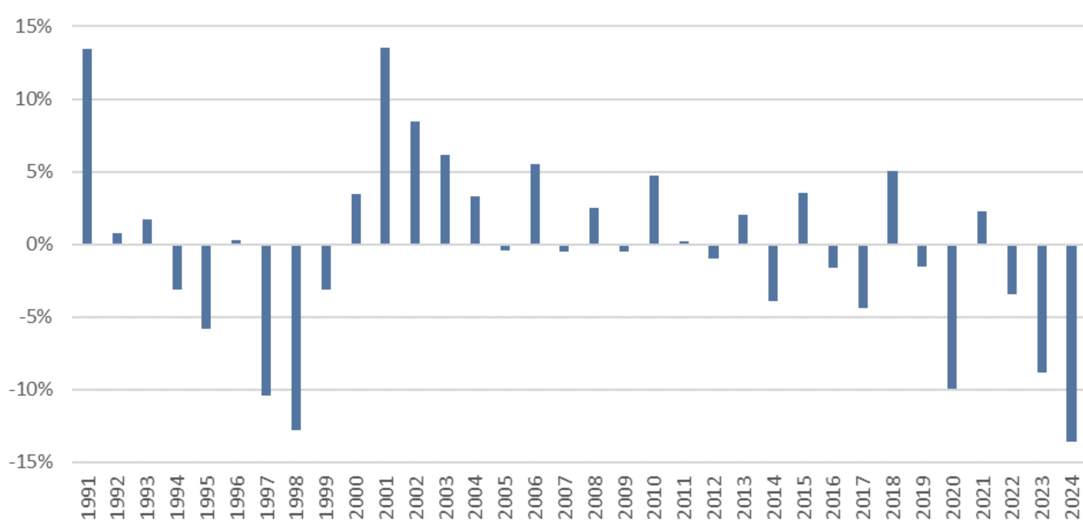
Market Commentary

Back to the Small Cap Future

Small cap US equities (companies with market capitalizations of $200mn to $10bn) just experienced the worst first half of a calendar year, relative to large cap equities, in 34 years (Fig. 1). Perhaps even more striking, over the last three years the Russell 2000 Index, a commonly used index for small cap stocks, has underperformed the S&P 500 by approximately 11% per year. Small cap comprises about 7% of the total US equity market. Our equity portfolios have an approximate 5% target allocation.

One might ask why we maintain the small cap position considering the recent underperformance.

Fig. 1: January-June small cap vs. large cap performance, 1991-2024



Source: Bloomberg, Mill Creek.

Such extremely small underperformance hasn't occurred since the late 1990s, which was a period that shared some similar characteristics with today:

1. Narrow equity markets driven by extreme performance in a limited number of companies,
2. High equity market concentration where a limited number of companies comprise a substantial percentage of the index, and
3. A Fed that was "on hold," following a tightening cycle, and trying to orchestrate a soft landing.

We don't want to take the dot com parallel too far because there are also plenty of differences between the late 1990s and today. The most important thing is simply that the best performing "Magnificent 7 (M7)" companies produce substantial earnings and free cash flow, which was not the case with the late 1990s stock market darlings.

On the other hand, concentration risk is a more concerning factor. Apple, Microsoft, NVIDIA, and Amazon are all individually larger components of the global stock market than the entirety of China. Investors have enough exposure to the current stock market darlings, and small cap should provide some protection, as it did in the early 2000s, if the M7 were to fall out of favor.

Additionally, a less-restrictive Fed should benefit call cap stocks. Last Thursday's CPI number further bolstered the case for a September or November rate cut and small cap responded with the third best 1-day performance (+ 4.4%) against large cap in 35 years. The relative performance between small cap and the M7 on Thursday was even more astonishing: +7.8%.

This week's contributor is Michael Crook, CAIA.

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