Mean reversion is a powerful force. Markets move in cycles; nothing outperforms or underperforms forever.

Large caps — measured by the S&P 500 — have been on a staggering run of outperformance for roughly a decade. Compared against small caps, large caps have outperformed in every trailing period of the past 10 years.

Exhibit 1

Investment Growth

![Graph showing investment growth for small caps and large caps](image)

<table>
<thead>
<tr>
<th>Trailing Returns</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Caps</td>
<td>-11.6</td>
<td>17.5</td>
<td>4.7</td>
<td>8.0</td>
</tr>
<tr>
<td>Large Caps</td>
<td>-7.7</td>
<td>18.6</td>
<td>11.2</td>
<td>12.2</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. 4/1/2013 - 3/31/2023. Indexes shown are unmanaged and not available for direct investment.

However, bear markets and recessions (or the expectation of one) can lead to rotations in leadership.

Considering the recent bear market, evidence suggests an interesting opportunity may be forming in small caps, as they have exhibited some of their best periods of outperformance compared to large caps after bear markets.
2022: A Historically Bad Year for Small Caps

The chart below depicts all the calendar years in which small caps – measured by the Russell 2000 – had a negative return.

The chart is filtered by severity of drawdown. As you can see, 2022 was the third worst year for small caps since 1979. With hockey playoffs starting, it’s a good time to remember Wayne Gretzky’s quote, to “skate where the puck is going,” not where it is now.

- Since 1979, there have been 13 instances where calendar year returns were negative for the Russell 2000.
- One year later, the Russell 2000 was positive 92% of the time, with an average return of nearly 22%.
- The 3-year, 5-year, and 10-year returns were positive 100% of the time with average cumulative returns of 49%, 92%, and 191%, respectively.

### Exhibit 2

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Calendar Year Return</th>
<th>1yr</th>
<th>3yr</th>
<th>5yr</th>
<th>10yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>-33.8</td>
<td>27.2</td>
<td>54.6</td>
<td>149.7</td>
<td>209.8</td>
</tr>
<tr>
<td>2002</td>
<td>-20.5</td>
<td>47.3</td>
<td>82.2</td>
<td>112.3</td>
<td>152.8</td>
</tr>
<tr>
<td>2022</td>
<td>-20.4</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>1990</td>
<td>-19.5</td>
<td>46.0</td>
<td>105.6</td>
<td>159.3</td>
<td>323.5</td>
</tr>
<tr>
<td>2018</td>
<td>-11.0</td>
<td>25.5</td>
<td>72.9</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>1987</td>
<td>-8.8</td>
<td>25.0</td>
<td>17.0</td>
<td>102.4</td>
<td>332.5</td>
</tr>
<tr>
<td>1984</td>
<td>-7.3</td>
<td>31.0</td>
<td>26.3</td>
<td>83.6</td>
<td>198.3</td>
</tr>
<tr>
<td>2015</td>
<td>-4.4</td>
<td>21.3</td>
<td>23.8</td>
<td>86.4</td>
<td>?</td>
</tr>
<tr>
<td>2011</td>
<td>-4.2</td>
<td>16.3</td>
<td>69.4</td>
<td>96.5</td>
<td>246.5</td>
</tr>
<tr>
<td>2000</td>
<td>-3.0</td>
<td>2.5</td>
<td>20.0</td>
<td>48.5</td>
<td>84.8</td>
</tr>
<tr>
<td>1998</td>
<td>-2.5</td>
<td>21.3</td>
<td>20.5</td>
<td>41.1</td>
<td>34.7</td>
</tr>
<tr>
<td>1994</td>
<td>-1.8</td>
<td>28.5</td>
<td>83.1</td>
<td>116.4</td>
<td>198.0</td>
</tr>
<tr>
<td>2007</td>
<td>-1.6</td>
<td>-33.8</td>
<td>6.8</td>
<td>19.1</td>
<td>130.5</td>
</tr>
</tbody>
</table>

**Average** 21.5% 48.5% 92.3% 191.1%  
**Median** 25.3% 40.5% 96.5% 198.2%  
**% Positive** 92% 100% 100% 100%


Equities have a natural upward bias, so it’s not shocking that stocks eventually flip back to positive after disappointing periods.

However, it may be surprising to see how small caps have outperformed large caps after disappointing periods.

After a negative calendar year for small caps:

- 75% of the time (8 of 12 periods) small caps outperform large caps in the two years that follow.
- The average cumulative outperformance has been a little more than 5% per annum over those periods.
Exhibit 3

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Russell 2000 (Small Caps)</th>
<th>S&amp;P 500 (Large Caps)</th>
<th>+/-</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>61.3</td>
<td>45.5</td>
<td>15.8</td>
</tr>
<tr>
<td>2002</td>
<td>74.2</td>
<td>42.7</td>
<td>31.5</td>
</tr>
<tr>
<td>2022</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>1990</td>
<td>72.9</td>
<td>40.4</td>
<td>32.5</td>
</tr>
<tr>
<td>2018</td>
<td>50.6</td>
<td>55.6</td>
<td>-5.0</td>
</tr>
<tr>
<td>1987</td>
<td>45.4</td>
<td>53.6</td>
<td>-8.2</td>
</tr>
<tr>
<td>1984</td>
<td>38.5</td>
<td>56.3</td>
<td>-17.8</td>
</tr>
<tr>
<td>2015</td>
<td>39.1</td>
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<td>2007</td>
<td>-15.8</td>
<td>-20.3</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Average 5.4
Median 6.1
Win Rate 75%


None of this is to say small caps are better than large caps, rather they are a valuable part of a portfolio, particularly after turbulent periods.

