MARKET MINUTE
WITH McGAREL

Dave McGarel, CFA, CPA
Chief Investment Officer

October 2023

Opportunity Comes In Smaller Packages

While we wait around for the most anticipated recession in history, one thing seems clear to us. Only one size segment of the U.S. market has priced in any sort of recession, small capitalization stocks (small caps). As measured by the S&P SmallCap 600® Index, small caps peaked in early November 2021. Large caps (measured by the S&P 500® Index) did not peak until the first trading day of 2022. From their peak on November 8, 2021, the S&P SmallCap 600® Index has lost 19.0% on a total return basis versus a loss of just 6.0% for the S&P 500® Index. Since the S&P 500® Index peaked on January 3, 2022, small caps have also lagged large caps (-16.4% vs -8.0%).

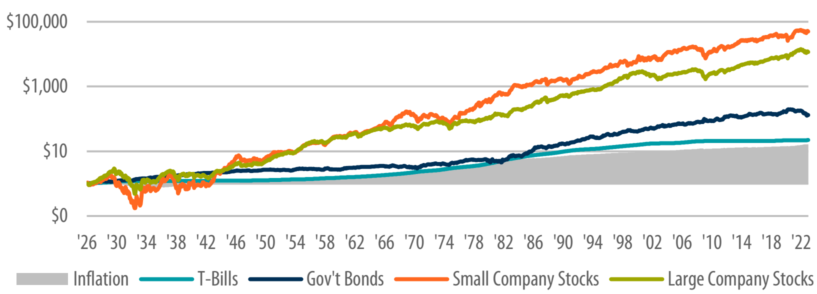
Not only have small cap stocks significantly underperformed large cap stocks over the last 21 months, they also trade at close to their biggest discount to large caps since the tech bubble burst in early 2000, over 23 years ago [Chart 1]. The S&P SmallCap 600® Index currently trades at 15.4x next 12 months earnings. The S&P 500® Index trades at 19.6x. On just about any other valuation measure, such as price-to-sales, price-to-cash flow and price-to-book, small caps are cheaper than large cap stocks.

It would be correct to point out small cap stocks typically suffer larger earnings declines in recessions than large caps. However, given the significant valuation disconnect versus large caps and the fact that, in our view, small caps have already priced in some degree of slowing economy, we believe there is an attractive risk/reward opportunity going forward in small cap stocks. Additionally, if we do get a shallow recession, small caps should lead their larger peers on the road to recovery. One thing is without dispute...small caps have provided the best returns in equities over the long run [Chart 2]. Today, there are many profitable, dividend paying small cap securities that may be attractive investments.

Chart 1: S&P SmallCap 600 Index/S&P 500 Index Forward Price-to-Earnings

Source: Bloomberg. Data from 1/1/1999 through 9/29/2023.

Chart 2: Stocks vs. Bonds



Average Annual Total Returns	
Inflation	2.9%
T-Bills	3.2%
Government Bonds	5.2%
Large Company Stocks	10.1%
Small Company Stocks	11.8%

Source: Ibbotson Associates. Hypothetical growth of a $1 investment made on 12/31/1925. Data is monthly and shows total returns through 12/31/2022. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. **Inflation** is represented by the Consumer Price Index (CPI-U) which measures the average change in prices over time that consumers pay for a basket of goods and services. **Treasury Bills (T-Bills)** are represented by the 30-day U.S. Treasury bill. **Government Bonds** are represented by the 20-year U.S. Government bond. **Small Company Stocks (Ibbotson Small Company Stocks Index)** are represented by the fifth capitalization quintile of stocks on the NYSE from 1926 to 1981 and the performance of the Dimensional Fund Advisors (DFA) Micro Cap Fund thereafter. **Large Company Stocks (Ibbotson Large Company Stocks Index)** are represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from1926 to 1956. Index returns do not reflect any fees, expenses, or sales charges. The asset classes shown here offer different characteristics in terms of income, tax treatment, capital appreciation and risk. U.S. government securities are subject to interest rate risk but generally do not involve the credit risks associated with investments in other types of debt securities. As a result, the yields available from U.S. government securities are generally lower than the yields available from other debt securities. Common stocks are subject to risks, such as an economic recession and the possible deterioration of either the financial condition of the issuers of the equity securities or the general condition of the stock market.

The **S&P 500® Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. The **S&P SmallCap 600® Index** is an unmanaged index of 600 stocks used to measure small cap U.S. stock market performance. Investors cannot invest directly in an index. **Forward Price-to-Earnings (P/E)** is the price of a stock divided by estimated forward earnings.