentum	OW	Dec-19
Size - Large	N	Jan-21
Quality	N	Aug-20
Value	N	Dec-19

Source: MarketDesk Research

Research Portal →

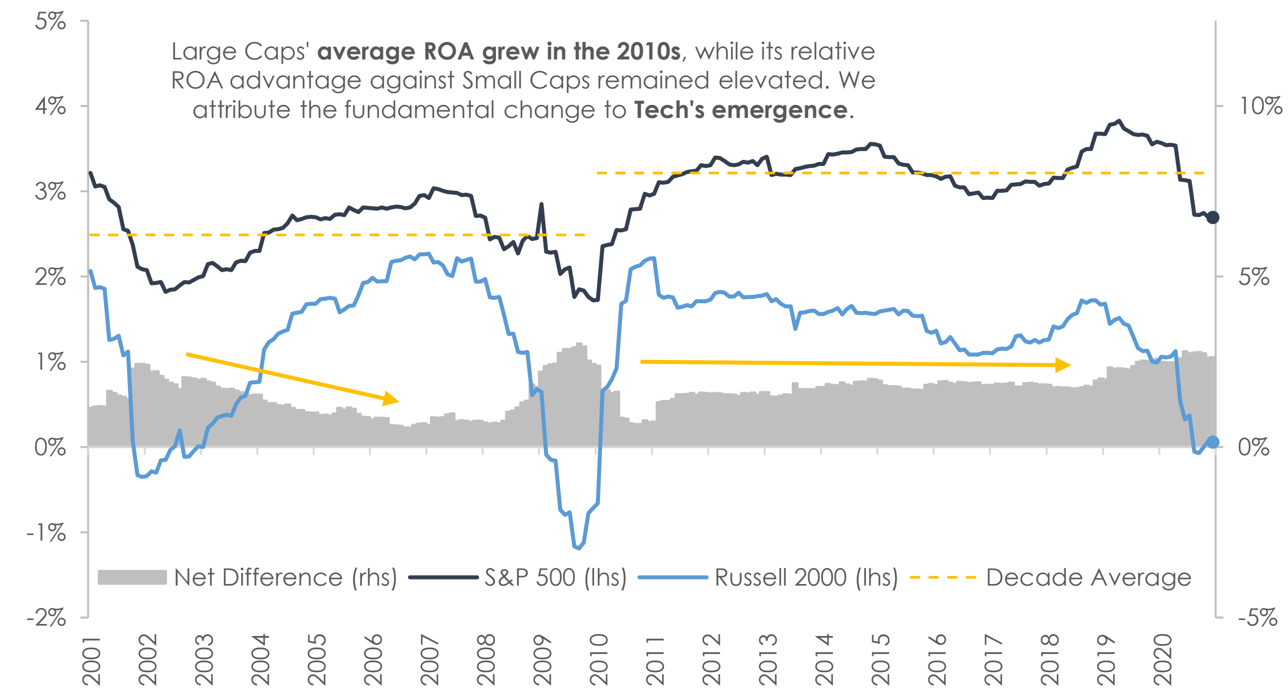
Small Caps Sit at Extreme Levels after Tech's Dominance & Multiple Years of Underperformance

