Insights
Equity

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Embrace Economic Recovery with Cyclical, Domestic Small Caps

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- The uneven post-pandemic rally has led to elevated concentration in large cap indices.
- Small cap equities, through their cyclical nature, allow investors to capture economic growth and may be less sensitive to yield rises compared to large cap tech giants.
- Small cap indices vary significantly around the world as underlying economies differ across regions. In addition, value-weighted exposures allow for an even greater level of cyclicality.

Overview

Developed market equities enjoyed strong performance following the onset of the pandemic, initially on the back of policy support and then strong economic recovery. However, the rally has reached the point at which investors have started asking whether equity markets can expand further amid tapering and yield expansion.

In the US, the rally was heavily concentrated around tech giants, such as the FAANG companies. In light of their sensitivity to interest rates, investors may look toward small cap, diversified exposures. These exposures allow investors to enjoy the economic recovery and may be less vulnerable to sticky inflation and subsequent policy tightening. Furthermore, in the post-COVID world, large cap tech giants could be perceived as a safe haven within the equity space. As economies recover and the world continues its journey back to normal, investors may seek out higher risk-reward exposures.

Why Small Cap, Why Now, and Why Index Exposure

Small cap companies tend to outperform their larger cap counterparts, as documented by Eugene Fama and Kenneth French.[1] However, it is important to note that none of the factors work at all times and thus the investment backdrop matters.

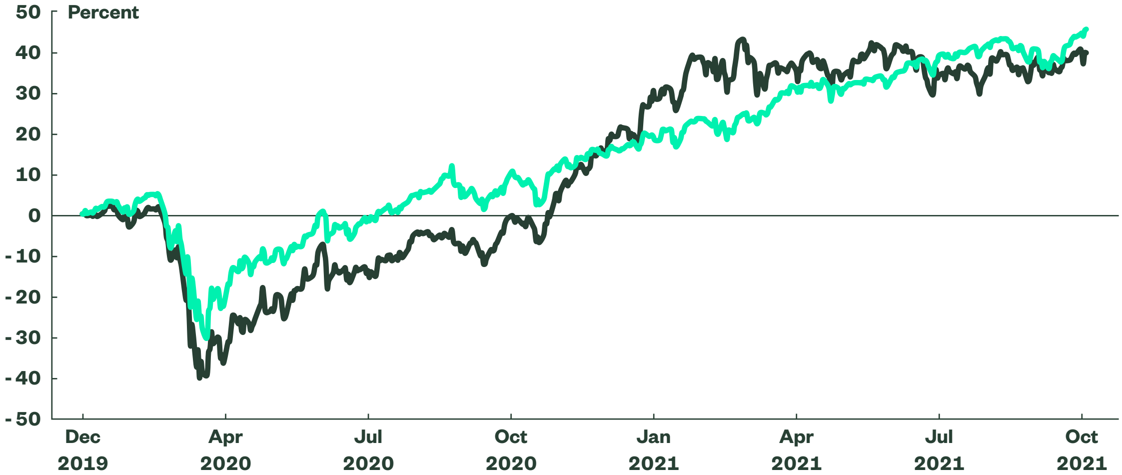
We believe that the current combination of economic recovery and tightening (but still easy) monetary policy could allow investors to extract value through small cap strategies, which when compared to their large cap counterparts are more cyclical and domestic in nature. To be sure, investing in a single small company brings higher risk as disclosures and analyst coverage are often limited. However, index strategies with thousands of components provide a way to diversify away from some of these risks while still enjoying the size premia.

Recent Performance Pause May Present an Opportunity

Smaller stocks suffered disproportionately from the negative impacts of the global pandemic but have bounced back firmly since vaccine development. More recently, we noticed a pause in the performance of small caps, particularly in the US. We believe this pause represents an opportunity to gain cyclical exposure as economies continue their expansion and yields remain low, although they are moderately increasing.

