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OnPoint

A Series of Industry and Investment Insights

The case for small-cap growth remains solid

What is small cap?

Federated generally defines small-cap stocks as those with a market capitalization within the $300 million to $3 billion range, although the market-cap parameters are not set in stone.

The difference between small-cap growth and value

Small-cap growth stocks represent companies that exhibit strong growth characteristics, i.e., annualized sales and revenue growth of 30% or higher, and generally are less reactive to changes in the overall economy. In contrast, small-cap value stocks are viewed as being undervalued relative to their peers as well as inexpensive based on fundamentals such as book value, cash flow, earnings per share and sales.

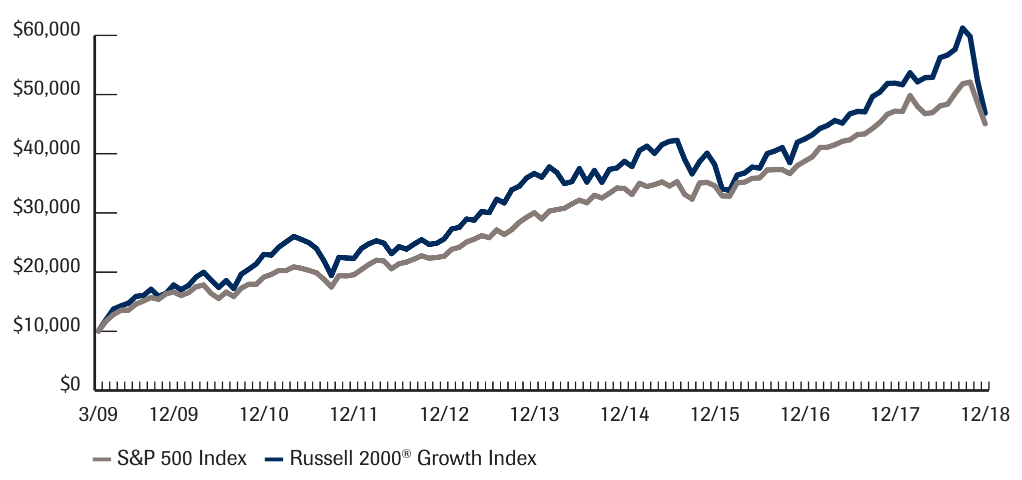
Large-cap stocks as represented by the S&P 500 Index have had a solid run since the equity market's March 2009 low, with occasional pullbacks overwhelmed by a stronger uptrend.

With this stalwart sector of the market expected to continue to benefit under the current pro-growth environment of lower taxes and less regulation, why look outside of this investment space? And why small-cap growth stocks in particular?

Two reasons: diversification and performance. No one knows if large-cap stocks, or any asset class for that matter, will continue to behave in the future as they have in the recent past. That's why portfolio diversification is key. Small-cap growth stocks historically have had a low performance correlation to large caps and other asset classes, and over time have tended to outperform large-cap stocks.

"What we love about small-cap growth stocks is that they are small businesses that constantly innovate and are creating their own demand," said Stephen DeNichilo, a Federated Kaufmann portfolio manager. "They are not reliant on market tailwinds. They create their own trajectory and are masters of their own universe."

Growth of $10,000: Russell 2000® Index vs. S&P 500 Index



Source: Morningstar, Inc. 3/6/09-12/31/18

Past performance is no guarantee of future results. This chart is for illustrative purposes only and is not representative of performance for any specific investment.

Size has its advantages

Because they usually are young and lack exposure, small-cap growth companies tend to fly under the radar. They are less closely followed and understood by the community of securities analysts, which sometimes means they sell for less than their true or potential value, creating opportunities if the market comes to re-price their shares accordingly.

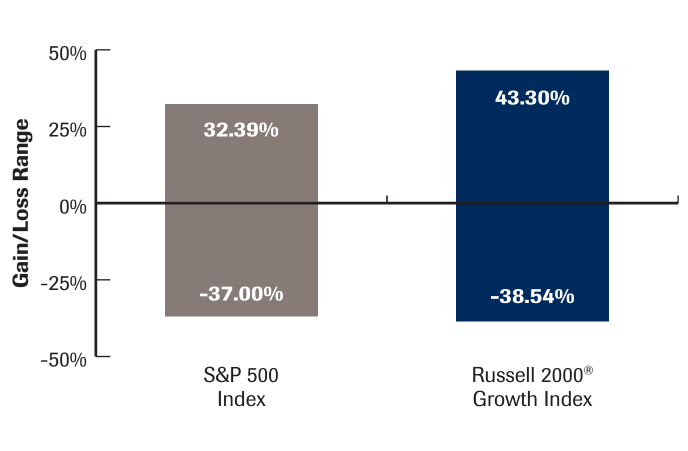
Small-cap growth companies also don't regularly get caught up in the broader macro environment—they live in their own world, so to speak, dealing with products and services that tend to focus on a specific audience or market. This helps to make them all-weather investments of sorts. They can be more nimble than larger companies, capable of more quickly ramping up to meet demand during fair-weather periods, and doing the opposite during periods of economic and market distress.

