Go Time? The Case for Small-Cap Value

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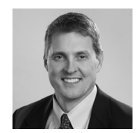

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Among public U.S. equity styles, small-cap value has provided an indispensable means to accumulate capital. The historical evidence shows this asset class has significantly outperformed other U.S. equity categories over the long run. Small-cap value allocations made during recessions and early in economic recoveries have also consistently provided superior returns over much shorter horizons. With calls for slowing economic growth growing louder in the financial press, we thought now would be an excellent time to explore the historical record. This paper presents our findings and makes what we believe to be a compelling case for small-cap value equities today.

Small-cap value equity allocations have delivered the highest returns in the long run

What constitutes the long term means different things to different people. Thankfully, data from the Center for Research in Security Prices (CRSP)—recognized as among the most complete and accurate U.S. equity returns databases available—allow a unique view into both very long-term planning horizons that may be applicable for institutions and "shorter" long-term horizons that are more relevant to most individuals.

No matter your working definition of long term, you should expect higher returns for assuming higher levels of expected risk. The historical performance record of small-cap value fully lives up to this tenet. As shown in the top panel of Table 1 (next page), small-cap value generated both the highest annualized return (14.2%) and standard deviation (28.1%) among six U.S. equity styles from July 1926 through March 2023. So, has small-cap value been a "good deal" from a risk/return perspective? The Sharpe ratio, a measure that allows direct comparison of assets with different risk/return characteristics, suggests it has. Small-cap value and small-cap core produced the highest Sharpe ratios, indicating that higher returns attractively compensated for higher levels of risk vis-a-vis other equity categories.

TABLE 1: LONG-TERM PERFORMANCE CHARACTERISTICS OF U.S. EQUITY STYLES

	SMALL VALUE	SMALL CORE	SMALL GROWTH	LARGE VALUE	LARGE CORE	LARGE GROWTH
JULY 1926 THROUGH MARCH 2023						
Annualized return	**14.2%**	12.7%	8.8%	11.9%	10.0%	9.9%
Annualized standard deviation	**28.1%**	24.1%	25.9%	24.7%	19.5%	18.4%
Sharpe ratio	**0.39**	0.39	0.21	0.35	0.35	0.36
ROLLING 20-YEAR PERIODS*						
# top category	**783**	85	0	48	0	6
% top category	**85%**	9%	0%	5%	0%	1%
Median growth of $1	**$21.55**	$14.15	$6.09	$13.89	$8.82	$7.02
Best growth of $1	**$77.46**	$50.19	$34.18	$44.95	$26.87	$29.75
Worst growth of $1	**$4.04**	$3.10	$1.77	$1.93	$1.39	$1.27

Sources: Allspring, the Kenneth French Data Library, and CRSP. Data presented in this table is based on the total returns of six portfolios formed on the intersection of two categories of size (small and large) and three categories of book to market value (value, core, and growth). *There were 922 observations of 20-year periods rolling monthly from July 1926 through March 2023. The Sharpe ratio is the annualized excess return over the risk-free rate divided by the annualized standard deviation of returns. The annualized risk-free rate used in Sharpe ratio calculations was 3.24%. **Past performance is not a reliable indicator of future results.**

Clearly, most investors have a planning horizon far less than the 95-year-plus history shown here. The bottom panel of Table 1 summarizes data gleaned from all 20-year periods rolling monthly within the full return history. We find that small-cap value was the top-performing category in 85% of all 20-year observations. A $1 investment in small-cap value would have grown to a median terminal value of $21.55, dwarfing the other styles.

The timing of investment can have a considerable impact on terminal value. Even so, the worst possible moment to invest in small-cap value (March 1929) still produced a 20-year annualized return of 7.23%, generating $4.04 in terminal wealth from a $1 investment in a period dominated by the Great Depression and World War II. The best 20-year period for investment in small-cap value (made in July 1932, near the depths of the Great Depression) returned 24.29% annualized, generating $77.46 in terminal value from a $1 investment!

Excellent long-term results aside, most investors also must plan for intermediate horizons. In today's markets—with relatively high expected volatility and inflation, and on what may be the leading edge of a recession—many rightly wonder if current conditions present a favorable environment for investment. We explore this next.

Small-cap value performance has dominated surrounding recessions

At the time of this writing, the U.S. may be heading into a recession or may already be in the midst of one. The National Bureau of Economic Research (NBER) assigns recession beginning and ending dates after the fact. Markets are leading indicators, and 2022 witnessed the worst drawdown in broad U.S. equity markets since the Global Financial Crisis, largely in response to higher rates and stagnating prospects for macroeconomic conditions. We think the return of inflation, higher interest rates, and slowing growth makes the current environment most similar to conditions that prevailed in the 1970s and early 1980s.

The top panel of Table 2 shows five-year annualized returns of investments made in the first month of all officially declared recessions since 1926[1]. Prior to the 1970s, no clear pattern of small-cap value dominance can be observed. However, since the 1970s, small-cap value dominated other equity categories in all but the Global Financial Crisis, when it was the third-best-performing category.