Figure 1
US Large vs Small Cap Returns

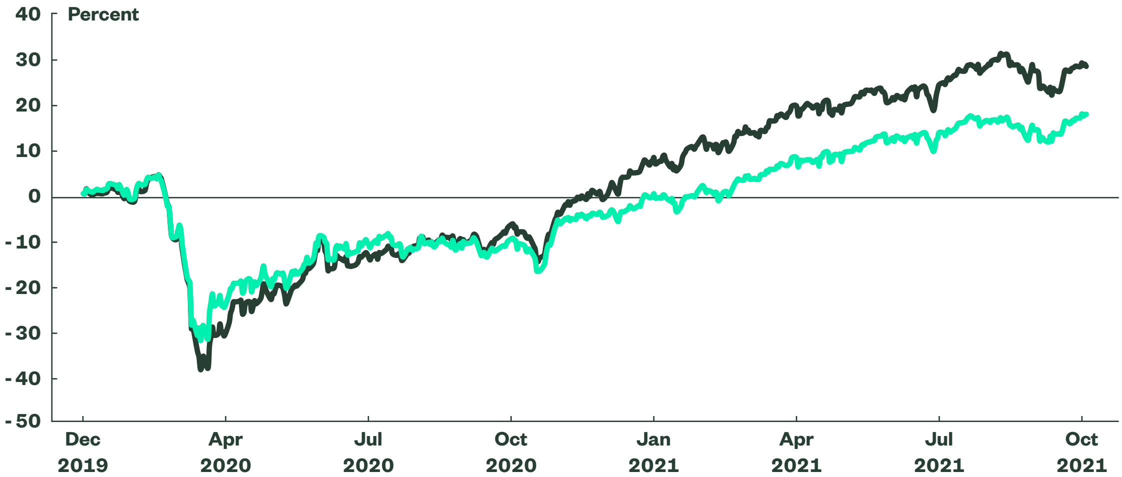
Russell 2000 U.S. Small Cap
S&P 500



Source: Bloomberg Finance L.P., as of 29 October 2021. Russell 2000 U.S. Small Cap is Russell 2000 Net 30% Return while S&P 500 is S&P 500 Net Total Return Index. Past performance is no guarantee of future results.

Figure 2
Europe Equity vs Europe Small Cap Returns (EUR)

MSCI Europe Small Cap
MSCI Europe



Source: Bloomberg Finance L.P., as of 29 October 2021. MSCI Europe Small Cap is MSCI Europe Small Cap Net Return EUR Index. Returns in EUR. MSCI Europe is MSCI Europe Net Total Return EUR Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Small Cap Characteristics

Small cap indices vary significantly around the world, as reflected in sector and industry breakdowns, which we discuss in later sections of this paper. Looking at valuation ratios, small cap indices reflect what can be observed in the broader market with undemanding multiples in Europe and stronger growth in the US. It is important to note, however, that not all small companies have available estimates and hence valuation ratios may not always be fully representative.

In the current low but rising yield environment, it is important to monitor debt levels to ensure rising interest costs remain manageable. Small cap companies are well positioned in that regard. Debt-to-EBITDA levels remain subdued, in most instances below 10-year average levels, despite the significant yield compression we have observed in recent years. The second compelling feature of small caps is the diverse exposure they provide. This diversification can help portfolios during an uneven recovery with further uncertainty ahead, particularly when considering high-risk, high-reward exposures. The small cap indices captured in the following table include between 1,000 to more than 4,000 components, thus providing this necessary diversification.

Figure 3
Small Cap Indices — Key Characteristics

	P/E (fwd)	P/B	RoE (%)	Debt to EBITDA	10y Avg. Debt to EBITDA	Market Cap ($bn)	No. of Holdings
Russell 2000	26.5	2.69	9.12	4.21	4.84	3,475	2,026
MSCI US Small Cap	13.6	1.71	—	—	—	4,956	1,856
MSCI Europe Small Cap	18.0	1.94	6.21	3.60	4.40	1,721	1,018
MSCI Europe Small Cap Value Weighted	13.3	1.25	—	—	—	—	1,017
MSCI World Small Cap	19.1	2.10	7.25	2.94	3.68	8,401	4,430
MSCI Emerging Market Small Cap	12.9	1.61	8.33	3.37	3.13	1,120	1,817

Source: Bloomberg Finance L.P., MSCI, FTSE Russell, as of 30 September 2021. Characteristics are as of the date indicated and should not be relied upon as current thereafter.

Procyclical Yet Unique Exposures Across Regions

Across all regions, small cap indices represent an interesting alternative for playing the expansionary phase of the economic cycle, thanks to their cyclical nature. A lack of exposure to tech giants and their long-duration profile offer a level of protection against yield increases. Each small cap strategy (US, world, Europe or emerging market) offers a unique mix of sectors and, as such, a unique mix of advantages. In addition, investors may further boost the cyclicality in their portfolio by taking exposures via value-weighted US or Europe small cap strategies. In the following sections we discuss common and distinct characteristics and features of selected small cap indices.

US Small Caps: Economic Recovery Beyond FAANGs

The Russell 2000 allows investors to play cyclical recovery through higher exposure toward industrials and financials sectors relative to the S&P 500. Within financials, US small caps are naturally more oriented toward domestic, regional banks rather than global players. Should yield expansion continue, these regional banks may more efficiently capture improved net interest margins. Industrials represents another cyclical sector that may benefit from broader recovery, once corporates invest their heavy cash piles.