FIGURE 1: Trading Price Ratio - Russell 2000 vs NASDAQ 100



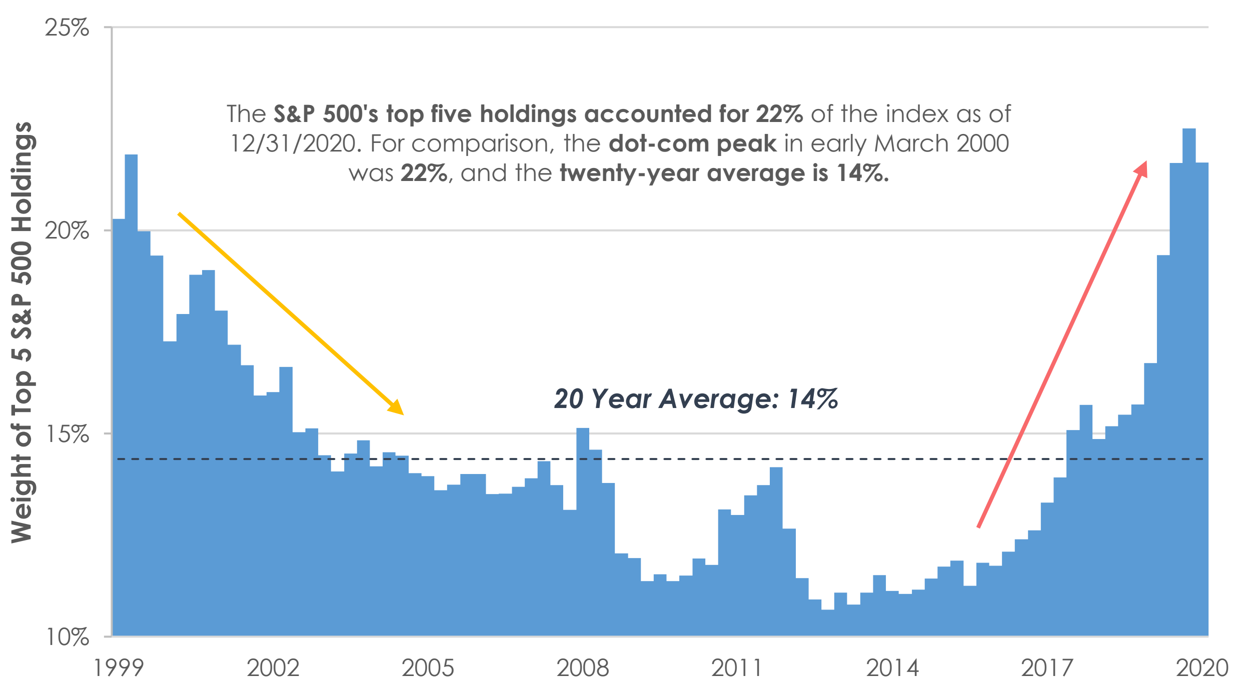
Source: MarketDesk Research. ***Note:*** *Trading Price Ratio calculated as trading price of Russell 2000 Index divided by trading price of NASDAQ 100 Index.*

FIGURE 2: Return on Assets - Large Caps (S&P 500) vs Small Caps (Russell 2000)



Source: MarketDesk Research

FIGURE 3: Top 5 Holdings Weight as a Percentage of S&P 500 Index



Source: MarketDesk Research

Figure 1: Small Caps vs NASDAQ 100 Trading Price Ratio Bounces off Extreme Level ...

- Figure 1 charts the Russell 2000 / NASDAQ 100 trading price ratio from over the past 25 years. It highlights how Small Caps steadily underperformed their Large Cap counterparts over the last 15 years after rallying in the wake of the dot-com bubble bust.
- Small Caps' steady underperformance against Large Caps creates an attractive setup in our view. With Large Caps, especially Tech, pricing in strong future growth expectations, we believe the stage is set for Small Caps to outperform in the coming months and years.

Figure 2: Tech's Emergence Changed Large Caps' Fundamental Profile ...

