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Equities | Small Cap

In US small caps, risk sentiment may shift as the economy recovers

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Boston - A big story in the U.S. equity market this year has been the power of retail investors to move the share prices of a handful of otherwise left-for-dead stocks, and the resulting impact on the U.S. stock market, particularly small caps. Although risk momentum has dominated the small-cap market recently, we believe this trend is unsustainable and will likely shift in the months ahead.

A Reddit group's effort to create and ride market momentum to crush hedge funds using the Robinhood app to invest in several microcap stocks — most notably, GameStop — is perhaps the "David and Goliath" story of the year.

Microcaps generally are companies with less than $1 billion in total market capitalization, whereas small caps fall in the $1 to 5 billion range. By the end of January, GameStop had skyrocketed 1,600% for the month, while other Reddit favorites like AMC Entertainment and Express Inc. surged more than 500%, sending the Russell Microcap Index up 14%. Microcaps helped drive the small-cap Russell 2000 Index to a 5% January gain. The S&P Small Cap 600 Index fared even better, up 6.2%, thanks to its much larger position in GameStop.

As a result, small-cap stocks far outpaced the returns of the broader large-cap indexes in the first month of 2021. This followed the surge of small caps after the Pfizer coronavirus vaccine announcement in November, which led to the Russell 2000 beating the S&P 500 Index for 2020, despite large caps outperforming small caps for most of the year.

Shifting market dynamics

Given these recent, aberrational small-cap market drivers, it's not surprising that only 10% of small-cap managers outperformed the Russell 2000 Index in January. We do not, however, expect the dynamics of January to be sustainable longer term. Notably, GameStop is down 87% so far in the month of February,[1] underscoring the volatility of this type of investing.

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We are finding compelling opportunities in a number of quality companies that have been left behind. With growth stocks posting extreme outperformance last year relative to value stocks in the Russell 2000, we are seeing potential in cyclical companies, which we think are poised to benefit from the improving economy.

While our focus remains on individual companies and business models, we believe it will be critical to monitor the long-term benefits of fiscal and monetary programs, the trajectory of the virus and vaccinations, interest rates and balance sheet leverage, inflation and, as always, valuations.

Bottom line: Our Quality, Valuation and Time (QVT) approach is centered on creating long-term profitability and downside protection for the portfolios we manage. Although this strategy has encountered headwinds in the near term amid strong risk sentiment, we are confident that it can continue to prove effective over time and across market cycles.

1. As of February 18, 2021.

Index definitions:

Russell Microcap Index consists of the smallest 1,000 securities in the small-cap Russell 2000 Index, plus the next 1,000 smallest eligible securities based on market cap and index membership weight.

Russell 2000® Index is an unmanaged index of 2,000 U.S. small cap stocks.

S&P Small Cap 600 Index is an unmanaged index of the 600 smallest U.S. stocks.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

About risk: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.