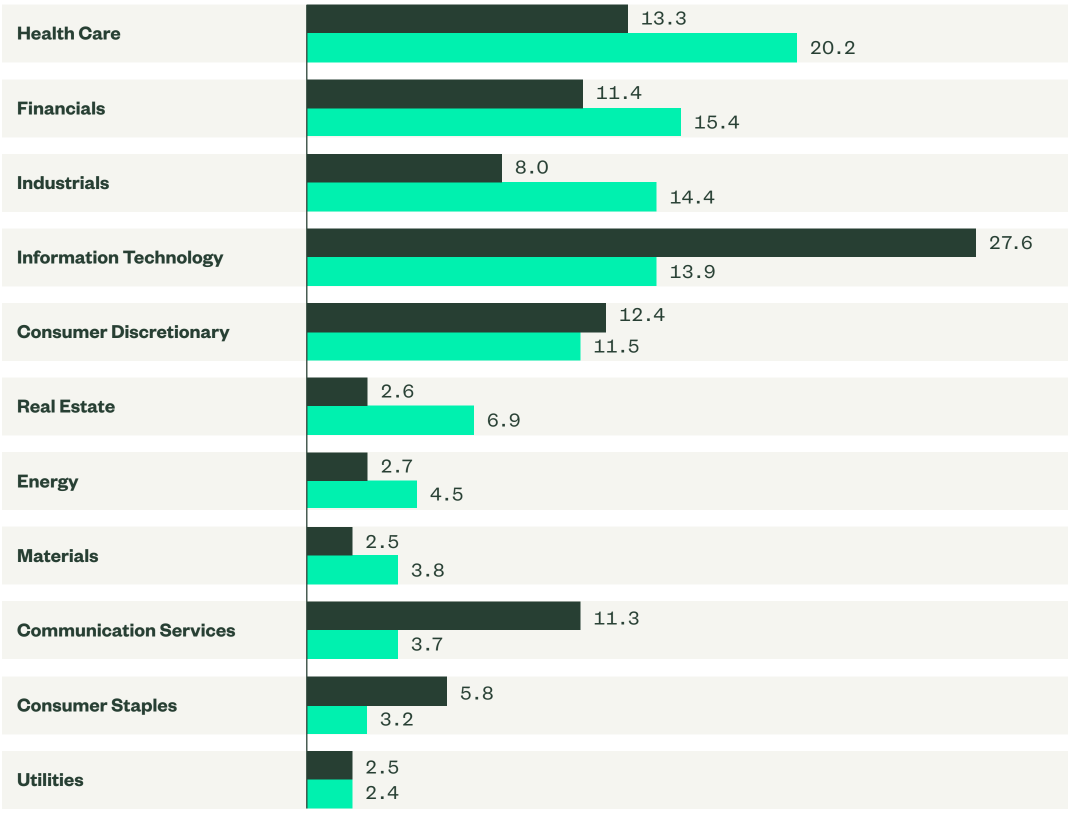
High exposure to biotech allows investors to embrace structural growth as health care will likely remain in the spotlight even in the post-COVID world. Despite lower exposure toward technology compared to the S&P 500, software plays a big part in the small cap segment and can benefit from structural technology megatrends, without running into heavy concentration. Finally, real estate companies could act as a tool for capturing economic growth through recovering occupancy in offices and residential assets as well as increased footfall in shopping malls.

The MSCI USA Small Cap Value Weighted Index is similar but with higher cyclical and value tilt. Financials represent more than a quarter of the overall exposure. Tech companies are more skewed to hardware than software. There is also less health care while cyclical sectors such as industrials, consumer discretionary and materials play even larger roles.

Both the Russell 2000 and MSCI USA Small Cap Value Weighted Index are less exposed to information technology and communication services companies, which are largely represented by tech giants in the S&P 500 and therefore might be prone to yield expansion given the long-duration profiles of their expected cash flows.

Figure 4
Russell 2000 vs. S&P 500 Sector Breakdown

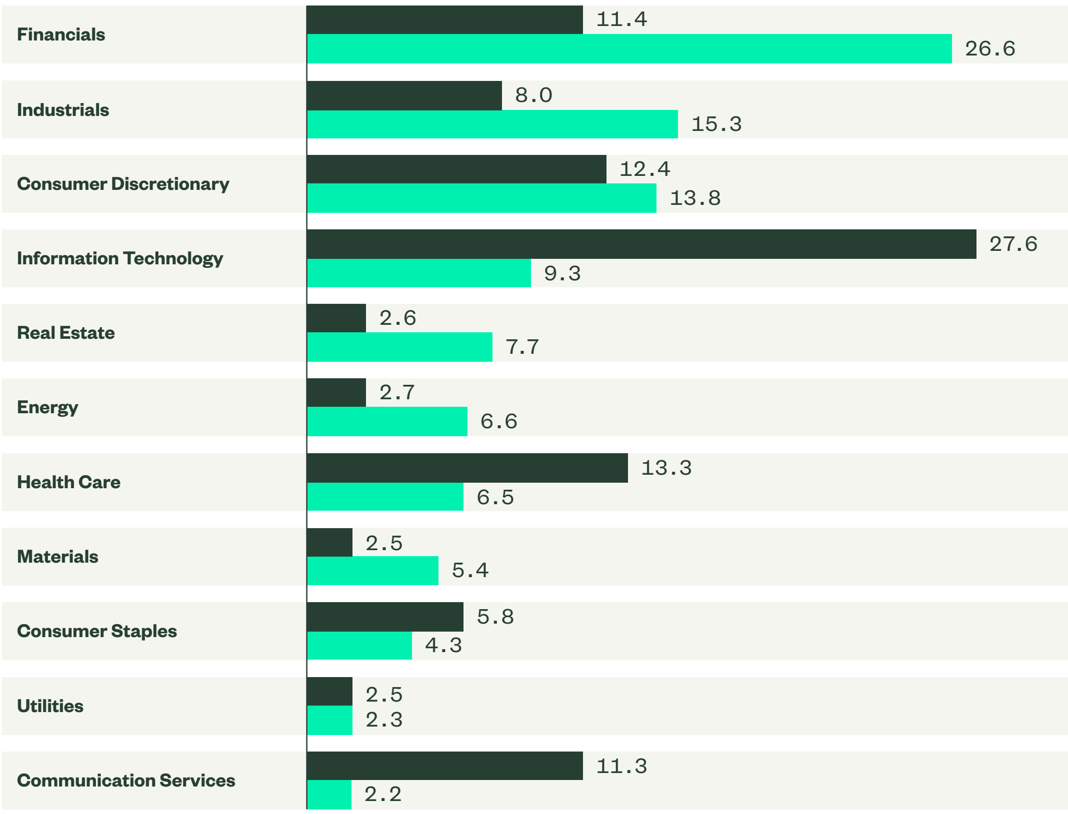
S&P 500
Russell 2000



Source: Bloomberg Finance L.P., MSCI, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Figure 5
MSCI USA Small Cap Value Weighted vs. S&P 500 Sector Breakdown