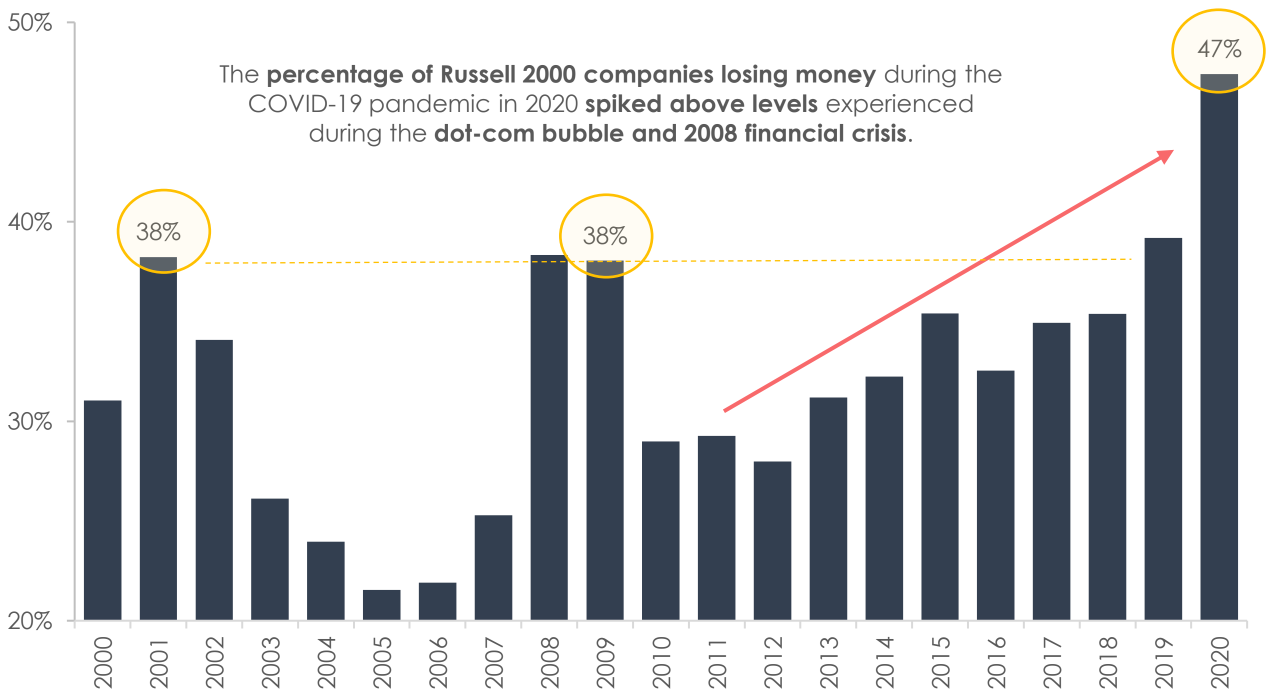
- Figure 2 compares Large Caps' return on assets (ROA) against Small Caps' ROA. ROA measures how profitable a company is relative to its total assets. Two trends stick out to us: (1) Large Caps' average ROA in the 2010s was 3.2% vs 2.5% in the 2000s and (2) Large Caps' relative ROA advantage held steady in the 2010s.
- We attribute Large Caps' ROA dominance to its Tech exposure. Tech is less asset intensive, more scalable, and grew exponentially over the last decade. When viewed through this lens, Large Caps' outperformance appears rational.

Figure 3: Tech's Dominance Created Concentration Risk within Large Caps ...

- Figure 3 tracks the weight of the S&P 500's top five holdings over the last two decades. The weight of the top five holdings fell after the dot-com bubble and held steady below 15% through 2018. Concentration risk rose recently as Mega Cap Tech dominated the index. In our view, S&P 500 concentration raises the risk of underperformance.

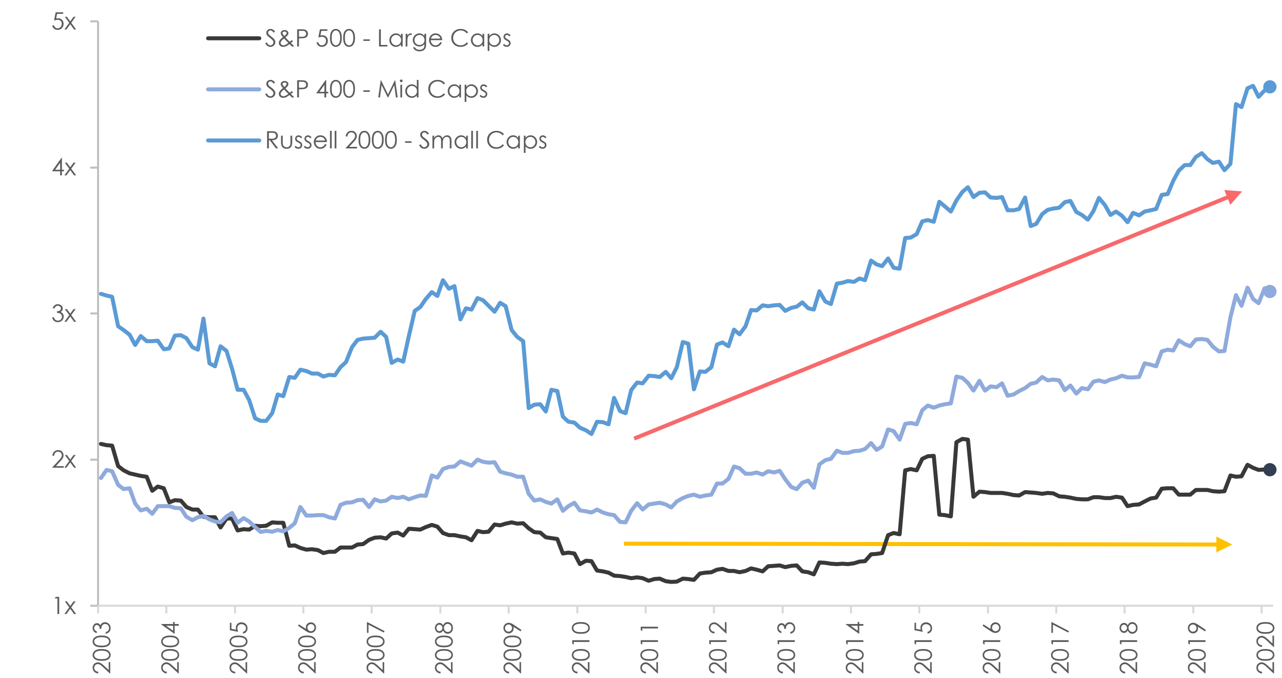
Favor Quality within Small Caps to Address Fundamental Issues

