A New Era for Small-Caps?

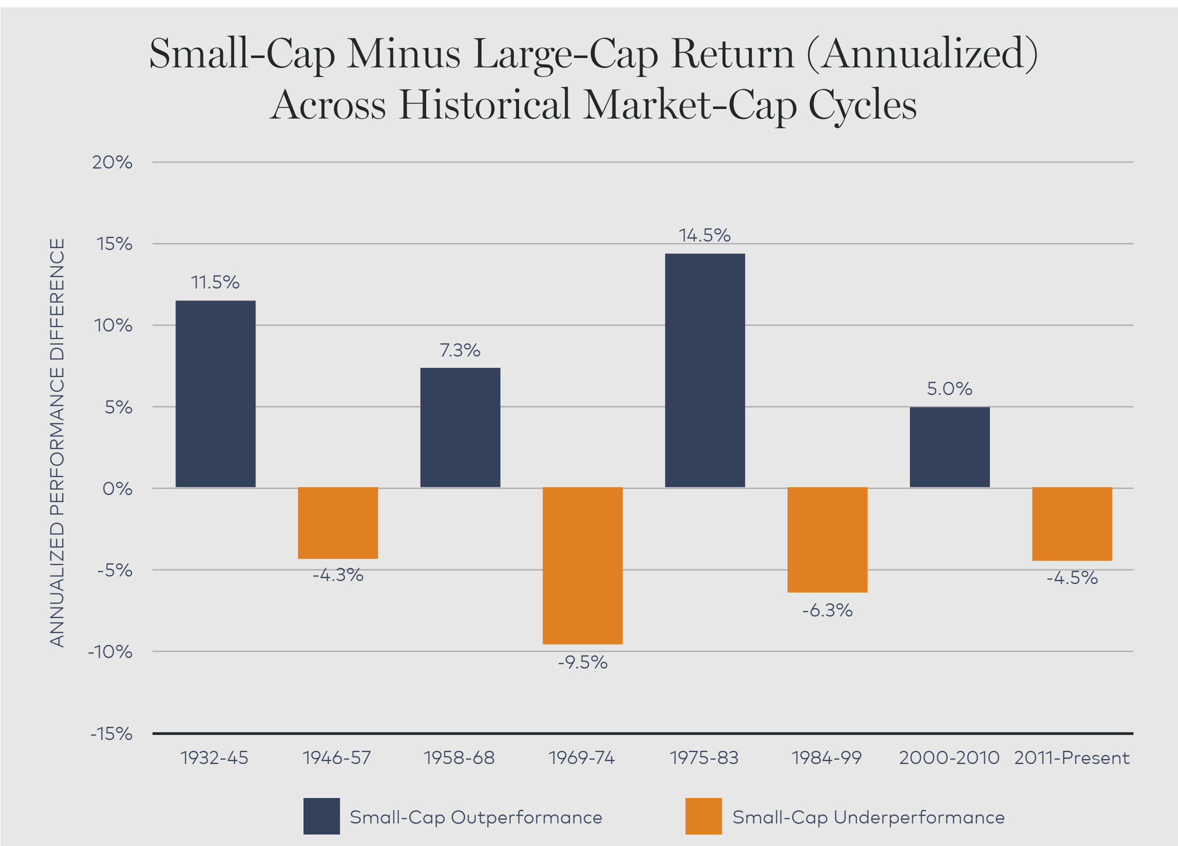
Five Charts That Underscore the Potential Opportunity

NOVEMBER 28, 2023

Large-cap stocks have outperformed small-caps for more than a decade. At this point in the cycle, we believe small-cap valuations are quite attractive relative to large-caps. Heading into 2024, we think it may be time for investors to consider increasing their small-cap allocations.

