

The Case for Small Caps in a Declining Rate Environment

May 31st, 2024

Interest rates are substantially elevated relative to recent history. The effective federal funds rate has been at 5.33% since July of 2023, a level that has not been reached since the early stages of the Great Financial Crisis in September of 2007. However, most market participants and policy makers believe that rates will decline to *some extent*, in the *near future* - though the exact timing and magnitude of the decline remains an intensely contested topic.

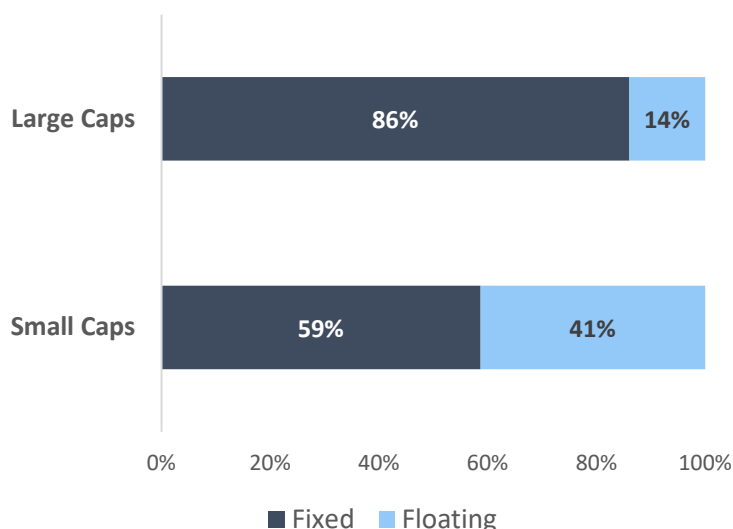
Consequently, investors might ask themselves, “How can I best position my portfolio to benefit from a declining interest rate environment?”. This piece looks at the current debt structure, interest rate sensitivity, and valuations of US large and small cap companies and finds that the latter have an advantage relative to the former in the current environment.

Debt Structure: small caps are positioned to profit

There are some significant differences between the debt characteristics of large and small companies. The latter have 3x the proportion of floating-rate debt versus their larger counterparts (see **Exhibit 1**). Also, small companies tend to have shorter duration debt (see **Exhibit 2**).

Given these differences, one should expect smaller companies will benefit more from falling rates. Small companies’ larger proportion of floating rate debt will quickly and mechanically lower their interest expense and their shorter maturities will enable them to capitalize on lower financing costs. All else equal, these two factors should lead to a relatively greater increase in free cash flow and profits for small companies.

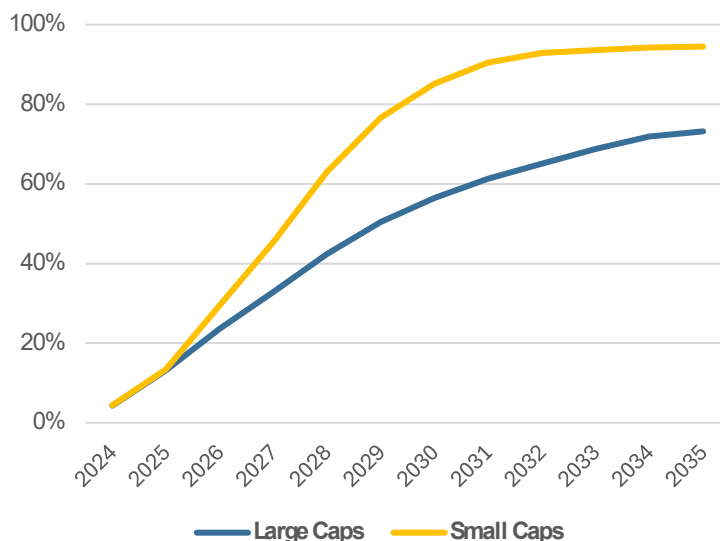
Exhibit 1: Debt Composition



Source: Innealta Capital using data from Bloomberg. Data pull date is 5/31/2024. Large Caps refers to Russell 1000 Index; Small Caps refers to Russell 2000 Index.

