

Why small-cap value now?

February 15, 2023

- Cheap valuations relative to other equity asset classes and to history
- History of outperformance versus large caps coming down from inflationary highs
- Early to bounce back coming out of recession
- Domestic orientation may provide some defense from turmoil abroad

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After a challenging 2022 that saw inflation surge to multidecade highs and the Federal Reserve (Fed) raise interest rates seven times, equity investors are hoping for a smoother ride in 2023. But which areas of the market should investors look toward? We make the case for small-cap value stocks, which we believe offer the potential for relative outperformance in the year ahead amid lingering uncertainty and a still-volatile market environment.

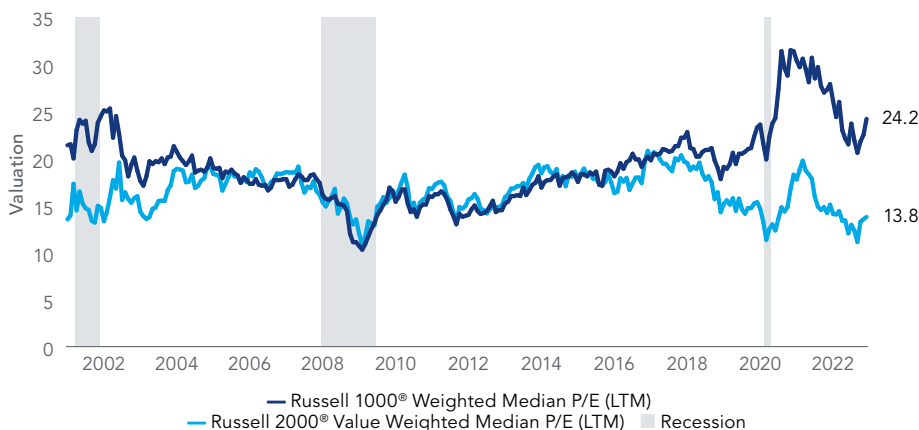
Valuations

The past decade-plus has not been kind to small-cap value. Growth stocks enjoyed a strong multiyear run—at the expense of value stocks—during the historic bull market following the Great Recession. Historically low interest rates have helped bid up the value of non-earning and low cash flow companies, many of which reside in the growth space.

These factors have combined to distort and suppress small-cap value equities, which are currently trading at a significant discount relative to peers and to historical price levels.

Current valuations are attractive versus other equity styles

Small-cap value stocks versus large caps historical price-to-earnings (p/e) ratio



12/31/22 P/E as a percentage of historical average P/E 1/31/01 to 12/31/22

	Value	Blend	Growth
Large	128.2%	126.0%	115.2%
Mid	121.3%	119.3%	123.8%
Small	84.1%	88.6%	90.1%

Data as of 12/31/22. Sources: Federated Hermes analysis and FactSet.

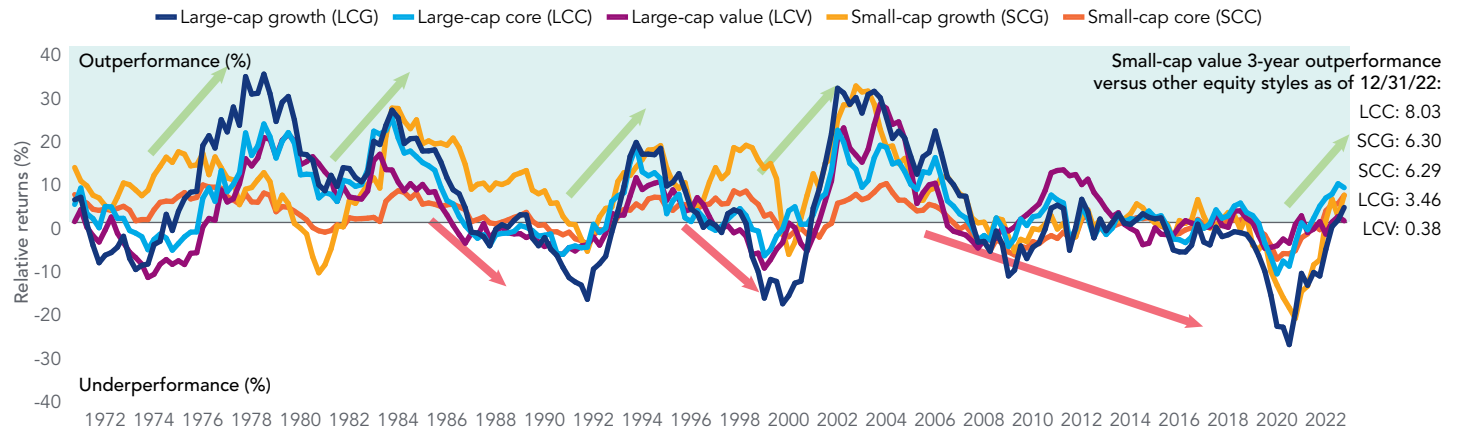
Last 12 months weighted median p/e ratio. Sources: FactSet, Federated Hermes analysis, Russell 1000®, 1000 Growth, 1000 Value, Midcap®, Midcap Growth, Midcap Value, 2000®, 2000 Growth and 2000 Value Indexes.