LARGE-CAPS HAVE HAD A LONG RUN OUTPERFORMING SMALL-CAPS

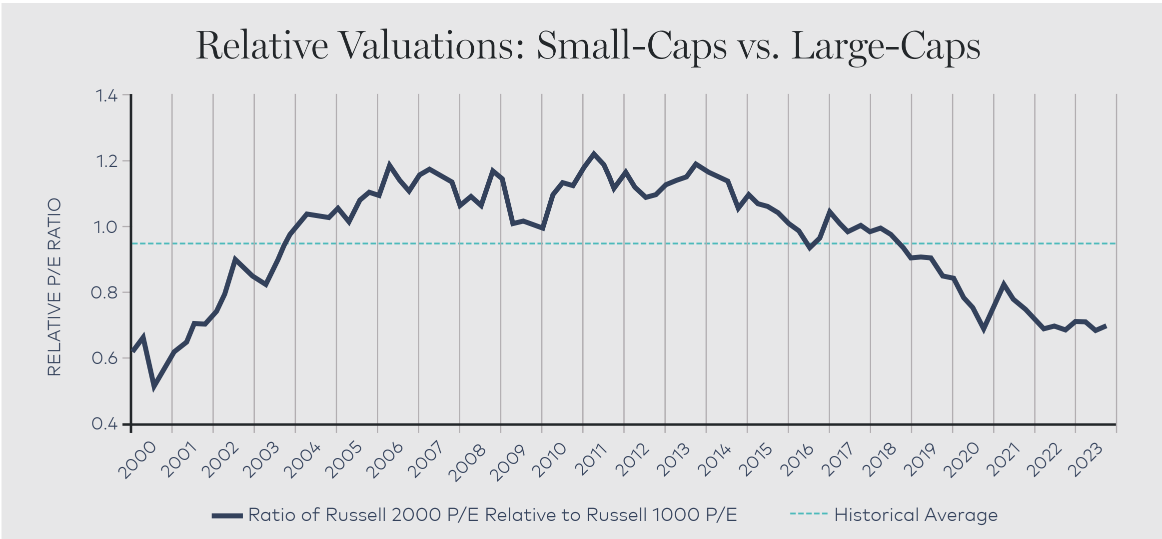
Large- and small-cap stocks can go through long cycles of outperforming one another. Large-caps' current run of outperformance has stretched more than a decade. The following chart, provided with data from Furey Research Partners, shows some of the dominant periods of both market-cap segments and the level of outperformance by small- or large-caps.



Source: Furey Research Partners as of October 31, 2023. Annualized small-cap performance is represented by the Russell 2000 Index from 1979 to July 31, 2023, and by the CRSP 6-8 Decile Index before 1979. Annualized large-cap performance is represented by the S&P 500 Index for all periods. Past performance is no guarantee of future results.

THE LARGE-CAP CYCLE HAS MADE SMALL-CAP VALUATIONS QUITE ATTRACTIVE ON A RELATIVE BASIS

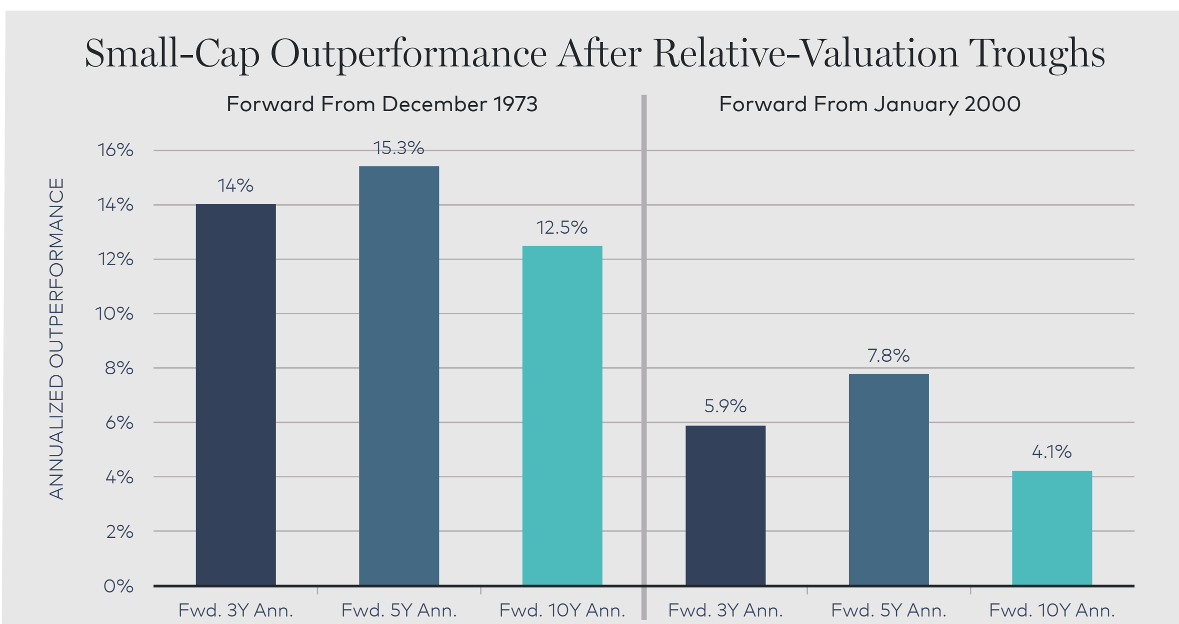
One way to assess the attractiveness of small-cap stocks is to compare their valuations to those of large-caps. Based on that relative comparison, our view is that small-caps haven't been this attractive in more than 20 years. The following chart shows how the valuations of the two market-cap segments have compared over time.



Source: FactSet from December 31, 1999 to September 30, 2023. For both indexes, the P/E is the weighted-average P/E multiple, based on fiscal-year forward earnings, of all companies with positive earnings within the respective index.

