Taking Stock of Small Caps

Exploring the opportunities and risks of a useful and sometimes overlooked asset class.

Key Takeaways

- Small-cap equities can provide vital growth potential for diversified portfolios despite higher relative risk being a consideration.
- After years of underperformance relative to large caps, small caps may be positioned for a resurgence.
- In a vast, inefficient market with limited coverage, active managers and fundamental research may be essential for selecting promising companies and managing market risk.

Small-cap stocks may be less well known than their large-cap counterparts but they offer investors a chance to participate early and grow with companies that could shape the future. However, these stocks generally are more risky and have underperformed in recent years, which may lead investors to question their place in a diversified portfolio. “That sentiment, while understandable, could lead investors to overlook some important opportunities,” says David Selbovitz, Head of Portfolio Strategy and Analytics for MassMutual Investments.

To get a better sense of current market conditions, what's ahead, and how actively managed strategies can help investors pursue alpha while being thoughtful about risk, Selbovitz spoke with two of MassMutual’s most experienced small-cap portfolio management partners:

- **Ranjit Ramachandran,** Portfolio Manager, Wellington Small Cap Growth Strategy—supporting MassMutual Small Cap Growth Equity Fund.
- **Matthew Ziehl,** Portfolio Manager, Invesco Small Cap Core Strategy—supporting MassMutual Small Cap Opportunities Fund.

David Selbovitz, CFA, CAIA
Head of Portfolio Strategy and Analytics

Ranjit Ramachandran
Equity Portfolio Manager
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Mathew Ziehl
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Understanding the small-cap space

David Selbovitz: First, some basics. How do you define small caps, how large is the opportunity set, and how do they differ from other stocks in terms of risk and performance?

Ranjit Ramachandran: We define small-cap companies as between $500 million and $7 billion in market capitalization. While that includes several thousand stocks, the combined market capitalization is less than $2 trillion—lower than for some of the largest individual companies. We look for small caps with the potential to become mid- or large-cap companies. Some companies we've invested in have gone on to be $40-$50 billion companies.

Matthew Ziehl: Smaller companies tend to be less profitable, more concentrated in terms of product mix and customer base, and more volatile than large companies. They tend to carry more leverage and rely more on bank debt, which means higher credit spreads. In exchange for those risks, smaller companies tend to have greater opportunity for secular growth, which often comes down to management being in the right place at the right time. And if you look at metrics such as price to earnings ratio versus earnings growth (PE to growth) small caps tend to trade at a discount.

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The current outlook

Selbovitz: Market volatility can hinder high-risk investments and over the last decade small-cap stocks have underperformed large caps. What's your outlook for the balance of 2024 and beyond?

Ziehl: Some of that underperformance has to do with economic turbulence and the sharp runup in interest rates. But it's also true that, historically, there tend to be multi-year waves of outperformance and underperformance of small companies versus large. If we believe interest rates have peaked and we expect lower rates over the next couple of years, that bodes very well for small caps, because it helps level the playing field in terms of financing costs and credit availability.

Selbovitz: What do you see as some of the most exciting small-cap areas today?

Ramachandran: Artificial Intelligence and machine learning remain rich areas of opportunity. We've all heard that 'software is eating the world', and it's true. Biotechnology is another promising area. In the last year or so we've seen more than 15 M&A deals where large cap pharma companies have acquired small-cap biotechs for access to their innovations. We're also excited about renewable energy. Looking further afield, even traditional, lower-growth areas such as beauty and cosmetics and restaurant concepts can be exciting for us.

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Portfolio Manager,
Wellington Management

An active approach

Selbovitz: At MassMutual, we believe experienced, active management is the best approach to an extensive small-cap market with only limited analyst coverage. How do your teams use active management to select promising companies, pursue alpha, and manage risk?

Ziehl: Our small-cap core strategy is driven by experienced fundamental investors who understand the opportunities and threats facing individual companies across sectors.

The real opportunity comes in being extremely selective and separating the wheat from the chaff. We look for companies that can create shareholder value for years by improving their market share and profitability, outcompeting competitors, and navigating ecosystems dominated by large companies. From a vast field of potential stocks, we aim for a diversified portfolio of less than 100 stocks.

Our goal is an all-weather portfolio that can be competitive in a range of market environments. That's why it's broadly diversified across all sectors of the Russell 2000 Index, including a healthy dose of value companies in areas like industrials and financials as well as more growth-oriented sectors like technology and healthcare.

Ramachandran: A key tenet of our small cap growth strategy is that stocks outperform when they beat earnings expectations—so we look for companies where we have a differentiated view on earnings potential. A running scorecard helps us identify stocks with strong fundamental momentum, growth, quality, and valuation characteristics. We focus on the quality of company management, engage closely with boards of directors, and consider what's happening in their industries or sectors. We are building a relatively concentrated portfolio of 90 to 100 stocks.

We also have a large risk management team as well as robust risk analytics tools available to all portfolio managers. The vast majority of risk in our portfolios is stock specific. We are looking to outperform the benchmark due to stock specific factors—not because of some embedded macro, factor, or style view. It's a process we've been improving upon for the last 20 years.

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Portfolio considerations

Selbovitz: What should investors consider when investing in small caps?

Ramachandran: I believe they have an important role to play in a diversified portfolio. After years of underperformance, they may be positioned for a period of outperforming broader markets. And they offer investors an opportunity for exposure to potential household names of the future. It's easy to forget that some of today's most recognizable brands, not too long ago, were small-cap companies owned by small-cap investors. But because of the higher risks, it's important to be very selective, which is why we think active management is so important.

Ziehl: The actual percentage of small caps in a portfolio will vary according to your goals, risk appetite, and other factors. An aggressive investor might devote up to 20% of equity holdings to small caps. If you're a conservative investor later in your life cycle with a very low or minimal equity allocation, that would call for a much smaller portion of small caps. Either way, having a portion of your equities in small caps can provide both long-term returns and a diversification benefit.

For a deeper dive into small caps and the role they could play in your portfolios, watch our panel discussion featuring David Selbovitz, Ranjit Ramachandran, and Matthew Ziehl at: MassMutualInvestments.com/small-caps-link-placeholder

To learn more about our small-cap offerings and investment solutions:

Call us
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