S&P 500
MSCI USA Small Cap Value Weighted



Source: Bloomberg Finance L.P., MSCI, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Europe Small Caps: Will Investments Lead the Second Leg of the Recovery?

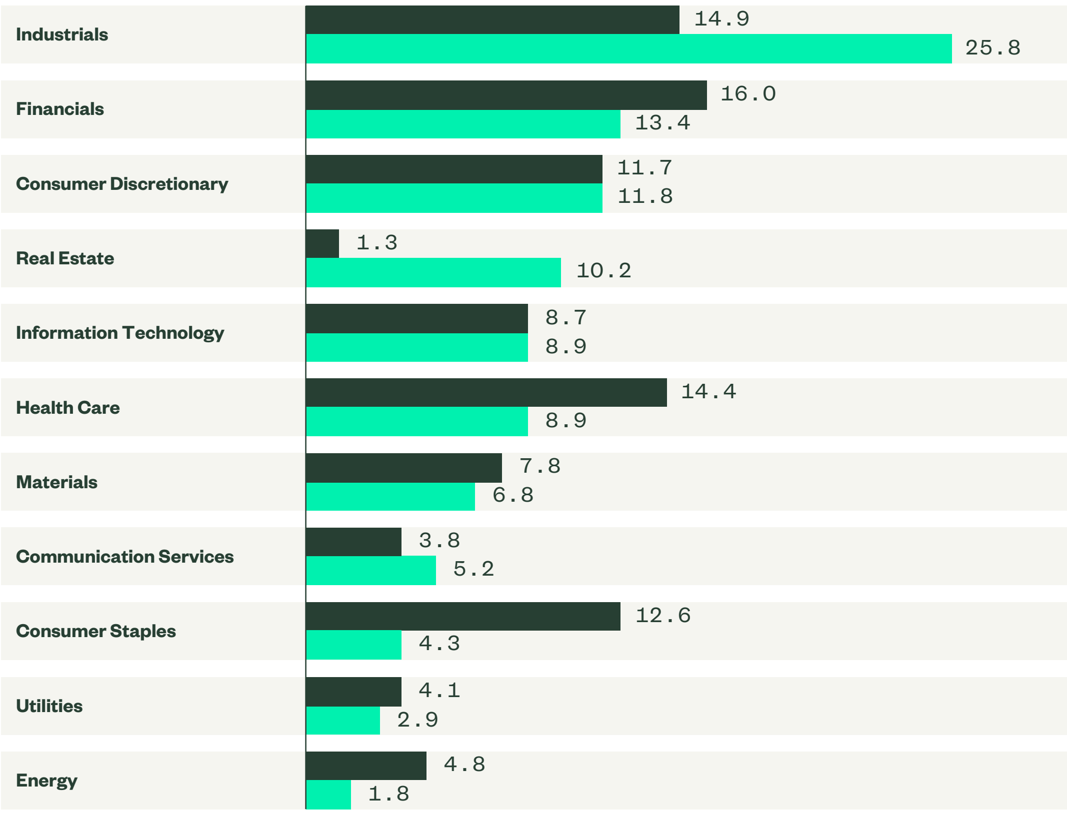
The backdrop for European equities remains supportive given their undemanding valuation, appealing spreads to local bonds and solid COVID management across the continent. Similar to the US, MSCI Europe Small Cap exposure and its value-weighted version allow investors to gain exposure toward more cyclical and domestic companies.

However, Europe small caps are oriented toward more traditional businesses. Heavy exposure to the industrials sector is particularly appealing as the sector may be the largest beneficiary of the next leg of the recovery, namely investments. Amid stabilising economies, corporates should start deploying their post-COVID cash piles into capital expenditure, while governments at the country and pan-European level are expected to boost infrastructure spending. These factors should support industrial companies.

Financial companies are a significant component of the MSCI Europe Index and are also one of the largest weights in both the MSCI Europe Small Cap Index and MSCI Europe Small Cap Value Weighted Index. We believe this segment is well positioned, as rising yields allow investors to capture improved net interest margins while economic recovery mitigates risks of increases in non-performing loans.

