

# THERE'S VALUE IN US SMALL CAPS

## Video Transcript



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**Link to video:** <https://vimeo.com/user125535958/global-perspectives-theres-value-in-us-small-caps>

**Bill Sterling:** Hi all, I'm Bill Sterling, GW&K's Global Strategist. Today I'm joined by my colleague, Equity Portfolio Manager Joe Craigen, to discuss the outlook for US small-cap equities.

Joe, as you know, I think there is a compelling case that US small caps could be poised for a multi-year period of outperformance of large caps, coming after almost a decade or more of underperformance of small caps.

The reasons have to do with both relative valuations and trends in long-term earnings growth.

On the valuation side, the forward P/E of the Russell 2000 Small Cap Index at the end of January stood at 13.1 times. This is based on a measure that weeds out the non-profitable firms in the index. A comparable measure for the S&P 500 stood at 19.8 times. That points to almost a 35% discount of small caps versus large caps, which is a degree of discount we haven't seen since the 1999 – 2001 tech bubble. That was followed by more than a decade of outperformance of small caps over large caps.

I've also found that looking over long horizons, on virtually every long-term horizon, small-cap earnings have outperformed large-cap earnings. And without getting into the weeds, I suspect that pattern will continue into the future, which makes the small-cap valuation discount all the more intriguing.

Joe, I know you're focused on bottom-up company research and stock selection, not on asset allocation issues, but my first question for you would be whether you and your team are finding a lot of attractively valued small-cap names, consistent with what I'm seeing in the macro data.

**Joe Craigen:** Thanks, Bill. Yes, first off let me say that we think small caps should be core holdings for most investors as part of a well-diversified portfolio. As you point out, depending on the time period that you're looking at, small caps can have more attractive earnings growth profiles than large caps over longer time horizons.

And yes, we are finding attractively valued small caps. Part of that has to do with the fact that we're playing in such a large investable universe. The Russell Small Cap Indexes consist of over 1,000 names, whereas in contrast, we're trying to put together portfolios of fewer than 100 stocks. So we can be highly selective in the stocks that we're looking to find.

I think that really highlights one of the benefits of active management over passive indexing, especially as it pertains to small caps. There can be wide variations in the Russell indexes, in terms

of the quality of the management teams, the quality of businesses, and as it pertains to your question, wide variations in the valuations that you can find in those businesses, as well.

So yes, we are finding attractively valued names and we do think small caps are attractive. However, as you point out, small caps can have more volatile earnings growth profiles than their large-cap peers.

**Bill Sterling:** Thanks, Joe. Can you elaborate on how your team’s process can address some of the risks of investing in small companies?

**Joe Craigen:** Absolutely. We’re trying to find companies that are better run, that have better business models, that have higher margins, and that have more consistent earnings growth than their peers. And the primary benefit of that is that those are the type of companies — the better businesses, the better run companies — that can outperform their peers and be the leaders in this space over a long time horizon.

One of the side benefits, though, is risk control. In market downturns and periods of market turmoil, investors tend to gravitate towards higher-quality companies — the types of companies that we like to invest in — and for that reason, those higher-quality companies tend to outperform in market downturns.

**Bill Sterling:** That makes sense. I guess whatever the merits of my “small is beautiful” theme might be, the key to success in small-cap strategies is solid company research and a bias towards higher-quality companies, from what you say.

I think we’ll have to leave it there for today, but I want to thank you very much for joining me. For listeners who are interested, you can see the paper on the GWKinvest.com website, under Global Perspectives, “[There’s Value in US Small Caps.](#)” is the title. Thank you all.

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