A more consistent pattern of small-cap value dominance emerges across the data set from the earliest stages of economic recoveries. The bottom panel shows five-year returns from the first month following the end of each recession. Here, the outperformance of small-cap value is remarkably uniform across the full history of the data set. We acknowledge that each recession is unique in severity, length, and causal factors. However, if history is a guide, investors can have some confidence that a variety of recovery scenarios strongly favor tactical allocations to this asset class today.

We believe the returns data alone make a very compelling case for small-cap value, but what can relative valuations tell us? We explore this in our final section below.

TABLE 2: RECESSIONS AND HISTORICAL PERFORMANCE OF U.S. EQUITY STYLES

NBER RECESSIONS
Oct-26–Nov-27 (14 months)
Aug-29–Mar-33 (44 months)
May-37–Jun-38 (14 months)
Feb-45–Oct-45 (9 months)
Nov-48–Oct-49 (12 months)
Jul-53–May-54 (11 months)
Aug-57–Apr-58 (9 months)
Apr-60–Feb-61 (11 months)
Dec-69–Nov-70 (12 months)
Nov-73–Mar-75 (17 months)
Jan-80–Jul-80 (7 months)
Jul-81–Nov-82 (17 months)
Jul-90–Mar-91 (9 months)
Mar-01–Nov-01 (9 months)
Dec-07–Jun-09 (19 months)
Feb-20–Apr-20 (3 months)
Average length (13.5 months)

5-YEAR ANNUALIZED RETURN FROM RECESSION START DATE (%)

Investment date	SMALL VALUE	SMALL CORE	SMALL GROWTH	LARGE VALUE	LARGE CORE	LARGE GROWTH
Oct-26	-15.0	-11.6	-15.2	-10.6	-7.5	-2.2
Aug-29	-16.4	-15.3	-13.9	-19.2	-19.7	-16.7
May-37	-13.0	-8.1	-7.9	-11.2	-7.6	-7.8
Feb-45	14.3	10.4	9.0	13.4	10.7	9.6
Nov-48	13.0	12.6	13.2	15.7	14.4	14.5
Jul-53	17.3	17.2	13.9	17.9	17.8	18.2
Aug-57	11.1	10.2	10.2	9.8	11.5	5.9
Apr-60	16.6	11.5	6.4	16.5	14.1	11.4
Dec-69	-4.8	-10.3	-17.4	1.5	-2.5	-4.0
Nov-73	19.2	12.8	7.4	10.7	8.3	-2.5
Jan-80	26.5	23.3	11.1	20.2	14.6	11.7
Jul-81	28.9	25.0	10.6	24.2	18.4	17.3
Jul-90	17.8	15.1	8.3	13.8	13.0	11.8
Mar-01	19.4	15.5	5.8	4.3	7.8	0.9
Dec-07	3.0	5.1	1.9	-3.5	1.1	3.5

5-YEAR ANNUALIZED RETURN FROM RECOVERY START DATE (%)

Investment date	SMALL VALUE	SMALL CORE	SMALL GROWTH	LARGE VALUE	LARGE CORE	LARGE GROWTH
Dec-27	-21.7	-19.6	-22.7	-19.5	-20.9	-13.2
Apr-33	22.2	24.4	22.5	11.9	17.6	12.3
Jul-38	20.9	15.9	14.0	14.7	9.4	6.7
Nov-45	10.9	6.5	5.4	12.9	9.1	7.8
Nov-49	20.2	19.0	17.1	24.5	20.2	19.2
Jun-54	24.8	21.9	20.2	24.4	19.4	18.8
May-58	17.4	14.4	13.5	18.6	15.9	12.3
Mar-61	20.5	13.9	8.2	17.0	10.6	10.1
Dec-70	4.8	2.2	-3.5	10.1	4.6	3.8
Apr-75	25.8	23.2	23.2	15.5	15.8	5.9
Aug-80	28.8	24.8	11.7	21.5	14.4	12.1
Dec-82	17.0	14.2	2.2	17.5	15.5	11.5
Apr-91	21.9	18.1	12.0	18.3	16.3	13.4
Dec-01	20.1	17.0	7.3	8.0	11.0	4.3
Jul-09	23.2	21.8	18.9	18.1	20.6	18.8

Sources: Allspring, the Kenneth French Data Library, CRSP, and NBER. The top-three-performing categories are shaded for each five-year period. **Past performance is not a reliable indicator of future results.**

