

A time and place for small cap equities

After handily outperforming both large caps and the broader U.S. equity market for the one-year period following the COVID recession in the spring of 2020, small cap stocks have since lagged, despite posting healthy double-digit gains in two of the past three calendar years. This performance gap reflects in part the narrow but persistent market leadership of a few high-flying mega cap technology companies supported by artificial intelligence (AI) tailwinds. Of course, the attractiveness of an asset class, or select opportunities within it, isn't simply a function of recent relative performance. Valuations, earnings growth estimates and interest rate expectations are also key factors for considering small caps in the current environment. Additionally, Nuveen's equity specialists believe a strategic allocation to the asset class remains an important component of a well-diversified, long-term investment portfolio.

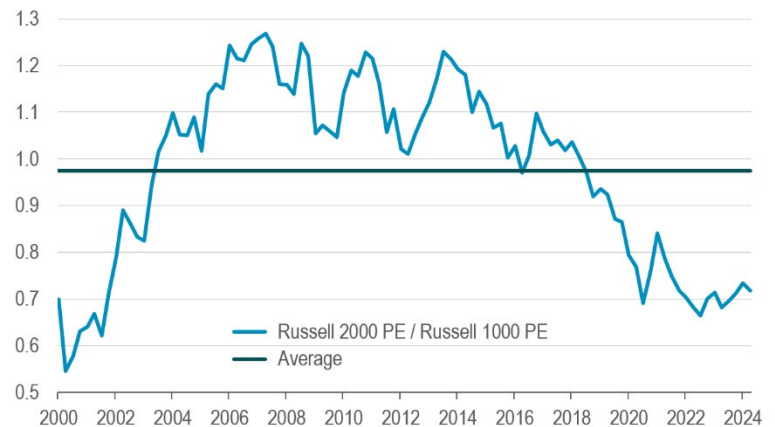
Global Equities Team
Nuveen

U.S. SMALL CAP STOCKS REMAIN ATTRACTIVELY VALUED

U.S. small cap equities underperformed their large cap counterparts by nearly 10 percentage points in 2023, causing the forward price-to-earnings (P/E) ratio of the small cap Russell 2000 Index versus the large cap Russell 1000 Index to hover near 22-year lows (Figure 1). With large caps looking expensive on this basis, valuations currently favor small caps.

Similarly, albeit to a lesser degree, the Russell 2000's P/E relative to that of the equal-weighted S&P 500 Index and compared to its own historical average shows small caps still trading at a discount at the end of the first quarter of 2024.¹

Figure 1. Small caps look inexpensive vs. large caps
P/E ratio, * Russell 2000 Index relative to Russell 1000 Index



*12 months forward. Last data point 30 June 2024. Data source: FactSet.

A number of asset class characteristics have contributed to small cap underperformance in the prevailing macro environment of the past few years. Compared to their large cap peers, small caps tend to have stronger ties to the economic cycle, use leverage to a greater degree and carry a larger percentage of variable rate debt on their balance sheets. These traits make them more vulnerable in a high interest rate environment, as does their “longer duration” profile (meaning more of their cash flows are delivered further out into the future).

Given the ongoing combination of late-cycle deceleration and stubbornly elevated inflation, it’s not surprising that small caps have been out of favor — or that the number of unprofitable small cap companies has increased substantially. Weak profitability numbers require a higher risk premium for small caps, which is reflected in lower valuations.

While valuations are helpful in gauging the relative attractiveness of small caps, there are other salient criteria to consider given the current economic and market outlook.

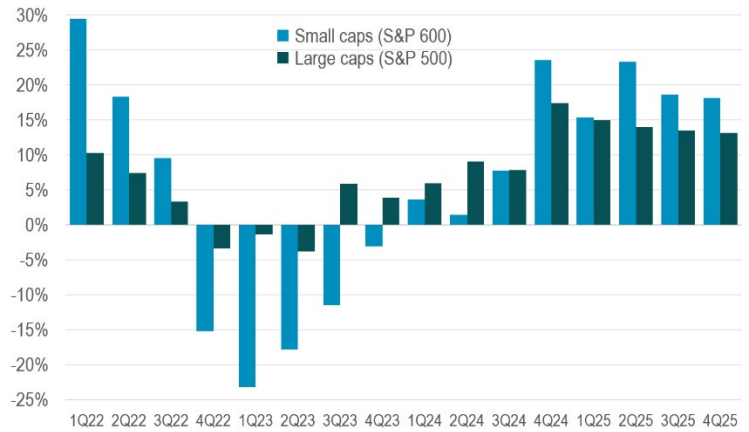
SMALL COMPANIES, POTENTIALLY BIG EARNINGS GROWTH ADVANTAGE

At the macro level, sticky inflation and a higher-for-longer rate environment have determined the trajectory of broad equity market performance over the past two years. Corporate earnings growth, however, has been the primary driver of stock price appreciation over the long run, and in our view will continue to be — particularly as inflation and interest rates gradually normalize from historically high levels. In such an environment, fundamental earnings growth and positive earnings per share (EPS) surprises may reclaim the spotlight and be rewarded accordingly.