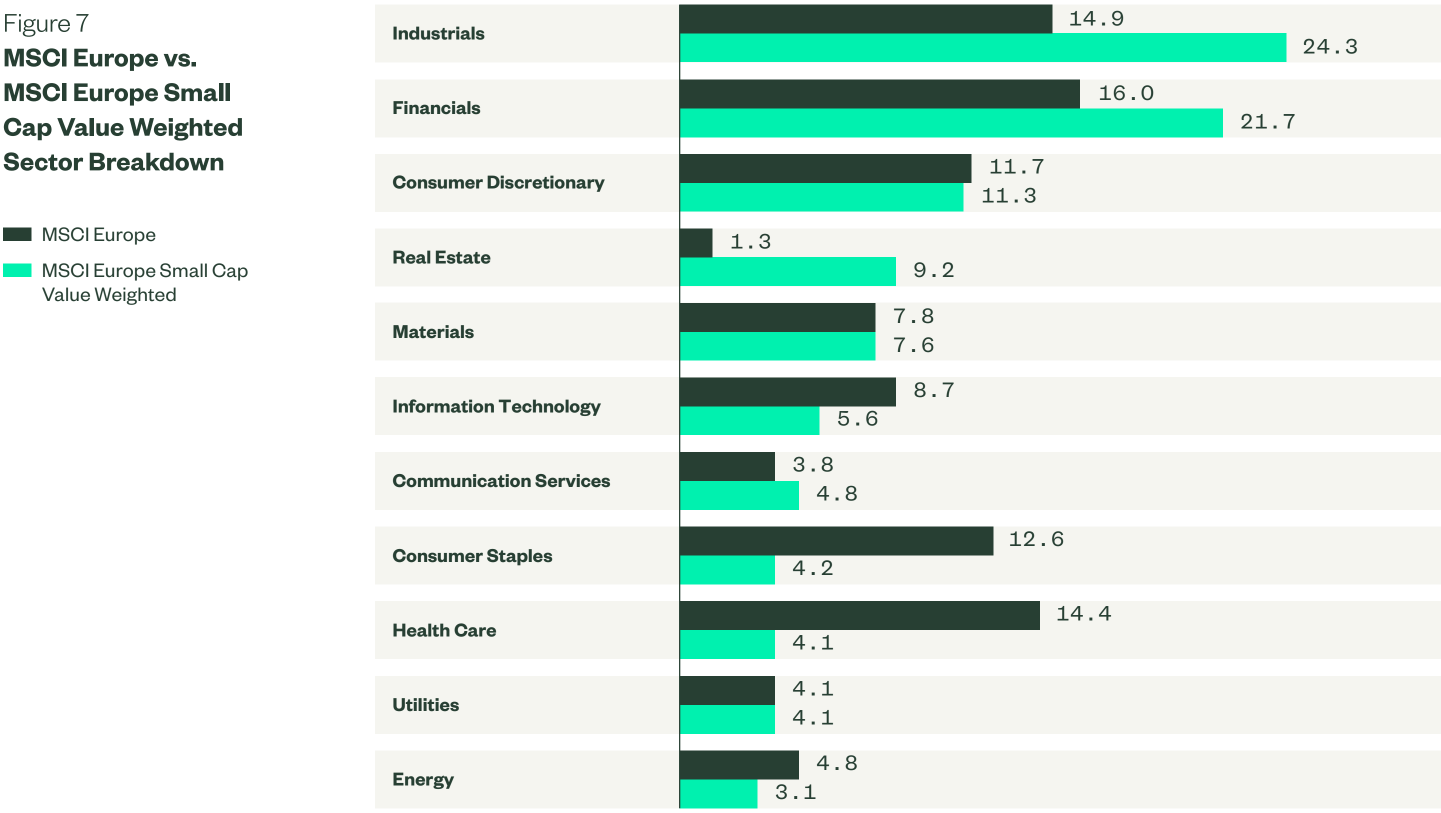
Another sector that allows investors to capture the recovery is real estate, which represents 10% of the MSCI Europe Small Cap Index and 9% of MSCI Europe Small Cap Value Weighted Index; meanwhile, for MSCI Europe the weight is only 1%. The sector is traditionally perceived as an inflation hedge but we believe that its ability to capture economic growth coming from reopening is an even more important feature given its performance gap and undemanding valuation relative to the broader market.

Figure 6
MSCI Europe Small Cap vs. MSCI Europe Sector Breakdown



Source: MSCI, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Figure 7
MSCI Europe vs. MSCI Europe Small Cap Value Weighted Sector Breakdown



