Investment Commentary: Small Cap Q4 2024

Small Caps Crushed in December as Market Concentration Intensifies

Small caps appeared set up for success in early November. The Russell 2000 ripped higher as the election results came in, gaining 7% the next day and nearly 11% for the month! Investors became optimistic about deglobalization and the onshoring of manufacturing, plus we were officially in a rate cut cycle, which typically favors small caps over large. And the valuation disconnect between large caps and small caps had hit record highs after a decade of large trouncing small.

But when inflation data came in hot in December, the Federal Reserve turned hawkish, suggesting inflation was re-emerging and there would likely be fewer rate cuts than expected. Small caps immediately reversed course and finished December ***down*** a whopping 8.2%.

The Russell 2000 finished the year +11.5% for 2024, versus +25.0% for the S&P 500. It was the fourth consecutive year of underperformance for the asset class, by an average of ~10% per year! The top-heavy market concentration in the US stock market is being felt across many asset classes, but nowhere more than small caps.

Market Concentration At 90+ Year Highs

We haven't seen concentration at the top like this since the Great Depression years. In fact, when examining the concentration of the top 10% of stocks, 2024 set a modern-day record, surpassing the Dot Com bubble of 2000. See below.

Exhibit 1: Market Concentration

Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research.

Lessons From the Past

Let's delve into market cycles and performance to see what we can learn from history.

<u>Market Cycles</u>

Markets move in cycles, whether it's value versus growth, large versus small, or US versus non-US, cycles (and extremes) come and go. Each cycle comes and goes, including the "concentrated versus diversified" cycle, and we are at a 90-year extreme.

If you believe in reversion to the mean, then you believe diversification will someday work again. Which means smaller stocks are likely to have a catch-up of some sort. The only questions are (1) when and (2) how long the concentration unwind might last.

The FirstLinks group at Morningstar studied market concentration cycles a few months back to examine how long the run-ups preceding the peak can last and how long the ensuing unwind of these concentration cycles can take. The results are below.

Exhibit 2: Cycle Lengths

Peak	1932	1957	1973	2000	Average	Current Cycle*
Concentration Cycle (Years)	—	11.4	4.3	15.3	10.3	17.7
Diversification Cycle (Years)	13.9	11.3	12.3	5.3	10.7	—

Note: Concentration cycle indicates the period of time from the trough in market concentration to the peak. Diversification cycle indicates the period of time from the peak in market concentration to the trough. Data is unavailable for the run-up period to the 1932 peak. *Measured through December 31, 2023.

Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research.

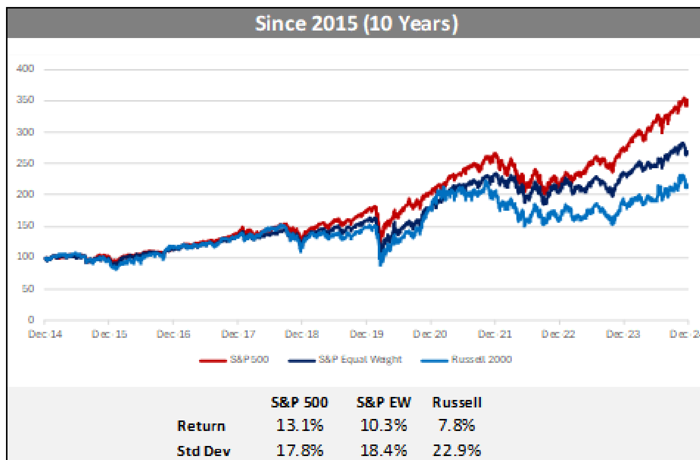
Their findings reveal that while the lengths of the various concentration and diversification cycles vary, they generally last about a decade. Even the shortest periods span four to five years, often considered a full market cycle. For context, the diversification period following 2000 lasted until April 2006. The current concentration run-up is approaching 18 years, significantly exceeding the average. While the end remains uncertain, empirical evidence suggests we are at an extreme in both magnitude and duration.