To be sure, their smaller size, shallower financial resources and narrower market focus means there can be less room for error. Smaller companies are not immune from and in some ways can be more vulnerable to broader market and economic gyrations if those forces impact their specific markets and customers.

Market hiccups, product malfunctions, management defections and other challenges that larger companies may be better able to absorb can be fatal if not properly and quickly addressed. This is why the small business failure rate is higher than that of larger companies and why small-cap stocks tend to have larger price swings.

But with that risk comes opportunity, as investors willing to assume the added risk of investing in small-cap companies may be rewarded for the extra risk associated with this asset class. This risk-premium factor reflects their tendency to outperform larger asset classes over time. This so-called Small Cap Effect has been documented through the work of Eugene Fama, one of 2013's winners of the Nobel Prize for economics, and his colleague Ken French, when both were at the University of Chicago.

Greater Risk — Greater Return Potential



Source: Morningstar, Inc. 1/1/08-12/31/18

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Industries of the future

Almost by definition, small-cap growth companies are innovative. They frequently emerge from an inspiring pioneer's or partner's invention or plan to do something that has never been done before (think Amazon or Google). They tend to launch businesses in new and untested markets, define and develop a market niche, or breathe life into products and services that leverage new or emerging technologies. Many fall into the technology, health care and consumer discretionary industries—sectors that in many ways represent the economy of tomorrow and are among the fastest growing of today.

> *"The management of small-cap growth companies makes the difference. They are the individuals solving the problems and taking risks, taking the shots that the big guys won't take."*
>
> Jordan Stuart
> Federated Client Portfolio Manager

After years of raising private funds and working on their business models, these companies typically debut in the publicly traded marketplace as initial public offerings (IPOs). It is here where many investors can capitalize on opportunities by getting in early on promising companies. After 2016's presidential and congressional elections that helped revive the market's animal spirits, IPOs rebounded from their mid-decade slowdown, with 190 last year and predictions for even stronger volume this year.

But what makes small-cap growth companies compelling now? Three reasons: earnings, tax reform and the outlook for more IPOs, particularly in the fastest-growing areas of the global economy:

- **Earnings** After a 3-year lull, corporate profits rebounded strongly the past two years. Earnings are expected to slow significantly this year, weighed down by decelerating global growth and the diminishing impact from the one-off effects of tax reform. Still, health care (medical devices, connectivity to life-changing medical breakthroughs, biotech advances, etc.) and technology (software as a service, cloud technologies, e-commerce, artificial intelligence, etc.) sectors with strong representation in the small-cap growth space are projected to experience rising demand.

- **Tax reform** The dramatic lowering in the top-line rate benefits small caps, most of which had been paying a higher effective rate. Because of numerous loopholes, the pre-reform effective tax rate for large corporations already had been lower than that of their small-cap counterparts. Moreover, repatriation of foreign cash is expected to be used to make strategic acquisitions, which happen mostly at the small-cap level. Larger companies tend to pay share price premiums to acquire smaller companies in order to solicit shareholders' approval of the deal. It's expected this repatriation will predominantly benefit growth sectors that have the most cash overseas: again, health care and technology.

- **IPOs & innovation** Among the catalysts for this year's IPO market are the debuts and anticipated debuts of Uber, Lyft, data analytics firm Palantiv and Pinterest. They represent the underlying forces of innovation that continue to be a powerful driver for long-term growth and areas where small-cap companies are thriving. They are tapping into the accelerating dominance of e-commerce to cloud computing to artificial intelligence to ever-evolving medicine.

U.S. IPO Activity

	Number of IPOs	Proceeds
2016	105	$18.8 B
2017	160	$35.5 B
2018	190	$46.8 B

Source: Renaissance Capital

In sum, given the current supportive environment, small-cap growth stocks offer the opportunity for potentially better long-term risk-adjusted returns than large cap or other asset classes for the long-term investor willing to accept the volatility.

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