BostonPartners

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WPG in Focus |
Small Cap Stocks in an Uncertain Environment

Video Transcript

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The broad-based negative returns across asset classes has created significant uncertainty in financial markets. We believe the shoot first ask questions later mentality has left small caps at a generationally attractive entry point. I'm Eric Gandhi, and on this episode of WPG in Focus, we explore the attractiveness of small caps in an uncertain environment.

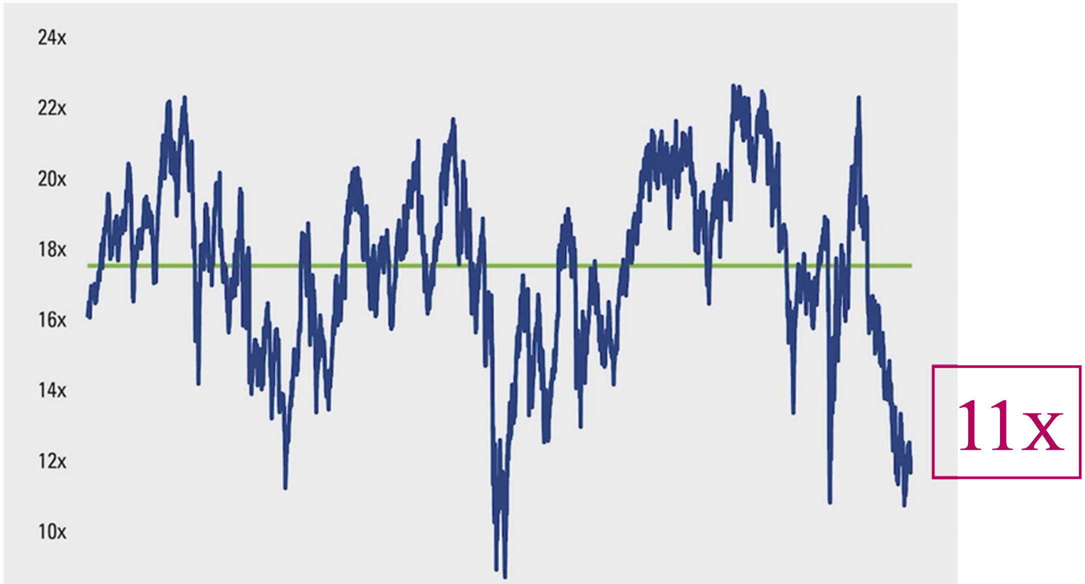
Today, small caps are generationally cheap on an absolute and relative basis. On an absolute basis small caps are trading at just 11 times earnings well below historical averages for perspective (*Figure 1*). Even with a 20% decline in earnings next year, small caps are still trading well below 30 year averages. On a relative basis, small caps are trading at a 35% discount to large caps (*Figure 2*). This is the largest discount in over 20 years. From a cross asset perspective, small caps trade at a higher earnings yield than the S&P 500 investment grade bonds and publicly traded real estate. The common belief is in downturns, small caps will underperform. However, a historical analysis of inflationary bear markets show that in inflationary bear markets like the ones we saw in the 1970s and early 1980s, small caps actually outperform large caps (*Figure 3*). In fact, in periods of high but declining inflation and below trend growth, small caps are the best performing asset class. Small caps outperform all other asset classes, and that's something allocators should be paying attention to (*Figure 4)*. Perhaps most importantly, early in an economic rebound, small caps outperform large caps by a wide margin, an analysis of the last 20 bear markets. Since 1932 shows in 18 of the 20 bear markets, small caps outperform large caps by 29 percentage points on average.[1]

A Time for Active Management

Given the bifurcation of global economies, the decoupling of goods and services demand, and the hidden concentration in many passive ETFs, we believe active managers are poised to outperform in the coming years. Active managers have an opportunity to avoid areas that benefited from one time pull forwards during the pandemic, as well as allocate resources to those beneficiaries of increasing CapEx in the U.S. Even in prolonged market downturns, single securities often make new highs affording active managers an opportunity to outperform passive vehicles (*Figure 5*). To summarize, we believe small caps are attractively valued on an absolute and relative basis, have the potential to outperform in a downturn and lead after the market bottoms. Given these trends as active managers, we could not be more excited for the environment ahead.