IN PRIOR PERIODS, ATTRACTIVE RELATIVE VALUATIONS FOR SMALL-CAPS LED TO STRONGER RELATIVE RETURNS

At Wasatch, we don't specialize in market forecasts and aren't making a prediction of exactly when a large-cap cycle will end and a new small-cap cycle will begin. However, we think it's worth noting that small-caps experienced outsized performance over large-caps at previous points when relative valuations were attractive. The following chart shows the 3-, 5- and 10-year outperformance of small-caps over large-caps, on an annualized basis, coming out of prior small-cap relative-valuation troughs over the last 50 years.



Source: Furey Research Partners. The two points depicted begin at the two lowest relative market-cap valuation troughs of the past 50 years. Small-cap performance is represented by the Russell 2000 Index from 1979 to July 31, 2023, and by the CRSP 6-8 Decile Index before 1979. Large-cap performance is represented by the S&P 500 Index for all periods. Past performance is no guarantee of future results.

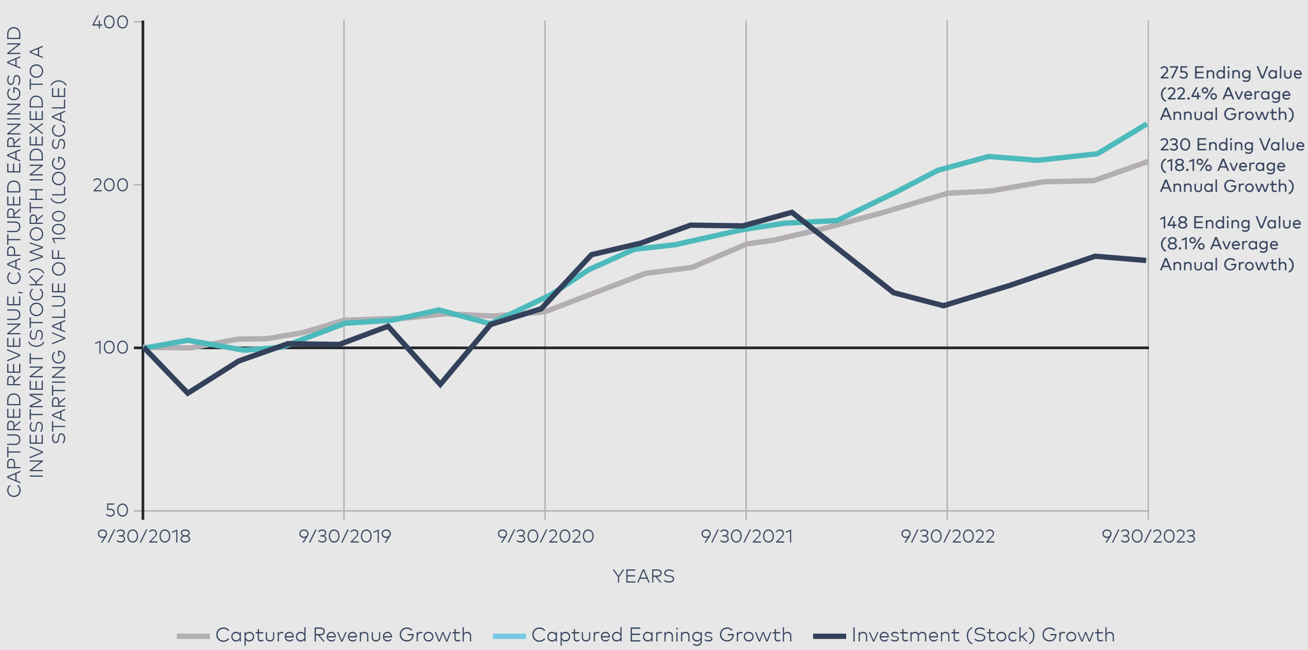
WE BELIEVE WASATCH PORTFOLIOS ARE POSITIONED TO BENEFIT WHEN THE CYCLE CHANGES

Since early 2022, we've noticed an unusual dislocation between stock-price movements of our companies on one hand, and companies' revenue growth and earnings growth on the other. Over longer periods, stock prices have tended to track revenue and earnings growth. But we believe the corporate operating performance that's recently been "captured" in our small-cap strategies isn't being properly reflected in recent stock returns.

The following chart shows the cumulative "capture" of quarterly revenue growth and earnings growth for all companies held in the Wasatch Small Cap Core Growth strategy over the last five years. While cumulative stock returns have periodically deviated from the trend in "captured" growth, they've generally come back into rough alignment. Based on our experience, this gap between stock returns and "captured" revenues and earnings should eventually close—with performance hopefully accruing in our favor.