FIGURE 4: Russell 2000 Index - % of Companies Losing Money (LTM)



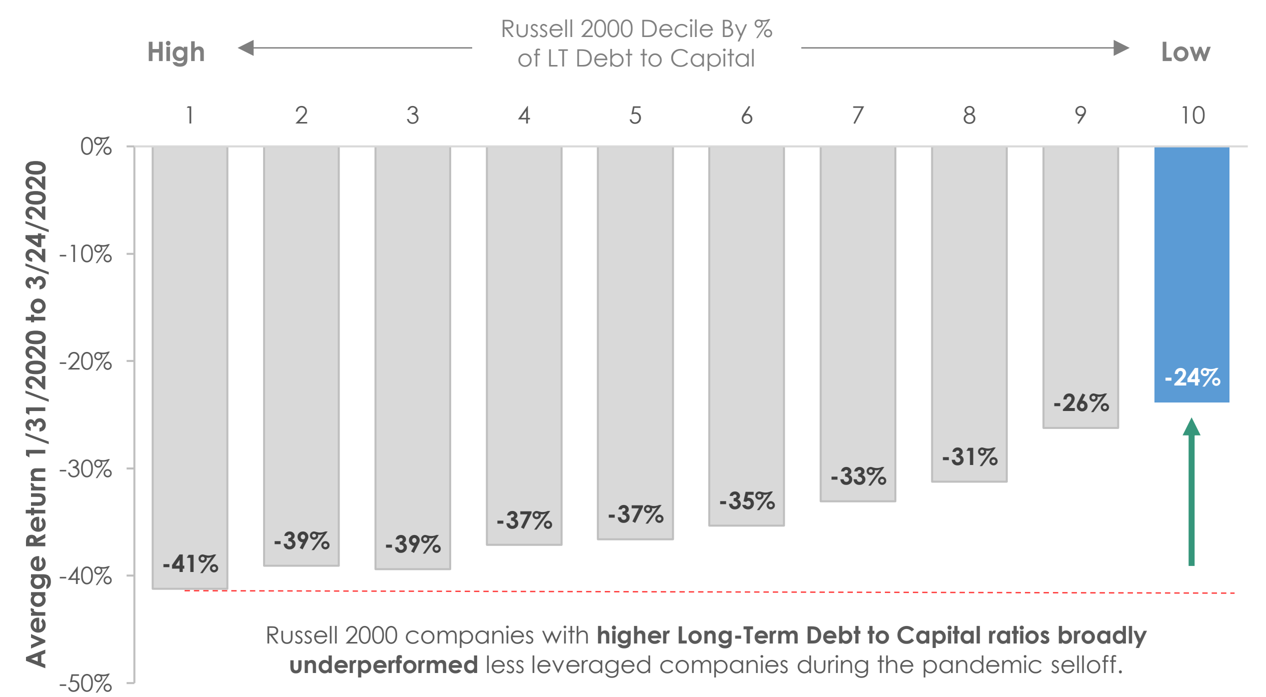
Source: MarketDesk Research

FIGURE 5: Corporate Leverage - (Net Debt / EBITDA Ratio)



Source: MarketDesk Research

FIGURE 6: Quality Key Driver During March 2020 Market Drawdown



*Source: MarketDesk Research. **Note:** The quality deciles are formed by calculating the Long-Term Debt to Capital ratio for each Russell 2000 company and splitting companies into ten equal groups based on ranking.*

Figure 4: Percentage of Money-Losing Russell 2000 Companies Sits at Two Decade High ...