Exhibit 2: Maturity Schedule

Principle Due as a % of Total (Cumulative)



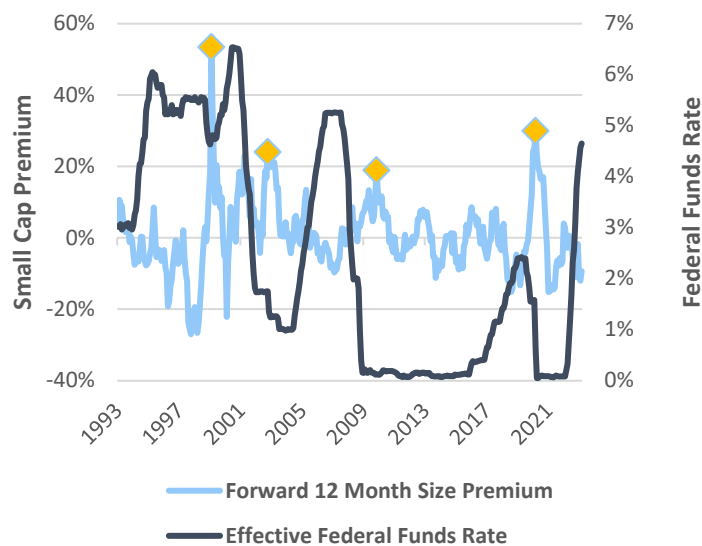
Source: Innealta Capital using data from Bloomberg. Data pull date is 5/31/2024. Large Caps refers to Russell 1000 Index; Small Caps refers to Russell 2000 Index.

Interest Rate Sensitivity: historic return differentials

We can also examine how the small cap premium (defined as the excess return of small caps over large caps) has historically varied in distinct interest rate environments. Although small caps tend to outperform large caps, their excess returns are often sporadic and condensed into short periods of time. By overlaying the fed funds rate with the size premium, we can observe the relationship between these two variables. Of note, the four largest small-cap premium periods follow significant rate declines.

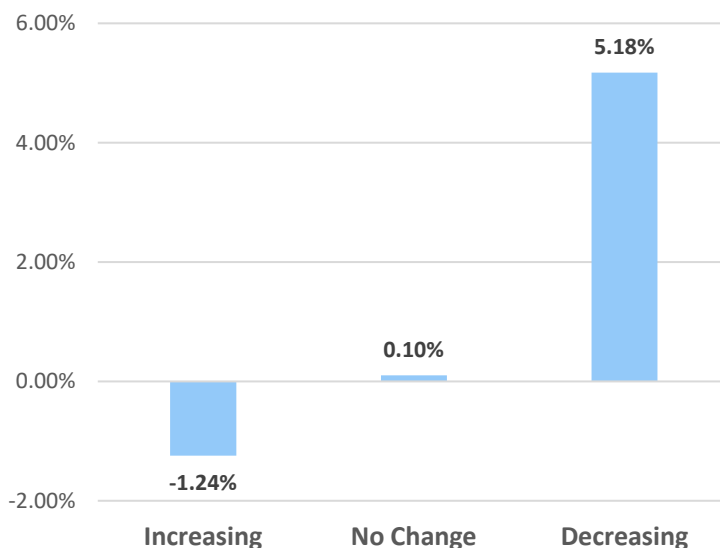
For robustness, we additionally classify each period into separate rate regimes and compare the average return of the size premium in the following 12 months. The three regime classifications are: increasing fed funds rate, decreasing fed funds rate, and no change. **Exhibit 4** shows the average return of the size premium in a declining fed funds rate environment is 5.18%, compared to -1.24% in a rising rate environment. This result confirms our prior observation: the size premium has historically been strongest during declining rate regimes.

Exhibit 3: Size Premium vs. Fed Funds Rate



Source: Ken French Data Library, Federal Reserve Bank of St. Louis, and Innealta Capital Calculations. 1/1/1993-3/31/2023. Effective Federal Funds Rate refers to the average effective federal funds rate for a given month.

Exhibit 4: Fed Funds Rate Regimes and the Size Premium



Effective Federal Funds Rate refers to the average effective federal funds rate for a given month. Increasing is defined as periods where the fed funds rate increased by .05% or more from the prior month. Decreasing is defined as periods where the fed funds rate decreased by .05% or more from the prior month. No Change are all other periods. Source: Ken French Data Library, Federal Reserve Bank of St. Louis, and Innealta Capital Calculations. 1/1/1993-3/31/2023.