That could give smaller companies an earnings growth advantage going forward, after lagging large caps on this metric for six consecutive quarters amid rapidly rising interest rates and heightened fears of a U.S. recession from late 2022 through early 2024. In the current environment, the odds of a recession are lower as the economy has proven resilient, productivity has improved and easier Fed policy now appears to be closer on the horizon — a plus for cyclical areas of the

Figure 2. Superior earnings growth ahead?

*Bottom-up consensus earnings growth estimates**



* Year over year. Earnings growth estimates shown after 1Q24 are projections as of 31 May 2024.

market like small caps. Based on analyst estimates, earnings are expected to grow faster for smaller than for larger companies, as shown in Figure 2 above.

IN PRIOR FED CYCLES, INITIAL LOOSENING BOLSTERED SMALL CAP RETURNS

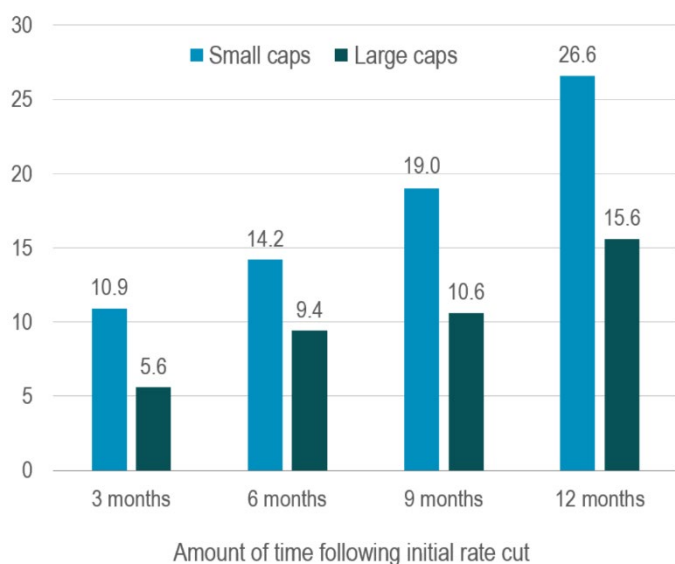
Nuveen currently anticipates one or two rate cuts of 25 basis points (bps) each, likely beginning later this year. If enacted, two reductions would lower the target federal funds rate to a range of 4.75%-5.0% by the end of 2024.

Historically, small cap stocks have outperformed large caps following the first move in a Fed rate-cutting cycle (Figure 3). Why? Because smaller companies generally benefit from easing financial conditions, rely more on borrowing to finance growth than large companies do and pay higher interest rates on that debt. When the Fed eases, the cost of capital declines. A given small company can refinance at cheaper rates and use the proceeds to expand its business, which in turn can help boost its stock price. There’s no guarantee history will repeat itself, but the expected initial cut this year could serve as a potential catalyst benefiting relative returns for small caps.

“ *Historically, small cap stocks have outperformed large caps following the first move in a Fed rate-cutting cycle. The next such cycle is expected to begin later this year.*

Figure 3. The first cut's been the kindest ... to small caps

Returns (%) after Fed rate-cutting commenced*



* Average returns based on past 13 rate-cut environments starting November 1957. Reflects the use of the federal funds rate from 1954 until 1963, the discount rate from 1963 until 1994 and the federal funds rate thereafter. Representative indexes: Large cap stocks: Russell 1000 Index, inception date 31 December 1978; small cap stocks: Russell 2000 Index, inception date 1 January 1984. **Past performance does not predict or guarantee future results.** It is not possible to invest directly in an index.

Sources: Federal Reserve Board, Haver Analytics, Center for Research in Security Prices (CRSP), University of Chicago Booth School of Business, Jefferies.

THERE'S NO ONE "RIGHT" WAY TO INVEST IN SMALL CAPS

Investors seeking opportunities in small cap equities can choose from a range of approaches:

- Growth, value, core or multistyle
- Active, quantitative or index
- U.S. or global/international

Nuveen offers strategies across the complete small cap spectrum for both individual and institutional investors. Whether separately or in combination, these approaches

have the potential to deliver attractive long-term returns and may be well-suited for the small cap equity portion of a diversified portfolio.