Source: MSCI, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

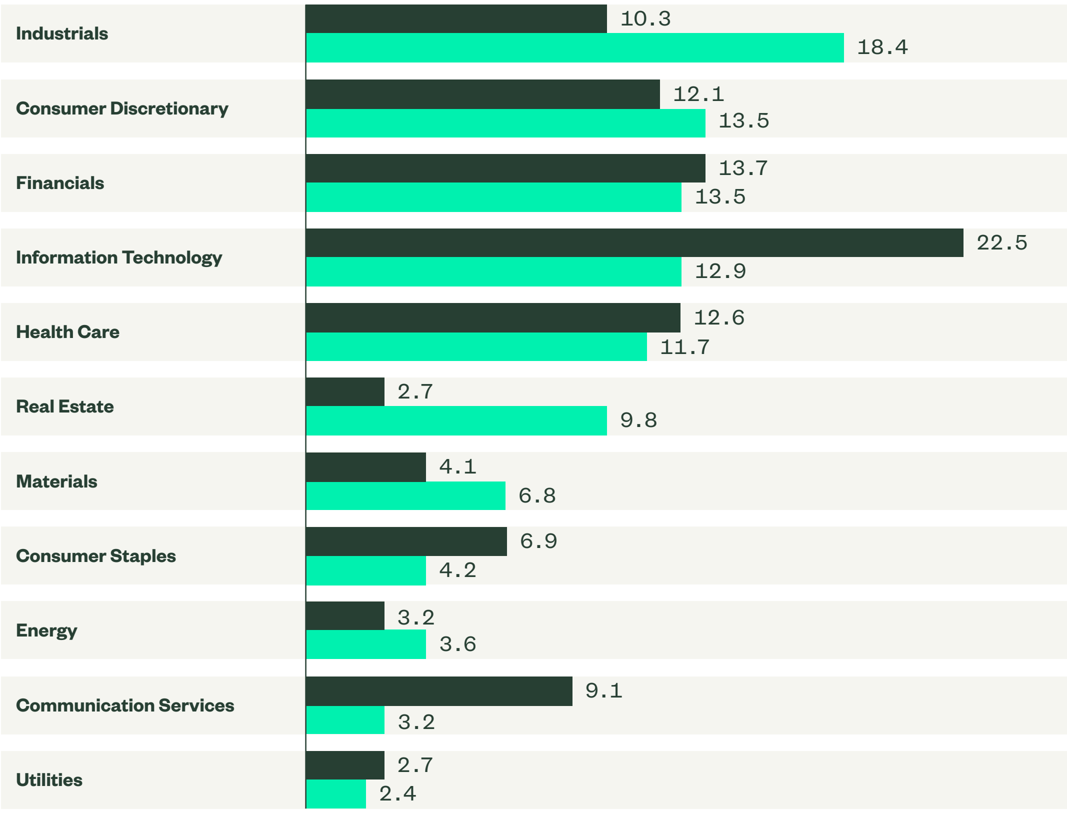
World Small Caps: Combining Cyclicality Within Developed Markets

Investing in global developed market small cap equities allows investors to gain cyclical exposure, combining the merits of smaller companies across the US (59% of the index) and Europe (21%). However, there is more to the exposure as the global index also provides access to Japan (11%), which is itself a cyclical, export-oriented economy. Furthermore, exposure to Canada and Australia (both 3%) allow investors to gain access to economies that benefit from high commodity prices.

The sector split naturally reflects the country mix. Industrials represent more than 18% of the index as stocks from Europe and US are accompanied by a significant component from Japan. Similarly, the weight of materials is relatively higher, driven by mining companies from Australia and Canada. The MSCI World Small Cap Index does not overweight financials relative to MSCI World but it offers more domestic exposures, which may benefit to a larger extent from local policy normalisation.

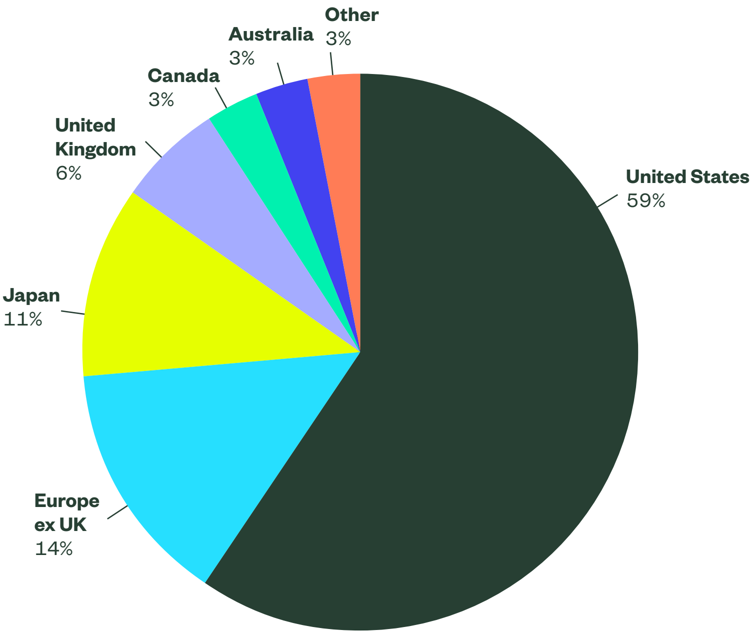
The weight of consumer discretionary is only marginally higher than for MSCI World; however, its composition is likely better suited to capture the recovery as it is less exposed to internet or EV giants, which enjoyed terrific performance throughout the pandemic but may face headwinds if yields continue to increase. Real estate companies are excellent tools for extracting value from reopening and they can also serve as an inflation hedge. Finally, given the US represents 59% of the index, it is worth reiterating the lack of exposure to FAANG stocks and their long-duration profile in the current low but rising yield environment.