Captured Cumulative Revenue Growth And Earnings Growth Of All Wasatch Small Cap Core Growth Companies, And Their Stock-Price Performance

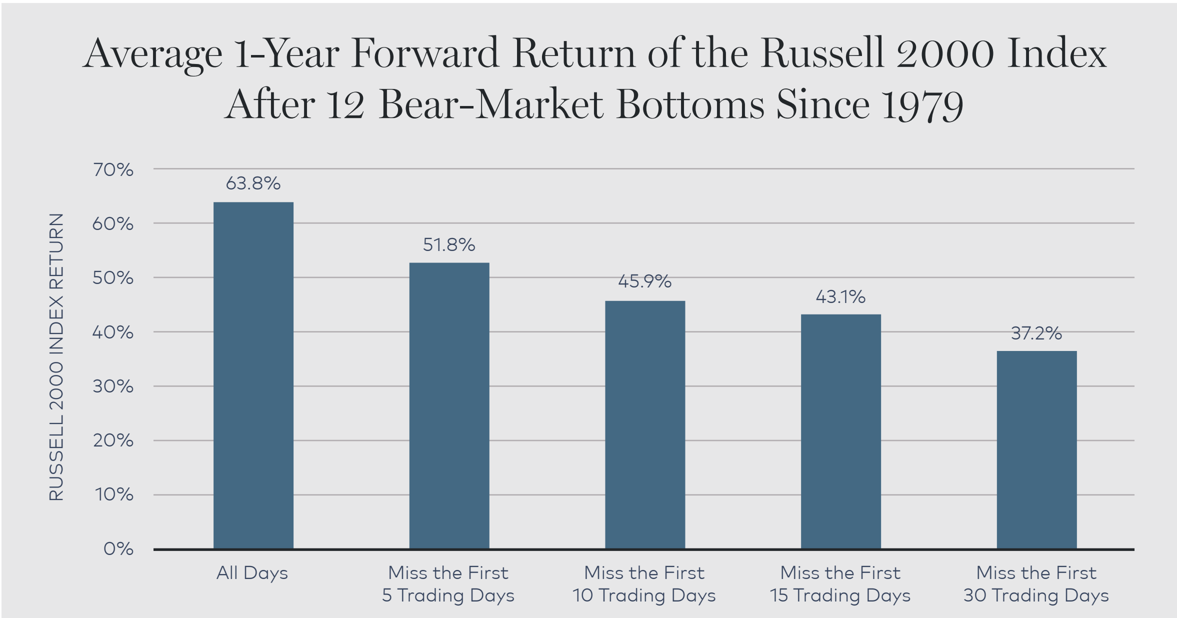
QUARTERLY DATA FROM SEPTEMBER 30, 2018 THROUGH SEPTEMBER 30, 2023



Source: FactSet and Wasatch from September 30, 2018 to September 30, 2023. Captured revenue growth and captured earnings growth represent the quarterly, cumulative revenue growth and earnings growth achieved by all the companies owned in the Wasatch Small Cap Core Growth strategy (based on a representative account) for the five years. To normalize earnings and revenue growth and avoid the influence of companies that were extreme outliers, the chart data limits earnings and revenue growth of any company to positive 50% and negative -33.33%. Past performance is no guarantee of future results.

INVESTORS CAN'T TIME CYCLES, BUT IT MAY BE A GOOD TIME TO REVIEW SMALL-CAP ALLOCATIONS

No one can time a market cycle with certainty. But given the recent long period of large-cap outperformance and small-cap stocks' attractive valuations relative to large-caps, we believe investors may want to review their small-cap allocations. Historically, investors have benefited from having a desired small-cap allocation in place before small-cap stocks rally. The following chart puts this in perspective. It shows the average one-year forward returns from the last 12 bear-market bottoms and what those returns were if investors missed the early days of the rally.



Source: Furey Research Partners. The performance periods used for market bottoms begin at 3/27/80, 8/12/82, 07/25/84, 10/28/87, 10/31/90, 10/08/98, 10/09/02, 03/09/09, 10/03/11, 02/11/16, 12/24/18, and 03/18/20. Past performance is no guarantee of future results.

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The Russell 1000 Index is an unmanaged total return index of the largest 1,000 companies in the Russell 3000 Index. The Russell 1000 typically comprises about 92% of the total market capitalization of all listed stocks in the U.S. equity market. It is considered a bellwether index for the performance of large company stocks.

The Russell 2000 Index is an unmanaged total return index of the smallest 2,000 companies in the Russell 3000 Index, as ranked by total market capitalization. The Russell 2000 is widely used in the industry to measure the performance of small company stocks.

The S&P 500 Index includes 500 of the United States' largest stocks from a broad variety of industries. The Index is unmanaged and is a commonly used measure of common stock total return performance.

The CRSP 6-8 Decile Index is a small-cap index created and maintained by the Center for Research in Security Prices (CRSP) at the University of Chicago's Graduate School of Business. CRSP capitalization-based indexes include common stocks listed on the NYSE, AMEX, and the NASDAQ National Market.

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