As an example, a core, actively managed mandate can aim to provide flexibility in a market where small cap index performance is often bifurcated between growth and value. Relative weightings of cyclical and defensive sectors may help active core managers navigate risk-on and risk-off environments, which tend to favor one style over the other. And because the small cap arena is less followed by analysts and less efficient than the broader market, active managers may have enhanced opportunities to add excess returns through stock selection. Of course, any investor's choice of a particular small cap approach depends on many factors, starting with their investment objectives and time horizon.

CONCLUSION

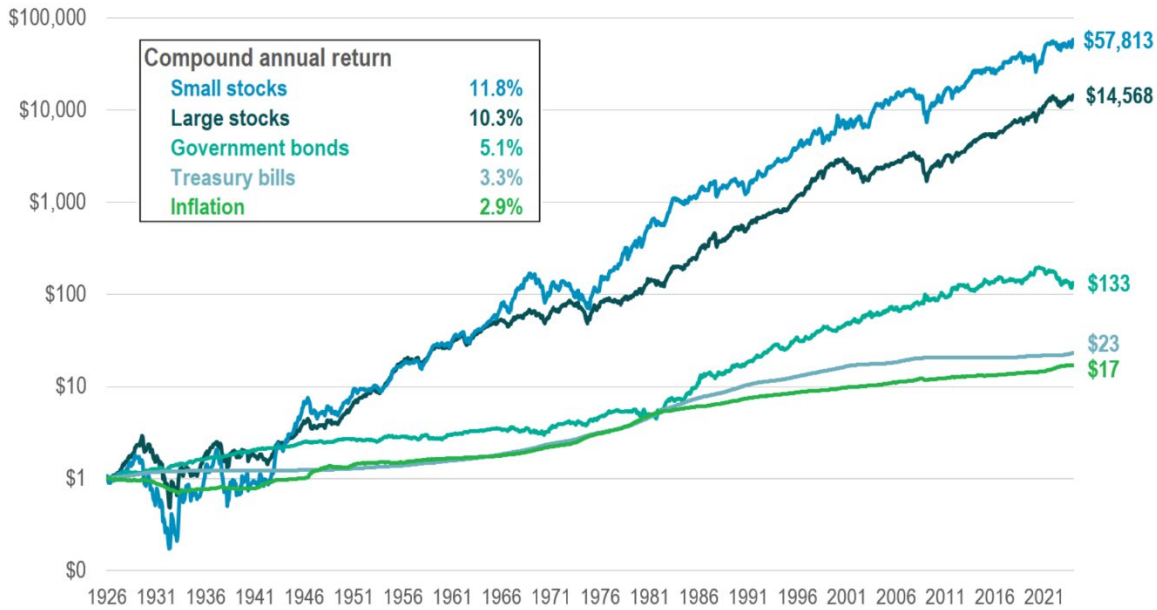
With their potential for strong long-term earnings growth and total returns, small caps have earned a place as a strategic equity component of diversified portfolios. Over the course of nearly a century, small caps have not only outpaced the rate of inflation but have also generated a higher compound annual return than other major U.S. asset classes, including large cap stocks (Figure 4, next page).² The relative performance of small caps has varied over shorter periods, with the economic and market dynamics discussed in this opinion piece suggesting opportunities for a potentially improving outlook.

Identifying and taking advantage of small cap opportunities requires an asset manager who knows where to look and has investment capabilities across multiple styles, approaches and geographies. At Nuveen, experienced equity professionals are empowered by our integrated platform to focus on adding alpha and building portfolios that meet our clients' objectives. We currently manage \$472 billion in equities, including \$63 billion in small and mid cap assets.³

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Figure 4. Small caps have substantially outperformed over the long run

Ibbotson® Stocks, Bonds, Bills and Inflation BBI® (SBBi), 1926-2023



Last data observation:
31 December 2023.

Source: Morningstar Direct. "Stocks, Bonds, Bills, and Inflation," "SBBi" and "Ibbotson" (when used in conjunction with a series or publication name) are registered trademarks of Morningstar, Inc.

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Endnotes

- 1 Source: FactSet.
- 2 Data for 1926–2023 from *Stocks, Bonds, Bills, and Inflation® (SBBi®) Yearbook*, Roger G. Ibbotson and Rex Sinquefeld, updated annually.
- 3 As of 31 March 2024.

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