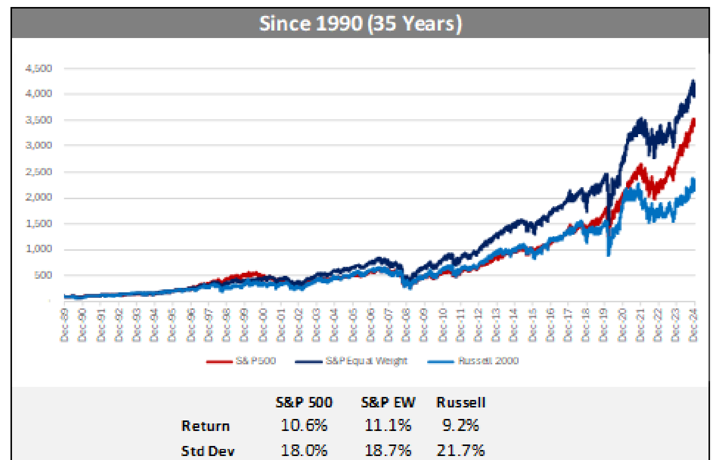
Market Weight vs Equal Weight

The Russell 2000 is one measure of diversification's effectiveness, as it holds 2000 companies and excludes the largest tech names that have dominated the market. Another measure is the **Equal Weight S&P 500** index, which holds the same stocks as the cap-weight S&P 500 but an equal amount of each stock (0.2% each).

The equal-weight S&P gained 13.0% in 2024 and 13.9% in 2023. This performance pales in comparison to the market-weighted index, of course, but it's remarkably close to the two-year average of the Russell 2000 (14.2%). Without the skew of the largest tech stocks, the US stock market has gained roughly 13-14% for the last two years.

What might surprise many people is that this equal-weighted index has actually ***outperformed*** its market-weighted counterpart over the long term. Consider the following two charts, compiled by our team from Bloomberg data. The chart on the left shows that the market-weighted S&P 500 outperformed the equal weighted index (13.1% vs 10.3%) over the past 10 years and absolutely trounced the Russell 2000 (7.8%). The concentration of the past decade has resulted in a significant dispersion between large and small. But the chart on the right shows the opposite…that the equal-weighted index has ***outperformed*** over the last 35 years. In the long run, diversification works.





<u>Cycle Performance</u>

Morningstar studied the performance of different styles in post-concentration cycles and uncovered some intriguing results. The table below shows the average annualized and cumulative results after the peak in concentration over various timeframes for the following: US equal-weighted index less US cap-weighted index; US small cap less US large cap; US value less US growth. The rightmost dataset indicates the average results across the entire diversification cycle, as indicated from a peak to trough in market concentration.

Exhibit 3: Performance After Concentration Peak

	3 Years		5 Years		10 Years		Diversification Cycle	
	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative
Equal Wgt. - Cap Wgt.	14%	50%	12%	82%	8%	125%	9%	197%
Small - Large	10%	36%	9%	61%	8%	114%	9%	158%
Value - Growth	5%	18%	7%	44%	4%	46%	7%	104%

Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research.

As expected, the better performing areas of the equity market during a diversification cycle are historically the ones that have been the laggards over the past many years — and by a wide margin. Specifically:

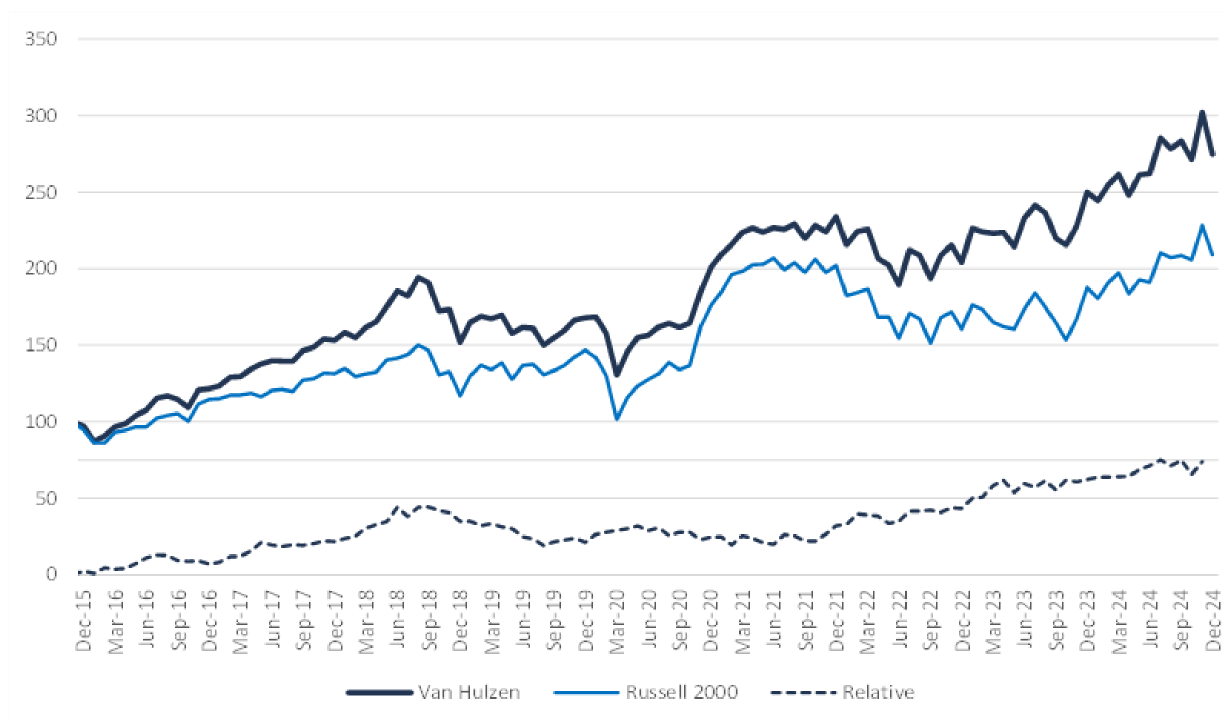
- **Breadth:** Equal-weighted equities significantly outperformed cap-weighted equities.
- **Size:** Small caps outperformed large caps.
- **Style:** Value outperformed growth.

While no one can perfectly time when concentration will peak, it's encouraging to note is that it is not critically important. Morningstar found directionally similar outcomes when measured from a starting point one and two years preceding market concentration peaks. So even if you are early, the benefits of diversification can be meaningful when the cycle turns. Our conclusion here is that ensuring proper diversification is more critical than the actual timing of diversification. And that small caps will once again have their day. Beginning to overweight this category makes a lot of sense.

Q4 & Full Year Performance

Our small cap strategy delivered a return of 8.1% in the third quarter, slightly behind the Russell 2000 (+9.3%), and 9.8% for the year (versus 11.5%). However, there was quite a bit of noise in Q4 related to the election and inflation data. The strategy has delivered an average return of 16.3% over the past two years, versus the 14.2% mentioned above for the Russell.

Since inception, our annualized return is 11.8% vs 8.5% for the Russell. This equates to an annualized alpha of 4.5% once you factor in our lower standard deviation. We attribute our outperformance to our disciplined fundamental research process, which insists on the highest quality holdings with strong Return on Capital, above average growth, and lower than average debt and default probability.



Alpha

$a = R_p - [R_f + (R_m - R_f)\, ß]$

	Russell 2000	**S&P 600**
Rp = Realized return of portfolio	11.8%	11.8%
Rm = Market return	8.5%	9.6%
Rf = risk-free rate	1.8%	1.8%
ß = Beta	0.82	0.82
Alpha (relative to RUT)	**4.5%**	**3.5%**

Portfolio Highlights

Despite a large post-election bump, it was a difficult quarter for many small caps as inflation fears re-emerged and sent small companies spiraling in December. Our top performer was Pacira Pharma, which bounced back from a steep decline in Q3 and has now filled that entire gap. The other winners included two consumer stocks (Simply Good Foods and Acushnet), an education technology company and a regional bank.

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
PCRX	Pacira Pharma	26.0%	Biopharma	*Sold in Q4 for tax loss*
LRN	Stride	21.8%	Learning technology	-
SMPL	Simply Good Foods	12.1%	Specialty chemicals	-
GOLF	Acushnet	11.8%	Leisure products	-
AX	Axos Financial	11.1%	Regional bank	-

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
ACLS	Axcelis Technologies	-29.4%	Semiconductors	*Sold in Q4 for tax loss*
YOU	Clear Secure	-26.3%	Security systems	*Added in Q4*
TDW	Tidewater	-24.2%	Marine service vessels	*Added in Q4*
BWIN	Baldwin Insurance	-22.3%	Insurance broker	-
ROCK	Gibraltar	-15.7%	Building products	-

Outlook

There are various "Trump trades" that began making news last fall. Small caps are one of them, as investors reposition for deglobalization/onshoring and the rate cut cycle. But so much depends on inflation. High inflation is generally bad for small caps, and it's unclear exactly where we are in the rate cut cycle. If the Fed can continue to manage inflation risk, we expect small caps to finally turn the corner and outperform. However, if inflation reemerges and the Fed stays hawkish, it could be a challenging year ahead. But our lower risk profile and insistence on quality will serve our clients well as we wait for the inevitable market turn.