[1] Source: Bank of America research

Figure 1: Russell 2000® Index P/E Ratio



Data as of December 16, 2022.

Source: Russell.

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Figure 2: Relative P/E Ratio: Russell 2000® Index vs. Russell 1000® Index

Data as of December 16, 2022.

Source: Russell.

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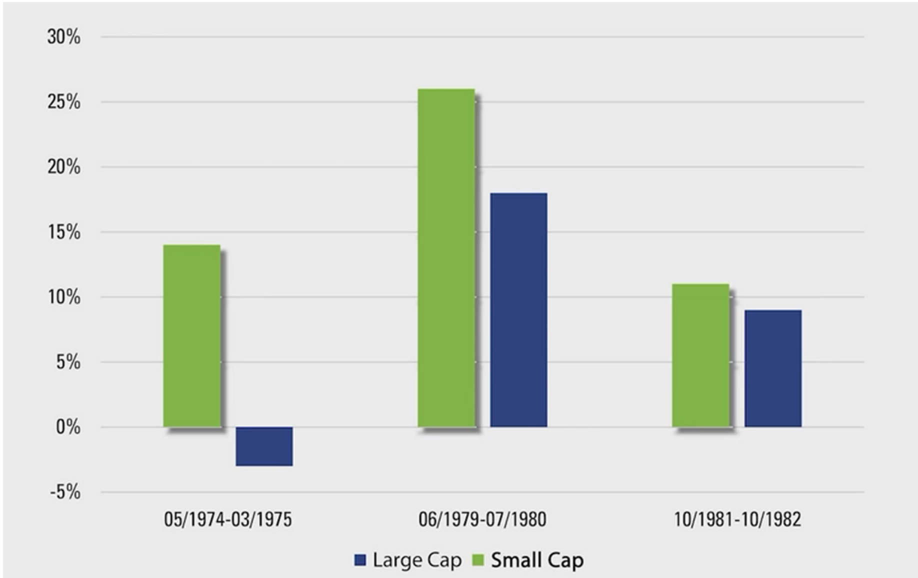
Figure 3: Relative Returns During Below Trend Equity Performance (1975-1982)

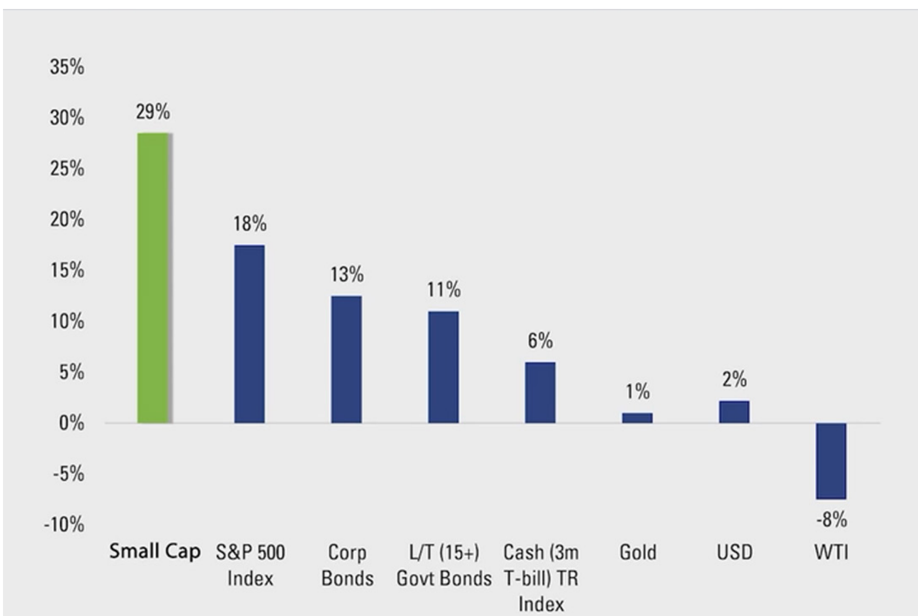


Data as of December 16, 2022.