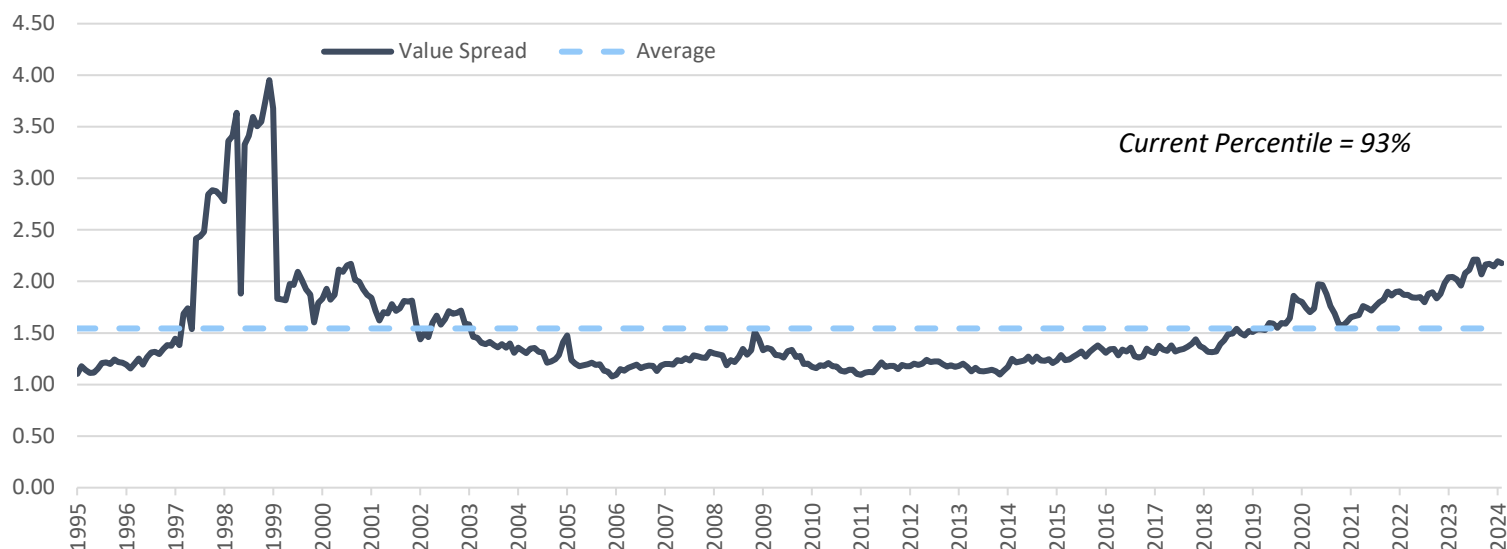
As always, the usual caveats apply when using historical data: there is no guarantee that the future will look like the past. This historical context can, however, provide a starting point to help formulate baseline assumptions for the future.

Valuations: small companies seem relatively cheap

Valuations tend to be highly predictive of long-term returns. As of May 30th, the value spread between large and small companies is at the 93rd percentile, suggesting that small caps are quite inexpensive compared to their larger counterparts (see **Exhibit 5**).

Interestingly, a much greater proportion of small companies are not profitable, implying that they tend to be higher duration securities. Therefore, small companies are likely to receive a greater valuation increase in the event of declining discount rates, which could act as a catalyst for the value spread's mean reversion.

Exhibit 5: Valuation Spread – Large vs Small



Value spread is defined as the ratio of the Price/Book of Large Caps to the Price/Book of Small Caps. Large Caps are measured using Russell 1000 Total Return Index (RU10INTR). Small Caps are measured using Russell 2000 Total Return Index (RU20INTR). 4/30/1995 – 5/30/2024. Source: Bloomberg; Innealta Capital Calculations.

Final thoughts

In general, the current environment appears to be set up favorably for small caps to outperform, but we wouldn't advise an all-in bet on small caps. Stickier than expected inflation could prolong the highly anticipated rate cuts by the Fed, delaying the effects of the tailwinds discussed above. Therefore, we believe in an approach of moderation where a strategic overweight is warranted. Additionally, a way to further increase the benefits of investing in small caps is to tilt towards a subset of the universe such as companies that are more profitable, have strong balance sheets, and exhibit favorable price momentum. We believe these enhancements would better position the portfolio to benefit from a declining rate environment while minimizing risk.

DISCLOSURES

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Index Definitions

The **Russell 2000 TR Index** measures the performance of the small-cap segment of the US equity universe. The **Russell 1000 Index** measures the performance of the large-cap segment of the US equity universe.