Why a Long-Term, Strategic Allocation to Smaller Companies Makes Sense

The reasons for maintaining a strategic allocation to small-caps are compelling.

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KEY INSIGHTS

- U.S. smaller companies have lagged their larger counterparts over the past year. However, the fundamental picture remains supportive, in our view.
- Moreover, there are compelling reasons for maintaining a long-term, strategic allocation to the smaller-company sector.
- The U.S. offers a particularly supportive, pro-business environment where entrepreneurship is esteemed and small business success stories are championed.

With the S&P 500 Index recently scaling new, all-time highs, U.S. smaller companies, in comparison, have lagged their larger counterparts over the past year. This has prompted some investors to question the outlook for smaller companies, as well as their continuing exposure to the asset class. However, not only does the near-term fundamental environment remain supportive, in our view, but there are also compelling reasons for maintaining a strategic, long-term allocation to smaller companies.

Understanding Smaller Company Characteristics

So, what is it that is currently weighing on the small-cap market? Some have suggested that the combination of slowing global economic trends and the U.S.-China trade war represent a particularly risky landscape for U.S. smaller companies. Indeed, smaller companies tend to hold higher levels of debt relative to cash and revenues, so they are generally more sensitive to the health of the broader economy.

However, while there is inevitably some flow through from a weaker global economy, the U.S. economy continues to expand at a healthy rate. Small-cap companies tend to be more domestically focused, with a relatively low international exposure, so they are generally more insulated from global economic trends than larger-company counterparts. Meanwhile, it is true that smaller companies are not immune from the impact of the China trade war. Given that these businesses import and export both materials and components, any disruption here is likely to result in volatility. However, it is arguable that the trade war could also potentially provide opportunities for certain smaller U.S. companies as new domestic suppliers are sought to fill some of the gaps previously met by Chinese companies.

USD 5.24 billion[1]

Average market capitalization—Russell 2500 Index companies.

Late-Cycle Concerns Have Prompted Some Rotation

Concerns about the late stage of the economic cycle have led some investors to reduce their smaller-company exposure. Already more than 10 years into the current expansionary phase, we are likely getting closer to the end of the economic cycle. While the appeal of smaller companies is that their size makes them more responsive to changes and opportunities, it also means that they tend to be more vulnerable during periods of slowdown. Accordingly, as we move deeper into the current cycle, some investors have started to pivot out of smaller companies in favor of larger, more established companies offering stable earnings, lower debt, and more substantial cash buffers.

Why the Fundamental Environment Remains Encouraging

Despite the late stage of the economic cycle, we believe a number of factors remain supportive of the asset class. First, consensus expectations for the next six to 12 months are for U.S. smaller companies to deliver superior growth to their larger counterparts, while valuations also appear more reasonable. While we do not know if this growth will be achieved, the upbeat consensus view signals a generally supportive landscape. Meanwhile, mergers and acquisitions (M&A) activity also continues to underpin small-cap performance. A combination of tax reform, reduced regulation, and, importantly, larger companies' ongoing searches to "buy in" small-cap innovation should continue to stimulate further M&A activity. Finally, the U.S. government and central bank have made clear commitments to do whatever is necessary to arrest any material slowdown in the economy.

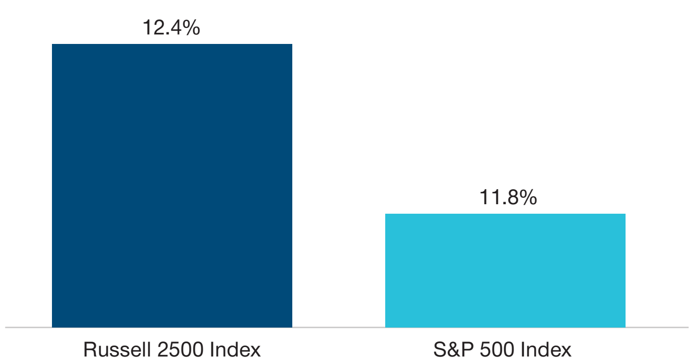
Revisiting the Rationale for a Long-Term, Strategic Allocation to Smaller Companies

Moreover, there are compelling reasons for maintaining a long-term, strategic allocation to the smaller-company sector. Principally, these include the potential to exceed large-cap performance over the long term, portfolio diversification, and the opportunities afforded through