The above charts are for illustrative purposes only and are not representative of any specific investment.

Environments in which an asset class is trading for less than its true or potential value creates opportunities for investors. Historical data shows that periods of relative underperformance for small-cap value tend to be followed by an extended period of outperformance. On a rolling three-year relative return basis, small-cap value performance have recently turned positive versus all other style boxes for the first time in years—with the potential for further gains if history is any guide. In our view, this is just the beginning of the next value cycle.

Strong outperformance versus other equity styles typically followed periods of underperformance

Small-cap value rolling three-year relative return versus:



Sources: Federated Hermes analysis, Fama French Small Value, Big Value, Big Neutral/Core, Small Neutral/Core, Big Growth and Small Growth Portfolios of all NYSE, AMEX and NASDAQ stocks for which data exists. For detailed information on portfolio construction, please see the disclaimers.

Relative three-year returns, rolling quarterly, using data from 1/1/70 to 12/31/22. **Past performance is no guarantee of future results.**

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Easing inflation

The Fed’s hawkish playbook seems to be paying off. Year-over-year inflation, while still high, appears to have peaked in mid-2022. Nominal retail CPI inflation spiked from 1.4% year-over-year (y/y) in January 2021 to a 41-year high of 9.1% in June 2022, but has since fallen to 6.5% in December 2022.

This market backdrop could bode well for small-cap stocks, which have been shown to outperform during periods in which inflation was coming down from highs going all the way back to the 1970s.

Disinflation periods

Annual return (%) years with disinflation greater than 3% year over year	1975	1981	1982	1991	2008
Small-cap value	58.75	17.64	40.71	40.64	-33.81
Large-cap value	55.75	14.16	27.45	27.47	-39.05
Small-cap growth	61.82	-10.74	19.32	54.31	-40.75
Large-cap growth	34.41	-7.55	22.27	43.24	-34.10

Sources: Federated Hermes analysis, Fama French Small Value, Big Value, Big Growth and Small Growth Portfolios of all NYSE, AMEX and NASDAQ stocks for which data exists. For detailed information on portfolio construction, please see the disclaimers.

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Early off the bottom

In our view, with every passing quarter, we are getting closer to a market bottom. Data going back to World War II shows that the S&P 500® Index reached bottom an average of seven months after reaching peak inflation—which is where we sit today.

This is exactly the time that history has shown it is prudent to have small-cap value exposure. As an asset class, small-cap value has outperformed small-cap growth, large-cap growth and large-cap value on a one-year total return basis following each of the last five recessions (with the partial exception of the Covid-19 recession, which led to small-cap growth outperforming small-cap value amid unique market conditions).

Small-cap value beat large caps after the last five recessions

Relative return 12 months after recession	12/1/82 to 11/30/83	4/1/91 to 3/31/92	12/1/01 to 11/30/02	7/1/09 to 6/30/10	5/1/20 to 4/30/21
Small-cap value versus:					
Small-cap growth	23.63	10.31	21.91	18.28	-0.10
Large-cap value	18.92	7.43	24.19	19.11	25.97
Large-cap growth	32.39	15.00	18.35	21.39	48.86

Past performance is no indication of future results. Sources: Federated Hermes analysis, Fama French Small Value, Big Value, Big Growth and Small Growth Portfolios of all NYSE, AMEX and NASDAQ stocks for which data exists. For detailed information on portfolio construction, please see the disclaimers.

