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Equities | Small Cap

US small caps on pace for strong year-end finish

Boston - In November, the US small-cap Russell 2000 Index surged 18.4% — its largest monthly gain in the index's 42-year history. With this epic rise, the Russell 2000 was up more than 90% from its March bottom to set an all-time record; the last being in August 2018. So far in December, the small-cap index has tacked on another 9.4%, as investors are heartened by coronavirus vaccine distribution, despite spiking COVID losses.

November's rapid rise seemed to stem from a rare combination of a focus on growth stocks alongside unbridled enthusiasm for a cyclical rebound — a trend that has continued. It wasn't just the small-cap space breaking new ground. The S&P 500 advanced about 11%, its largest November gain on record, and the Dow climbed 11.8%.

Resolution to the US elections and encouraging Pfizer and Moderna vaccine news helped unleash a powerful pro-cyclical rotation by Russell 2000 value stocks early in November. By the end of the month, the outperformance of small-cap value relative to small-cap growth stood at just 1.7% for November as growth reasserted its leadership role. Value, however, is still lagging growth within the Russell 2000 by a massive 35 percentage points year-to-date.

Market leadership rotations

Since March, we've been positioning our portfolios toward value-oriented, high-quality cyclical stocks, but our results did not keep pace with November's dramatic moves. Our long-term focus of investing in high-quality, reasonably valued companies ran into the perfect storm in recent months, as small-cap market leadership has come from the extremes of deep value, cyclical stocks and high-growth companies.

Looking at factor performance in the index really drives this home. In November, the five best-performing areas were penny stocks, unprofitable health care and technology companies, low share-price stocks, and pure value and high-beta stocks. On the other end of the spectrum, the five worst-performing areas in November were stocks with the characteristics of low-beta, strong dividend growth, stability, low volatility and quality.

A focus on quality

In our view, seeking higher-quality securities has been a consistent way to tap excess return over the long term. The small-cap opportunity set embodied in the Russell 2000 historically and consistently tilts toward low-quality characteristics. On the whole, margins, free cash flow and leverage remain poor for constituents of the Russell small-cap universe. Currently, valuations appear to be becoming stretched for both value and high-growth index stocks.



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"US small-cap stocks have set new records during the last months of 2020, led by a rare combination of a focus on growth stocks alongside unbridled enthusiasm for a cyclical rebound."

Overall, we think quality stocks look very attractive on a historical basis and now, as ever, our focus is on high-quality, sound businesses that can deliver on fundamentals. In addition, we believe focusing on quality companies is critical in seeking to deliver favorable downside protection. Our long-term analysis, as well as our track record, indicate that although quality doesn't always deliver over the short term, it bears results over long-term, shifting market cycles.

Bottom line: US small-cap stocks have set new records during the last months of 2020, led by an unlikely mix of both deep value and strong growth stocks. We continue to adhere to a disciplined application of our (Q)uality, (V)aluation, and (T)ime approach, which, although out of favor at times, has produced positive long-term results.

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