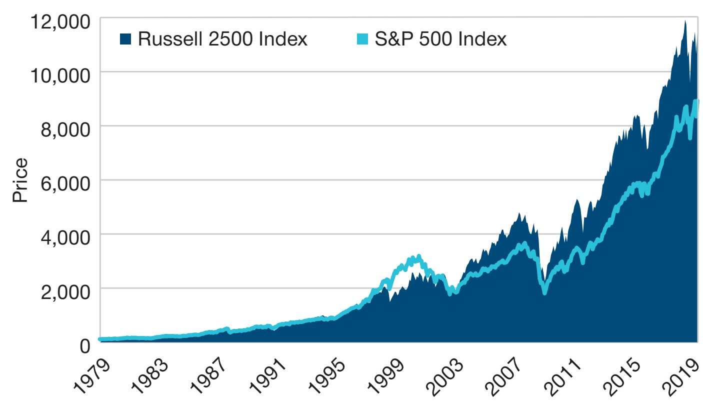
(Fig. 1) Comparing Long-Term Performance

Smaller companies have generated superior long-term returns versus larger counterparts

Annualized Returns
January 1979 to June 2019



Long-Term Growth
January 1979 through June 2019. Rebased to 100.



Past performance is not a reliable indicator of future performance.
Sources: FTSE Russell (see Additional Disclosures), and S&P (see Additional Disclosures). Data analysis by T. Rowe Price.

[1] Source: FTSE Russell (see Additional Disclosures), as of July 31, 2019.

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— **Curt Organt**
Portfolio Manager, T. Rowe Price US Smaller Companies Equity Strategy

well-researched stock selection by the greater dispersion of returns on offer.

Historically Superior Returns

U.S. smaller companies have the potential to achieve higher investment returns over the long term (Fig. 1, left-hand side). While it is true that smaller companies tend to be more volatile, they have historically outperformed their larger-company counterparts. This makes sense as many of these companies are in the early stages of their development, are potentially undergoing rapid expansion, and yet are still small enough to deliver growth that is meaningful (Fig. 1, right-hand side).

Lower Correlation and Higher Returns Improve Risk-Adjusted Performance

Historically, returns of U.S. smaller companies have been less correlated with other large segments of European-based investors' portfolios, compared with U.S. large-caps. Therefore, at the total portfolio level, adding exposure to U.S. smaller companies—an asset class with historically high returns and lower correlations to other portfolio holdings—can improve the risk-adjusted returns of a balanced portfolio (Fig. 2). That is counterintuitive to the way many investors think about the asset class. However, the evidence shows that for only limited additional risk, historical annual total returns have been greater.