Source: CRSP Data, Russell.

Large cap and small cap as defined by top 20% and bottom 20% market cap via CRSPR Fama-French data. This information is provided for informational purposes only and should not be considered a recommendation or investment

Figure 4: Performance in High but Slowing Inflation and Below-Trend Economic Growth



Data as of December 16, 2022.

Source: CRSPR Data and Russell 2000 Value data.

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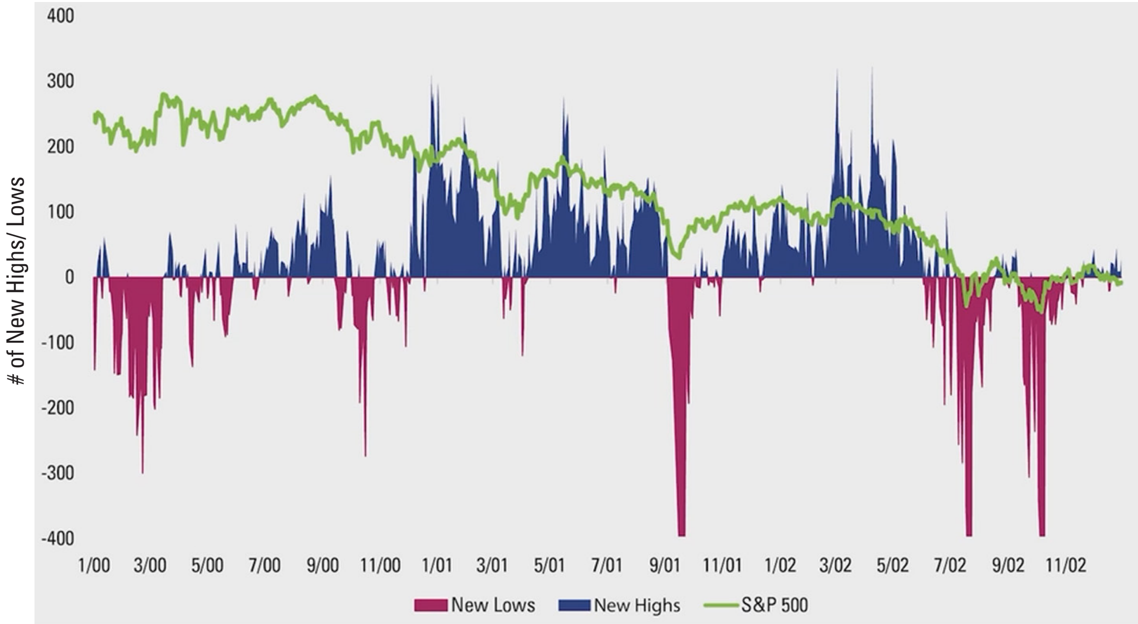
Figure 5: NYSE New Highs vs. New Lows 2000-2002



Data as of December 31, 2022.

Source: Bloomberg.

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Eric Gandhi, CFA, CAIA | *Portfolio Manager*

Mr. Gandhi is the Lead Portfolio Manager for the WPG Select Small Cap Value product. He is also a Portfolio Manager for the WPG Partners Small and Micro Cap Value team. He joined WPG Partners in July 2012 as a research analyst with a concentration in technology, media, telecom and consumer. Prior to joining the firm, he was a member of the Applied Value Investing program at Columbia Business School. Prior to Columbia, Mr. Gandhi was an Associate in the investment banking division at Needham & Company. He graduated with a B.S. degree from the University of Maryland and received an M.B.A. from Columbia Business School. Mr. Gandhi holds the Chartered Financial Analyst® designation. Mr. Gandhi has fifteen years of investment experience.

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Investments in small companies present a greater risk of loss than investments in large companies due to greater volatility and less liquidity.

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