Key Takeaways

- We turned in a solid fourth quarter and full year 2024 and continue to deliver alpha
- We believe small caps are due for a period of outperformance relative to large caps, for three specifics reasons
    - There is an extreme disconnect between small cap and large cap valuations
    - Although its length is uncertain, we are still in a rate cut cycle, which has historically
    - benefited small caps
    - Deglobalization and onshoring should support smaller US companies
- Our continued focus on quality and our disciplined approach to management put us in a great position to succeed in today's uncertain environment
- If inflation persists, many businesses will struggle in the coming years. But our insistence on quality and aversion to credit risk positions us well. We avoid these over-levered companies
- Our portfolio holdings are high quality companies with strong cash flows, low debt and above average growth rates. This approach has created strong alpha (5.2%) for us over the past nine years

APPROACH

The strategy uses a “Growth At A Reasonable Profile” approach, which basically means we are not speculative. Just like you’ve come to expect from us in the large cap space, our focus is on quality first. But in the small cap space, we are just as open to growth and momentum stocks as we are value stocks. A “reasonable profile” means the business must be established and already profitable, earning returns above its cost of capital. Beyond these simple parameters, we look for companies that are leaders in their industries, expanding rapidly (2-3x the market), and consistently beating expectations for growth.

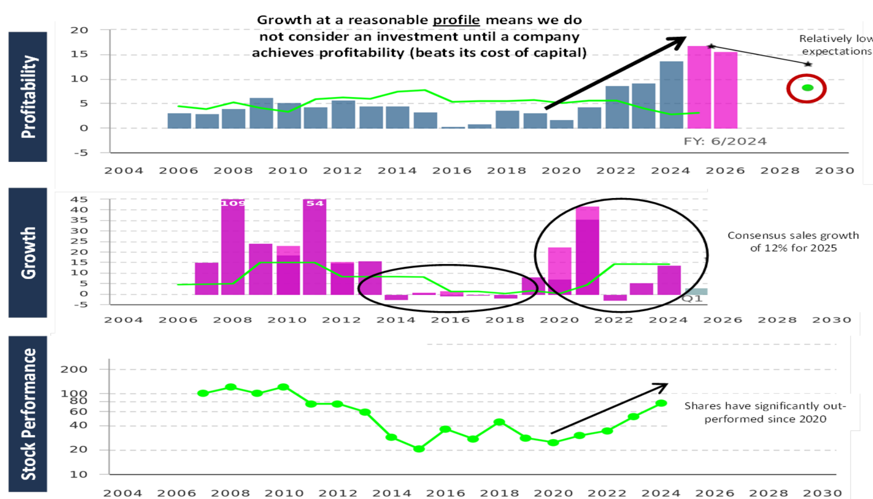
Portfolio Construction

Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with market caps between $1-5 billion and have a below average portfolio turnover profile.

Fundamental Analysis

Fundamentals come first. Always. But we also incorporate technical analysis into our investment process, to provide key downside/support levels and also to provide confirmation of buy/sell signals. Small-cap stocks can be volatile and technical analysis provides information into position sizing, entry and exit decisions and can trigger due diligence reviews.

To better understand our investment approach, consider one of our holdings: Stride Inc (LRN). Stride provides online curriculums and software systems in the education services industry. It is a high growth company with great momentum and, we believe, plenty of room for further upside.



Source: Credit Suisse HOLT

Key Points

- Market cap: $4.8 billion
- Strong & improving Cash Flow ROI, above average for the sector.
- Future ROI priced into the stock price (green dot on right side) very low relative to current levels.

- Management restructured the business in 2014-2018, when it was unprofitable...
- Company is back in growth mode now.

- Investors have applauded the shift towards profitability
- Shares have out-performed the index nearly 4-to-1 since 2020
- We believe the shares are still undervalued

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