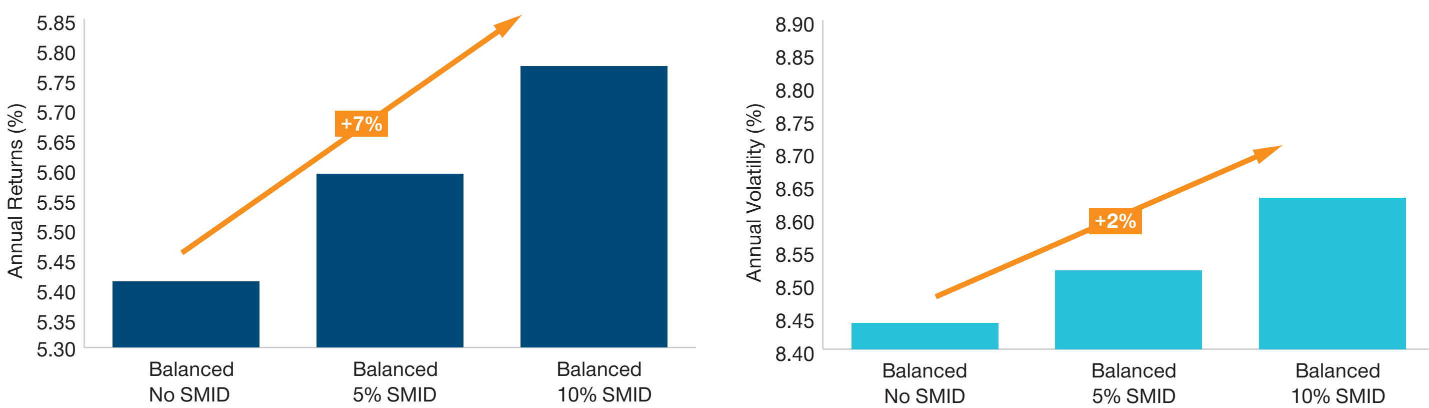
Greater Potential to Add Value

There is greater dispersion within the smaller-company asset class, providing active investment managers with better opportunities to add value. Identifying mispriced stocks, such as uniquely advantaged companies, or businesses that are undervalued relative to their assets, the smaller-company segment typically offers greater rewards as the dispersion of returns is greater than for large-cap equities. Effectively, investors are better rewarded for picking potential winners in the small-cap space.

At the same time, smaller companies are less covered by traditional Wall Street analysts, as indicated below (Fig. 3). If an investment team has the resources to independently meet with these underfollowed companies and

(Fig. 2) Improved Risk-Adjusted Returns

Adding small-/mid-cap (SMID) company exposure can improve risk-adjusted portfolio returns
January 1999 through June 2019



Simulated past performance is not a reliable indicator of future performance.
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Sources: FTSE Russell (see Additional Disclosures), S&P (see Additional Disclosures), MSCI (see Additional Disclosures), and Bloomberg Index Services Limited (see Additional Disclosures). Data analysis by T. Rowe Price. Balanced portfolio = 30% European Equities, 15% World ex-Europe, 15% S&P 500, and 40% Euro Bonds.

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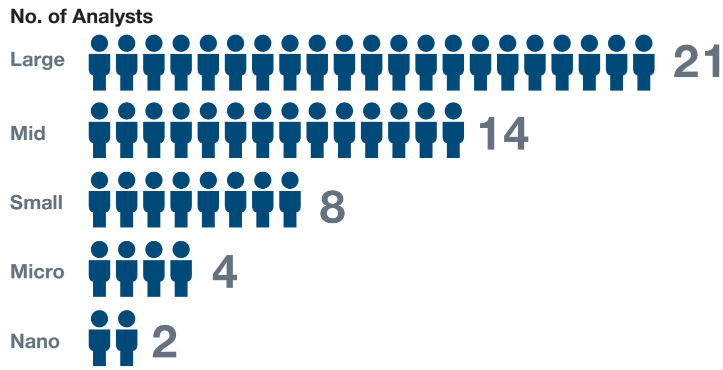
Portfolio Manager,
T. Rowe Price US Smaller Companies Equity Strategy

(Fig. 3) Where Active Investing Can Make a Real Difference

The under-researched, less efficient nature of the small-cap segment creates opportunities.

As of June 30, 2019.



Source: Bank of America Merrill Lynch.

assess their prospects for success, there are tremendous opportunities to add value, as many are under appreciated, or even unknown, by the broader investment community.

We believe there are compelling reasons for maintaining a long-term, strategic allocation to U.S. smaller companies. While they do come with risks and the prospect of higher volatility, consistent exposure to smaller companies as part of a balanced portfolio can add value over the long term. With superior growth potential, smaller companies can also provide diversification, as the drivers of performance tend to be different from those of larger companies. They tend to have simpler business models, with less sensitivity to macro issues or industry developments; they are typically more dependent on company specific news and developments. Finally, the U.S. market is a hugely important space for smaller companies to grow. The size of the domestic economy gives companies plenty of room to scale up and grow into. The U.S. offers a particularly supportive, pro-business environment where entrepreneurship is esteemed, and small business success stories are championed, encouraging others to follow suit.

WHAT WE'RE WATCHING NEXT

While uncertainty levels have risen due to changes in China trade policy, the latest data from the National Federation of Independent Business (NFIB),[2] a leading small- and mid-cap business association, showed that small business owners' optimism remains around historically high levels. Additionally, June 2019 marked the 19th month of consecutive small business employment growth, according to NFIB's monthly jobs report. We continue to monitor these and other data sets for any signs of material weakness emerging in the U.S. smaller-company segment.

[2] NFIB Small Business Optimism Index, as of June 30, 2019.

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