- Figure 4 graphs the percentage of Russell 2000 companies with negative EPS by year since 2000. Slightly less than 50% of the small cap index failed to make a profit in 2020 after COVID-19 shutdowns froze the U.S. and global economies.
- Small caps' profitability was already worsening before the pandemic. 39% of the Russell 2000 Index lost money in 2019 compared to the 38% peak in both the dot-com bubble and 2008 financial crisis. The pandemic exposed small caps' profitability issues; however, it could force companies to focus on costs and improve operating leverage.

Figure 5: Leverage Intensifies Small Caps' Risk in an Uncertain Economic Environment ...

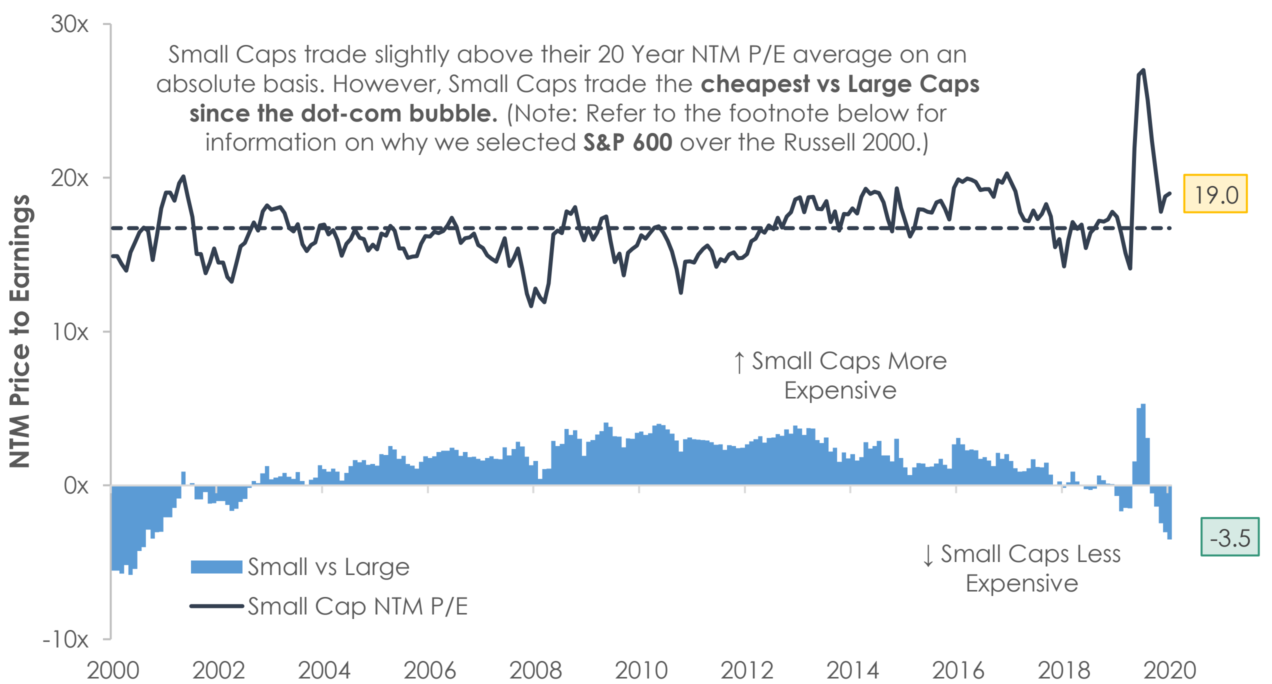
- Figure 5 charts the Net Debt to EBITDA ratio for U.S. large, mid, and small caps. Small Caps' leverage soared following the 2008 financial crisis. Mid Caps' leverage followed behind, while Large Caps' leverage sits within historical bounds.
- Increased leverage adds to Small Caps' profitability issues and raises the risk profile. Small caps already tend to be vulnerable during economic downturns, and the two factors could combine to pressure the lowest quality Small Cap companies.

Figure 6: Quality was a Key Performance Differentiator During the Pandemic Selloff ...

- Figure 6 graphs Russell 2000 Index performance by quality decile during the March 2020 selloff. The performance data highlights higher quality deciles outperformance. Replacing the Russell 2000 with the S&P 600, which includes a profitability factor, is our preferred way to emphasize quality. Vanguard and iShares both offer S&P 600 Growth and Value ETFs.