**Small Caps and Inflation**

Per NYU Professor Aswath Damodaran, historically, small-cap stocks have outperformed large-cap stocks during periods of high inflation, such as the 1970s.

In a podcast appearance on "Invest Like the Best," Damodaran explained:

"Some sub-groups of stocks do better than others during periods of high inflation. In the 70s, low P/E stocks and small cap stocks did much better than other groups of stocks. Much of the small cap premium that academics talk about was earned during this period. For whatever reason, small cap companies had more flexibility to adjust to inflation."

Expanding his answer, and referring to large caps, he added:

"The more established you are as a company, the more your business model has already been set, the more adjustment is involved when inflation hits you, because you've got to change the way you do business."
This makes sense intuitively. If Apple, the largest company in the world raises iPhone prices, it hits the newswire immediately and the story is front page news the next day. If Crocs, the footwear brand, and a small-cap company raises prices, it’s much like a tree falling in the forest; almost no one will notice. In theory, small caps can be more nimble than larger companies in difficult environments, because they adjust more rapidly.

**Small-Cap Valuations**

Valuations may not inform the direction of prices over the next day or year, but they do paint a picture of potential long-term performance.

More expensive valuations often mean many things must go right for the company to grow into the valuation. Meanwhile, cheaper valuations may set a lower bar, allowing more margin for error for the company to sustain or even grow its valuation.

On a price-to-earnings basis, small- and mid-caps are the only part of the U.S. market trading at a discount to their long-term, historic multiples.

---

### Exhibit 4

<table>
<thead>
<tr>
<th></th>
<th>Current P/E as % of 20yr Average P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value</td>
</tr>
<tr>
<td>Large</td>
<td>103%</td>
</tr>
<tr>
<td>Mid</td>
<td>94%</td>
</tr>
<tr>
<td>Small</td>
<td>93%</td>
</tr>
</tbody>
</table>


This could make for an attractive entry point. While discounted price/earnings ratios don’t guarantee strong returns, they do create relative bargains, compared to other parts of the U.S. market.

**Not All Small Caps Created Equally**

A unique aspect of small caps is that the universe of companies is much larger.

Measured by total market value (i.e., capitalization), the large cap market is significantly larger than the small-cap market. Measured by total number of opportunities (i.e., the number of stocks), however, the small-cap market dwarfs the large-cap market. In fact, nearly two-thirds of publicly traded U.S. stocks are small-cap, as highlighted below.
Source: Bloomberg

There are more companies to select from, and more importantly, more companies to filter through. Active management, done well, can add tremendous value in small caps.

There are several reasons for this, which include:

**Less Analyst Coverage**
There are thousands of analysts covering the U.S. equity market. The relationship between the level of analyst coverage and a company’s market cap is summarized in the below chart.

**Exhibit 6**
The average mega cap company has 20 analysts covering it. A company like Apple might have more than 50 analysts covering it, debating whether gross margin will be 42.8% or 43.2% in any given quarter, for example. Point being the level of detail in evaluation leaves virtually no stone unturned.

Thus, outperformance in large caps must be achieved by interpreting available information in a different way than everyone else, and then being correct about that interpretation.

Contrast that with small caps, the same principles of interpreting information remain true, but active management can also add value by uncovering information that has been overlooked or is simply not known to the market.

**Quality Filter**

Today, roughly 42% of the Russell 2000 is companies that are unprofitable, according to data from J.P. Morgan. Lack of profitability is one of the biggest problems with small caps, and the follow-on effect is some may go out of business or become distressed more frequently than larger companies.

Active management can improve the results for small caps by controlling for quality or removing “junk” from the equation.

Morningstar strives to do this by typically investing in small caps with:

- Consistent growth in profits and cash flows
- Solid balance sheets, which are typically companies with more cash than debt and investment-grade credit ratings
- Competitive advantages: those that have carved out narrow or wide moats to defend against rivals and threat of new entrants
- Competent management teams and boards, with strong track records of winning for shareholders

**Investing in Comfortable Assets Not Always the Best Path**

At Morningstar, we believe small caps present a great opportunity for discerning long-term investors.

Given the choice, most humans would rather be comfortable than uncomfortable. Admittedly, that statement is not particularly earth-shattering. But when applied to investing, it can be costly.

Desire for comfort often extends to the way most individuals invest. Many investors tend to buy when it is easy and comfortable (i.e., when stocks are going up) and sell when times get tough (i.e., when the market is going down).

They also tend to prefer owning companies they know well (i.e., large caps) and eschew those they don’t know (i.e., small caps).

History has proven time and again markets move in cycles. Certain asset classes, like small caps, have operated like springtime fashion lines, moving in and out of style.
There’s compelling evidence that small caps could become fashionable again. And it’s never all or nothing. Investors can add small caps to a portfolio without abandoning large caps. In fact, one could argue that they’re better together.

If you understand their volatile nature and control for quality, small caps can make for a valuable portfolio diversifier for those investors who can stomach the ups and downs.

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**About Morningstar’s Investment Management Group**

Your investment goals matter to us. Our mission is to empower investor success by building investment portfolios selected by your financial advisor. Our world-class investment strategies draw on our core capabilities in research, asset allocation, investment selection and portfolio construction. Our investment professionals are located around the world, which provides both a global point of view and local market expertise.

Based on a proprietary valuation-driven asset-allocation process, our strategies offer investors a range of multi-asset, risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers’ best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey matters.

**For More Information**

Phone:  + 1-877-626-3227  
Email:  ManagedPortfolios.US@morningstar.com  
Online:  www.mp.morningstar.com

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22 West Washington Street  
Chicago, IL 60602 USA

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