Figure 8
MSCI World Small Cap vs. MSCI World Sector Breakdown



Source: MSCI, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Figure 9
MSCI World Small Cap Region Breakdown

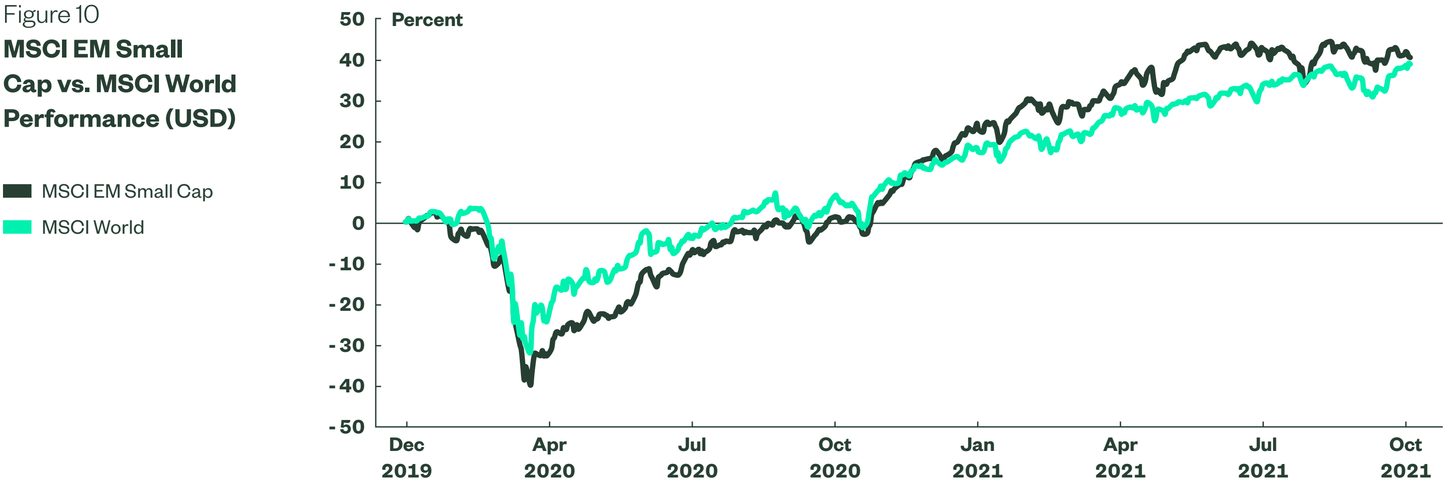


Source: FactSet, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Emerging Markets: Keep a Low Profile to Avoid the Dragon's Wrath

Year to date, emerging markets have underperformed developed world equities by a wide margin. They have been challenged by regulatory pressure from China, scarcity of vaccines and an unexpectedly stronger USD, with the China factor being the most impactful drag. Emerging market small caps were one of a few parts of the broader emerging markets that actually performed in line with developed markets.

Figure 10
MSCI EM Small Cap vs. MSCI World Performance (USD)



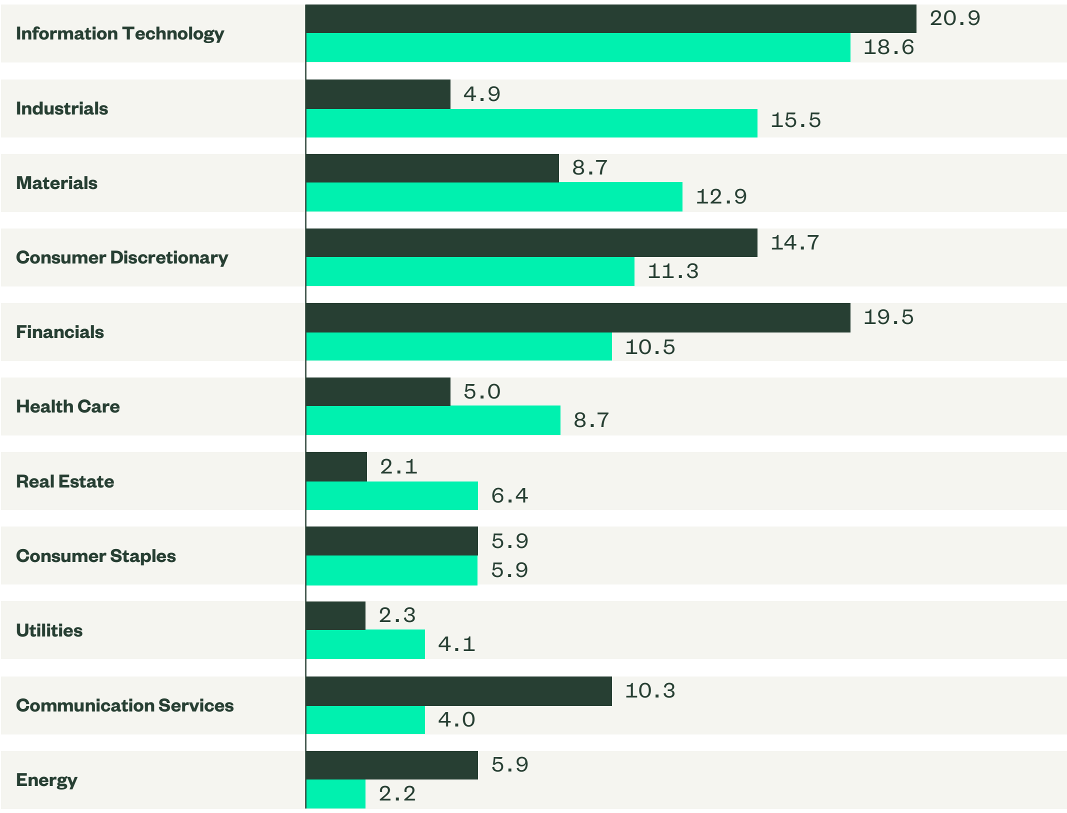
Source: Bloomberg Finance L.P., as of 29 October 2021. MSCI EM Small Cap is MSCI EM Emerging Markets Small Cap USD Net while MSCI World is MSCI World Net Total Return USD Index. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index.