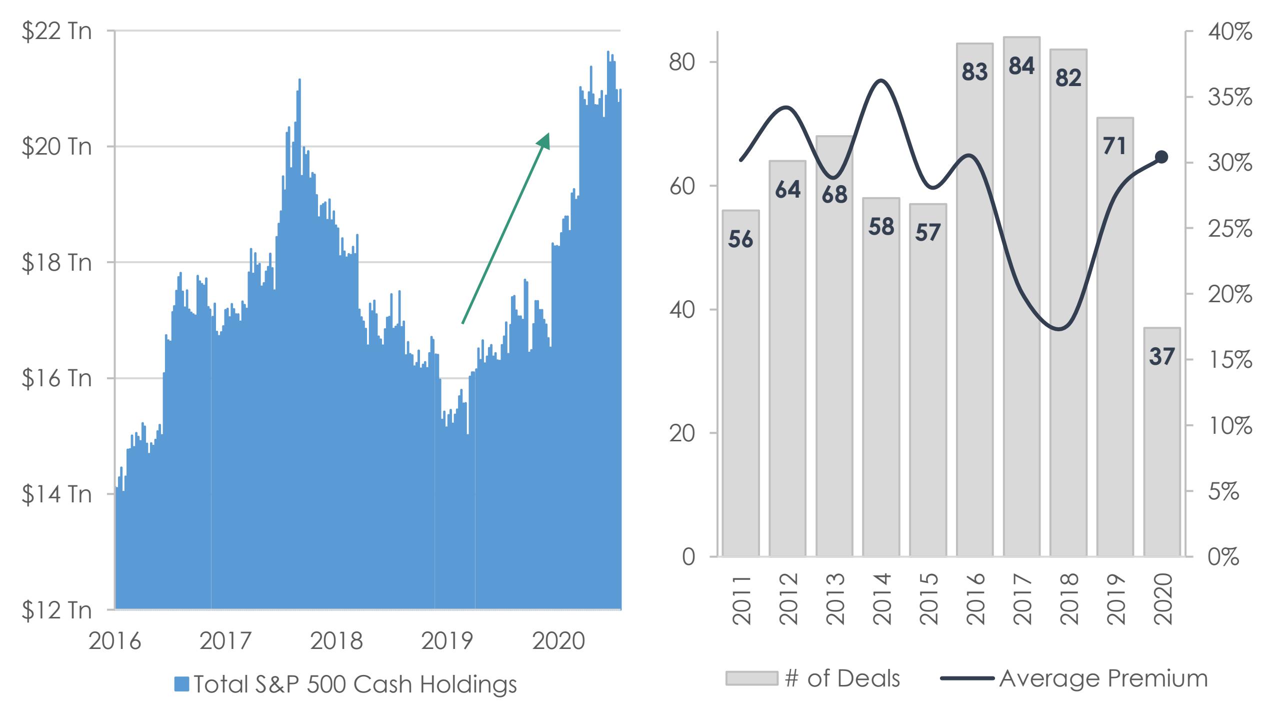
NTM P/E Valuation Discount, Favorable Earnings Yield Gap, and Attractive M&A Targets

FIGURE 7: NTM P/E Valuation - Large Caps (S&P 500) vs Small Caps (S&P 600)