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Why small-cap value now?

Why have these stocks tended to outperform in the early stages of bull markets? Small-cap companies can react quickly to market changes: The small cap value space is populated by more cyclical companies than other equity styles, with Industrials, Financials, Materials and Consumer Discretionary stocks that tend to be the earliest beneficiaries when conditions begin to turn positive. These companies are more susceptible to changes in economic conditions than larger companies. Small-cap companies face fundamental headwinds to revenue growth earlier in a downturn, and likewise experience fundamental stabilization and growth tailwinds earlier in an economic recovery.

As a perennially undervalued asset class, small-cap value also tends to enjoy a stronger bounce than more richly valued areas of the market following an earnings recession. When a low-valuation stock delivers earnings growth, there is a much greater positive impact on the price than when a high-valuation stock delivers earnings growth.

Domestic orientation

Small-cap stocks—particularly small value—tend to be relatively insulated from global events given their U.S. focus. Companies in the small-cap value universe derive roughly 83% of their revenue from within U.S. borders,¹ substantially more than large, multinational firms.

This U.S. concentration carries several advantages in today's market. It provides a measure of shelter from geopolitical eruptions such as the ongoing war in Ukraine. It also avoids the currency headwinds that are hitting virtually all businesses with non-U.S. operations. Finally, a domestic orientation hedges against the more pronounced economic uncertainty that exists across European markets relative to the U.S.

Why Federated Hermes small-cap value?

We think economic growth and corporate earnings will be challenged in 2023 as the level and cadence of inflation sows uncertainty and volatility in equity markets. The potential for a low-growth, higher-rate environment over a multiyear period looms as stocks rerate and investors adjust to this new normal.

Quality will matter. Investors must be selective in their asset allocation choices. Active management can make a difference—especially in small-cap, where a knowledgeable and disciplined investment team can find undiscovered value.

Views are as of the dates indicated and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

¹ Source: FactSet as of 12/31/2021.

Definitions

Fama French equity style portfolios are formed on size and book-to-market value and include NYSE, AMEX, and NASDAQ stocks for which market equity data and (positive) book equity data for exists. The portfolios, which are constructed at the end of each June, are the intersections of 2 portfolios formed on size (market equity, ME) and 3 portfolios formed on the ratio of book equity to market equity (BE/ME). The size breakpoint for year t is the median NYSE market equity at the end of June of year t. BE/ME for June of year t is the book equity for the last fiscal year end in t-1 divided by ME for December of t-1. The BE/ME breakpoints are the 30th and 70th NYSE percentiles. Fama French "Neutral" or core portfolios contain both value and growth stocks.

	Median ME	
	Small Value	Big Value
70th BE/ME percentile	Small Neutral/Core	Big Neutral/Core
30th BE/ME percentile	Small Growth	Big Growth

Russell 1000® Index is a stock market index used as a benchmark by investors. It is a subset of the larger Russell 300 index and represents the 1000 top companies by market capitalization in the United States

Russell 1000® Growth Index is designed to measure the performance of large-cap growth stocks in the United States.

Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe.

Russell Midcap® Index is a market capitalization-weighted index comprised of 800 publicly traded U.S. companies with market caps of between \$2 and \$10 billion. The 800 companies in the Russell Midcap Index are the 800 smallest of the 1,000 companies that comprise the Russell 1000 index.

Russell Midcap® Growth Index is an unmanaged index that measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values.

Russell Midcap® Value Index measures the performance of the mid-cap value segment of the US equity universe.

Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000 index is a subset of the Russell 3000 index.

Russell 2000® Growth Index measures the performance of the small cap growth segment of the US equity universe.

Russell 2000® Value Index measures the performance of the small-cap value segment of the US equity universe.

Indexes are unmanaged and cannot be invested in directly.

A word about risk

Investments are subject to risks and fluctuate in value.

Investments may invest in small capitalization (or "small-cap") companies. Small-cap companies may have less liquid stock, a more volatile share price, unproven track records, a limited product or service base and limited access to capital. The above factors could make small-cap companies more likely to fail than larger companies and increase the volatility of the fund's portfolio, performance and share price. Suitable securities of small-cap companies also can have limited availability and cause capacity constraints on investment strategies for funds that invest in them.

Value stocks may lag growth stocks in performance at times, particularly in late stages of a market advance.