The reason behind this performance lies in the composition of the MSCI EM Small Cap Index. China represents only 8.7% of the index while it is 34% for the broader MSCI EM Index. Instead, Taiwan, India and South Korea together make up 59% of the index. This allows investors to enjoy growth from developing economies and, at the same time, avoid the wrath of the Chinese regulators. Furthermore, small companies were rarely a target — unlike the internet giants.

EM small caps, just like the broader EM index, are heavy on tech. However, looking at the subsector level, they are more oriented toward semiconductors and electronic equipment rather than software or pure internet businesses. Again, this helps to mitigate regulatory risk coming from China. Industrials, materials, real estate and the more traditional profile of consumer discretionary companies introduce cyclicality, which we believe may flourish in the current environment.

Figure 11
MSCI EM Small Cap vs. MSCI EM Sector Breakdown

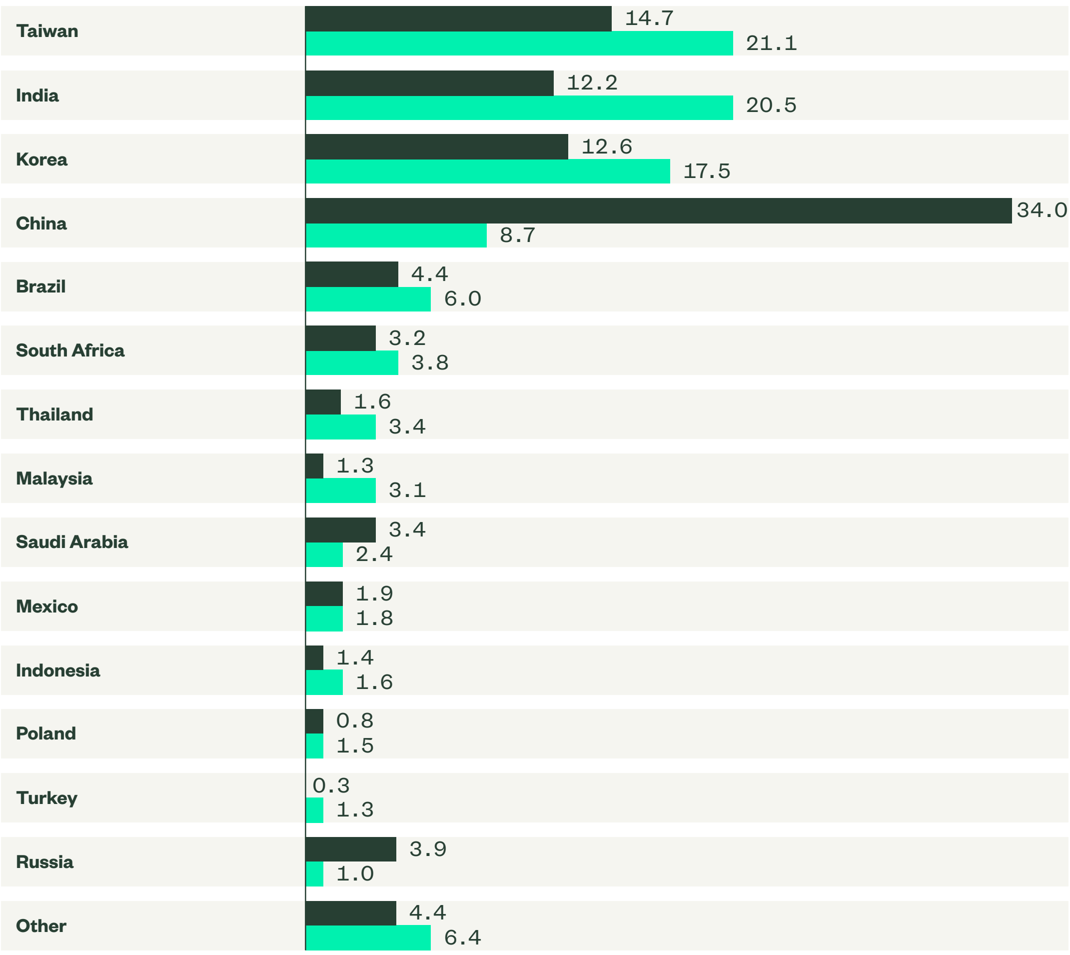
MSCI EM
MSCI EM Small Cap



Source: MSCI, FactSet, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Figure 12
MSCI EM Small Cap vs. MSCI EM Country Breakdown

MSCI EM
MSCI EM Small Cap



Source: MSCI, FactSet, as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

Endnote

1 Source: The Cross-Section of Expected Stock Returns, Eugene F. Fama and Kenneth R. French, The Journal of Finance, Vol. XLVII No. 2 (June 1992).

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