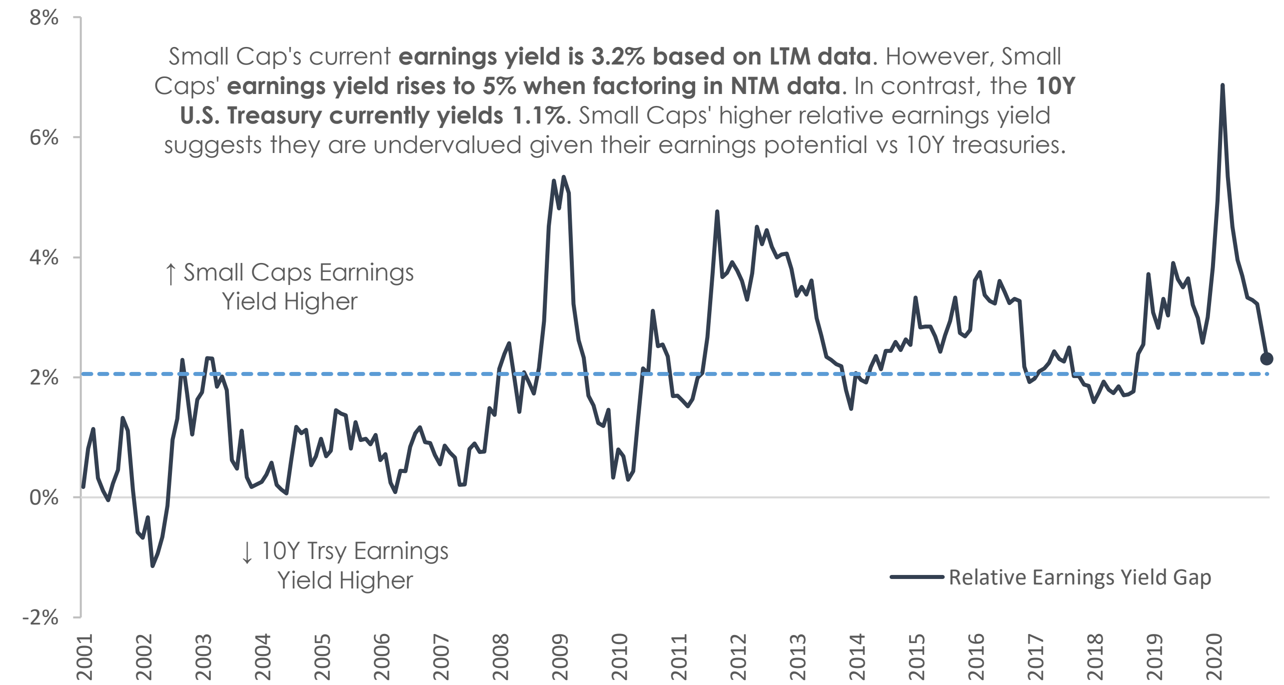
Source: MarketDesk Research. ***Note:*** *S&P 600 (IJR) is used for Small Caps and S&P 500 is used for Large Caps. The S&P 600 is used for Small Caps because the index only includes companies that meet certain profit requirements, which we believe addresses the risks on page 3 of this report.*

FIGURE 9: Total Cash Holdings on S&P 500 Balance Sheets & Small Cap M&A Statistics



Source: MarketDesk Research. ***Note:*** *M&A data based on transactions involving publicly traded companies with market caps in the range of $300M to $2Bn.*

FIGURE 8: Relative Earnings Yield - Small Caps (S&P 600) vs 10 Year U.S. Treasury



Source: MarketDesk Research. ***Note:*** *Earnings yield is the reverse of EPS and is calculated as earnings divided by price.*

Figure 7: Small Caps Trade at Biggest NTM P/E Discount Since Dot-Com Bubble ...

- Figure 7 charts the relative NTM P/E gap between Large Caps and Small Caps against Small Caps' absolute NTM P/E ratio. Small Caps trade at the largest NTM P/E discount to Large Caps since the dot-com bubble but only slightly above their 20Y NTM P/E average.
- Small Caps' relative valuation discount was -3.5x as of 12/31/2020 compared to the 20Y average premium of +1.3x. In our view, Small Caps' relative valuation discount is attractive in a market environment where low interest rates are pushing valuations higher and investors are pricing in Large Cap Tech's strong future growth expectations.

Figure 8: Small Caps' Earnings Yield Suggests They are Undervalued vs 10Y U.S. Treasury ...

- Figure 8 charts the earnings yield gap between Small Caps and the 10Y U.S. Treasury. Earnings yield is the reverse of EPS and offers a way to compare asset class valuations.
- Small Caps' higher risk justifies a higher earnings yield, but low interest rates make the current earnings yield gap compelling in our view. It becomes even more attractive when factoring in NTM data given LTM data distorts Small Caps' relative earnings power.

Figure 9: Small Cap M&A Could Benefit from Elevated Corporate Cash Balances ...

- Figure 9 charts: (1) total cash held on S&P 500 balance sheets and (2) the number of deals and average premium paid for Small Cap M&A transactions over the past decade.
- Corporations rushed to issue debt during the pandemic to fortify their balance sheets. With large cash reserves, management teams and boards will likely search for growth opportunities. Small Caps represent attractive M&A targets to boost inorganic growth.

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