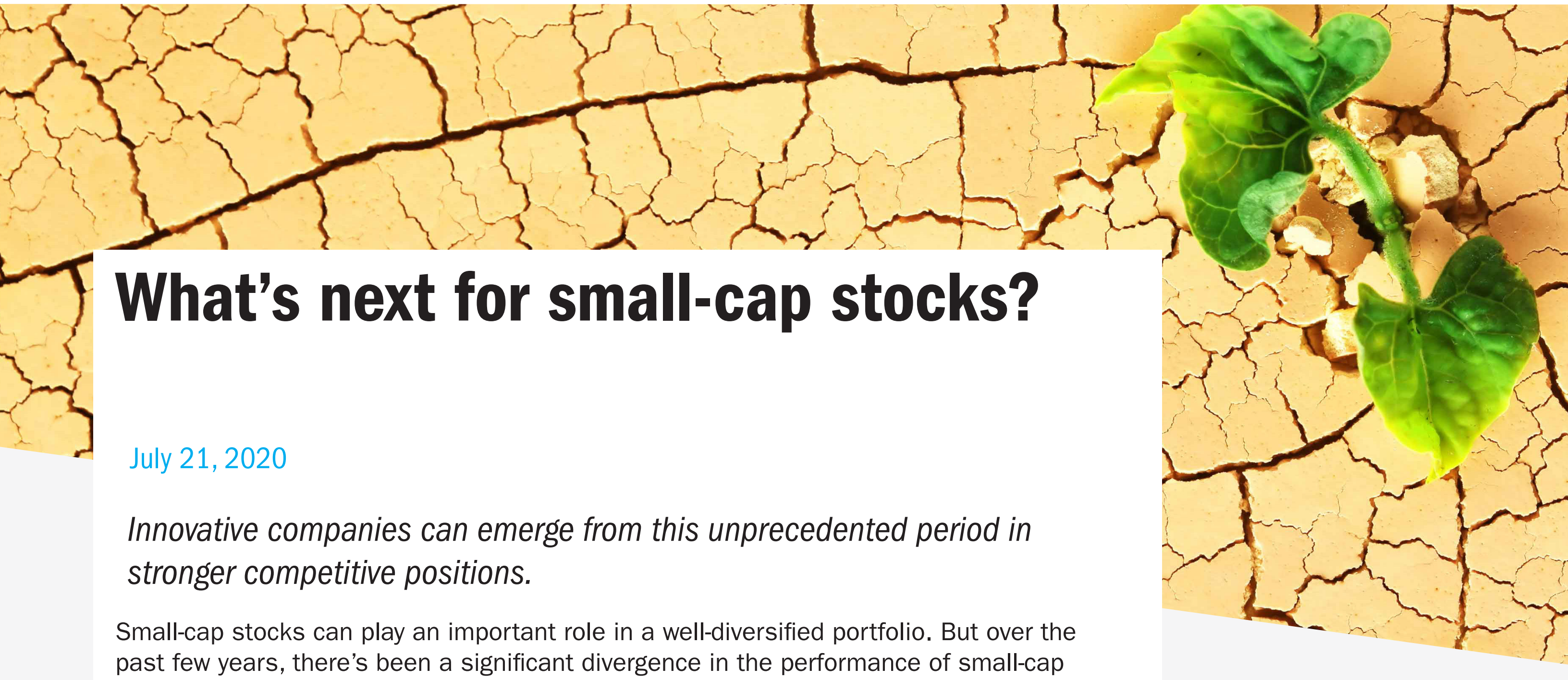

What's next for small-cap stocks?

July 21, 2020

Innovative companies can emerge from this unprecedented period in stronger competitive positions.

Columbia Threadneedle Investments

Small-cap stocks can play an important role in a well-diversified portfolio. But over the past few years, there's been a significant divergence in the performance of small-cap growth and small-cap value benchmarks — making it a "tale of two style boxes" for small-cap investors. Prior to the pandemic, small-caps had generally underperformed large-cap stocks, and through the market sell-off, the trend continued. But when we examine the performance of small-cap stocks, some clear distinctions emerge:

Small-cap growth stocks have outperformed value this year

	Russell 2000	Russell 2000 Growth	Russell 2000 Value
Market sell-off (%) (01/16/20–03/18/20)	–40.93	–38.82	–43.18
Market recovery (%) (03/19/20–06/15/20)	43.75	50.92	35.42
2020 YTD (%) through 06/30/20	–12.98	–3.06	–23.50

Past performance is not a guarantee of future results. The Russell 2000 Index is an unmanaged index that tracks the performance of the 2,000 smallest of the 3,000 largest U.S. companies, based on market capitalization. The Russell 2000 Growth Index is an unmanaged index that measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index tracks the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. It is not possible to invest directly in an index.

The division in performance between growth and value can be partially attributed to the composition of the small-cap indices:

- At the end of June, **financials** comprised more than 28% of the Russell 2000 Value Index. Financial stocks tend to do better when interest rates are rising, but the Federal Reserve cut rates to near zero as part of its response to the crisis. They're not expected to rise again meaningfully for the foreseeable future, which has weighed on this sector.

- The Russell 2000 Value Index is largely weighted in **cyclical stocks**, meaning that they do well when the economic cycle is on an upswing. Cyclically sensitive stocks like energy and industrial companies have lagged this year because the path to economic recovery is uncertain. We expect a u-shaped recovery to play out over 10 quarters. And, while we may see some dramatic initial gains, we expect a long road back to prepandemic levels of economic activity. This could weigh on stocks in these sectors.

- Many industrial names are struggling, but growth investors have still been able to benefit from several innovative **technology firms and healthcare companies** (with unique products or services that may fight the novel coronavirus). There are also opportunities in a select group of consumer-oriented firms more frequently found in the Russell 2000 Growth Index that are able to navigate this difficult economic backdrop.

It might be easy to conclude that simply buying a purely passive small-cap growth ETF is the way to gain small-cap exposure in the current environment. But we believe that this could be a mistake. Research can discern companies with the best business models — those that are more likely to emerge from this unprecedented period in stronger competitive positions at the expense of many of their peers. Small-cap portfolio manager Dan Cole offered his view on the subject:

"The small-cap markets have always been a rich source of new, innovative companies that grow faster than peers and the overall economy. Investigating companies with unique products or services that serve unmet needs or otherwise allow a job to be done in a way that saves time and money have always been great starting points — no matter if growth or value regimes were in vogue. The key is not just to find companies with faster than average growth, but also those with a business model that allows the company to consistently have a return on invested capital that's greater than the company's cost of capital."

Bottom line: Focus on the business model

It's important to do your research when you're considering small-cap equities. Discerning investors can find unique companies with strong business models across the asset class, and across growth and value styles.

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