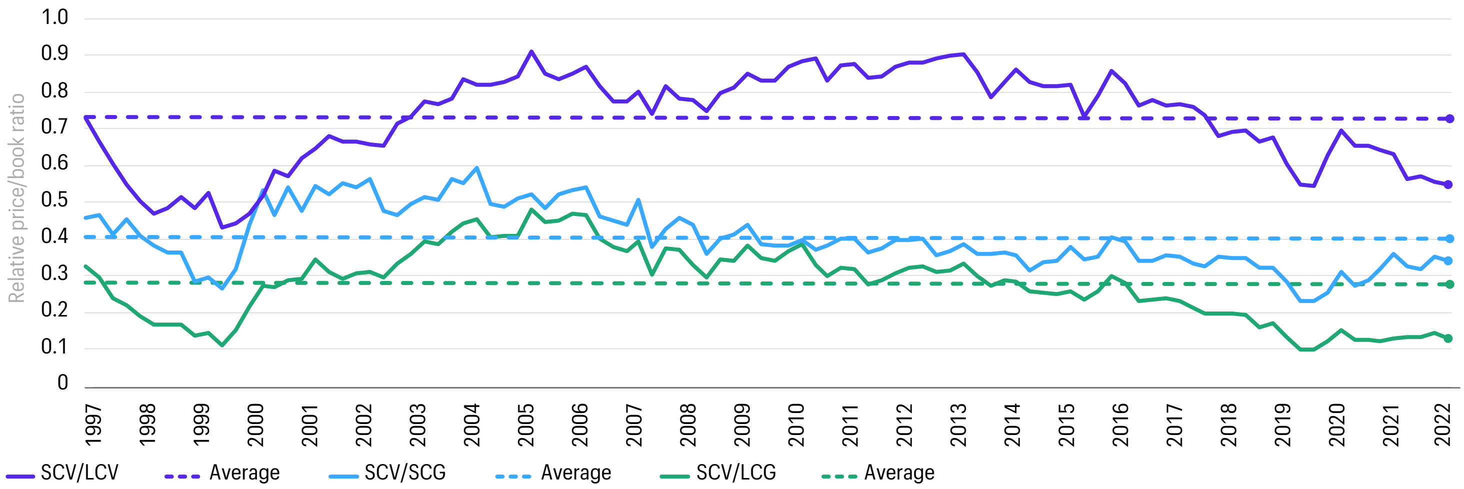
1. The most recent recession from February through April of 2020 is not included in the analysis because five years have not elapsed since it began.

Small-cap value offers attractive relative valuations and breadth

Analysis of the familiar Russell U.S. equity indexes illustrates the relative cheapness of small-cap value in today's markets. Below, we chart the relative price/book ratios of the Russell 2000 Value Index versus other U.S. style categories from December 1997 through March 2023. Small-cap value is currently discounted 24% to large-cap value, 15% to small-cap growth, and 53% to large-cap growth long-term average relative valuations. In other words, small-cap value typically has lower price/book ratios than the other styles, but today's discounts are near their historical lows.

The steep discount to large caps and large-cap growth in particular is notable. In the past several years, we have tracked the high levels of index concentration among large-cap stocks, which were amplified by the Federal Reserve's (Fed's) historic easing cycle that finally ended early in 2022. While breadth is steadily returning to equity markets, small-cap value equities—and small caps in general—offer greater selection opportunities than large caps, which are still dominated by a handful of mega-cap companies. In addition, small-cap value in particular has outperformed other equity categories in the latter stages of hiking cycles and, particularly during the 1970s and 1980s when the Fed was attempting to balance growth prospects against price stability—much as it is today[2].

FIGURE 1: RELATIVE VALUATIONS OF RUSSELL 2000 VALUE (SCV) INDEX VERSUS RUSSELL 1000 VALUE (LCV), RUSSELL 2000 GROWTH (SCG), AND RUSSELL 1000 GROWTH (LCG) INDEXES FROM DECEMBER 1997–MARCH 2023



Sources: Allspring and FactSet. **Past performance is not a reliable indicator of future results.**

2. BofA Global Research, March 7, 2023.

Final thoughts

In this note, we demonstrated that small-cap value equities should be a key part of a strategic asset allocation due to their persistent long-term return advantage over other U.S. equity categories. We also discussed why the medium-term outlook for the asset class is particularly attractive in today's inflationary, low-growth environment. The track record for small-cap value equities heading into recessions, and particularly in early stages of recoveries, presents a constructive argument for new allocations to this asset class today. Attractive relative valuations only bolster the case.

Recessions, and the market corrections that typically precede them, are tough pills for investors to swallow. However, recessions are an essential part of keeping a free-enterprise capitalist system healthy. They purge nonviable business models and encourage financial markets to redeploy scarce capital to businesses that can earn economic profits (i.e., rates of return that exceed their cost of capital). Lately, we have seen growing pressure on the banking system, particularly among regional banks sitting on longer-term assets that are duration mismatched to deposit liabilities and that often have greater exposure to the real estate sector. The Fed's removal of the "free" cost of capital punchbowl is revealing poor risk management practices at some of these banks—meanwhile, others are well positioned to come out unscathed.

This brings us to our final point. We think that active strategies are instrumental in separating the winners from the losers—not only in the banking sector but across all sectors where weak actors will likely be revealed should economic conditions continue to deteriorate in the months ahead. Our advice to investors is simple: First, take advantage of the tactical opportunity to invest in small-cap value in the months ahead; second, manage your risk by entrusting asset selection to active managers that have the experience and track records that demonstrate alpha generation over multiple market cycles.

For further information

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ALL-04282023-62zmyivq

MAY 2023