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Small caps poised to benefit as Fed pivots to easing cycle

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After months of speculation about the size and timing of the U.S. Federal Reserve's transition to a new easing cycle, the Fed made it official after its September 18 meeting with the first cut to the benchmark lending rate since the height of the Covid-19 pandemic. With inflation now appearing more under control, the next question for the Fed is whether it can successfully engineer a so-called soft landing for the economy, bringing short-term rates down further in the process. If the equity markets are any indication, there seems to be a good deal of confidence that the Fed can succeed. For investors taking a second look at their stock allocations as this transition unfolds, we believe that small caps look particularly well positioned as interest rates continue to fall.

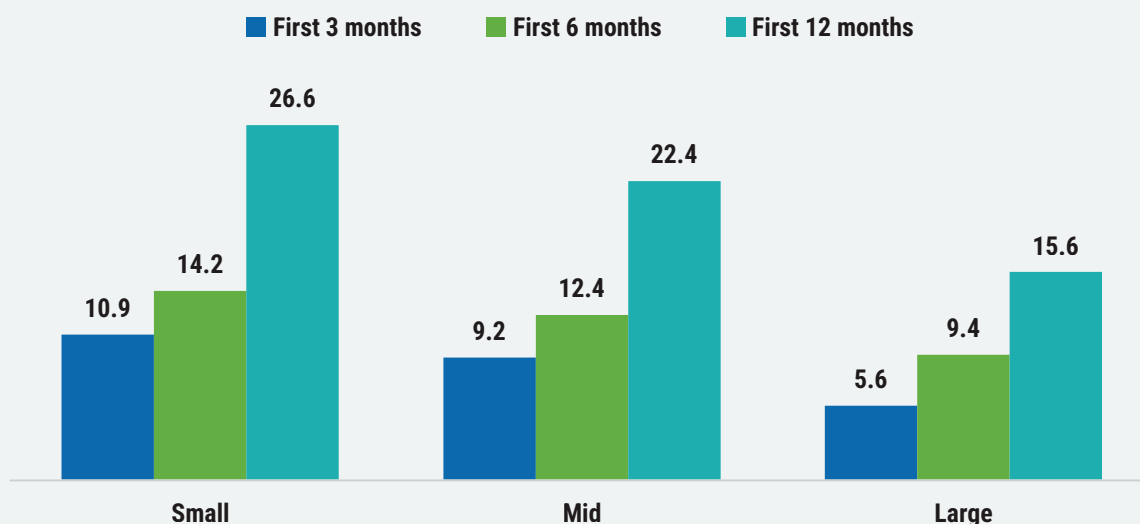
Small-cap stocks have outperformed during past easing cycles

Rate cuts generally have been good news for equities across market capitalizations—which in some ways highlights how unusual the circumstances surrounding September’s initial rate cut were. (The Fed cut rates an additional 25 basis points in early November, as expected.) More often than not, the Fed is cutting rates in response to deteriorating economic conditions rather than recalibrating after trying to tamp down inflation or trying to preempt a cooling economy, as seemed to be the case this time. This explains why equities, on average, have been higher just three months after an initial rate cut: The worst economic news has usually already been priced into markets by the time the Fed begins cutting.

While three months has generally been sufficient time to see a bounce in stock prices, six and twelve months after an initial rate cut equities historically have fared even better. It’s worth noting how dominant small caps have been over all three time periods, leading the pack in each and outperforming large caps by more than 1000 bps over the one-year time horizon.

Small caps historically lead the way after the first rate cut

Performance after first rate cut (%)



Source: Federal Reserve Board, Haver Analytics, Center for Research in Security Prices (CRSP), The University of Chicago Booth School of Business, Jefferies, as of January 2024. This illustration uses the fed funds rate from 1954 until 1963, the discount rate from 1963 until 1994, and fed funds rate after that. Market caps are defined by CRSP by dividing the U.S. equity market into deciles based on market capitalization. Deciles 1 and 2 are large, 3 through 5 are mid, and 6 through 8 are small (9 and 10 are micro and were excluded from this study). Past performance does not guarantee future results. It is not possible to invest directly in an index; see last page for definitions.

Lower borrowing costs disproportionately benefit smaller firms

It’s something of a given that smaller firms tend to employ greater leverage than larger firms, which also implies that they’re more directly affected by interest costs. Smaller firms also have naturally higher borrowing costs relative to larger ones given their debt is often rated lower, resulting in higher required interest payments.

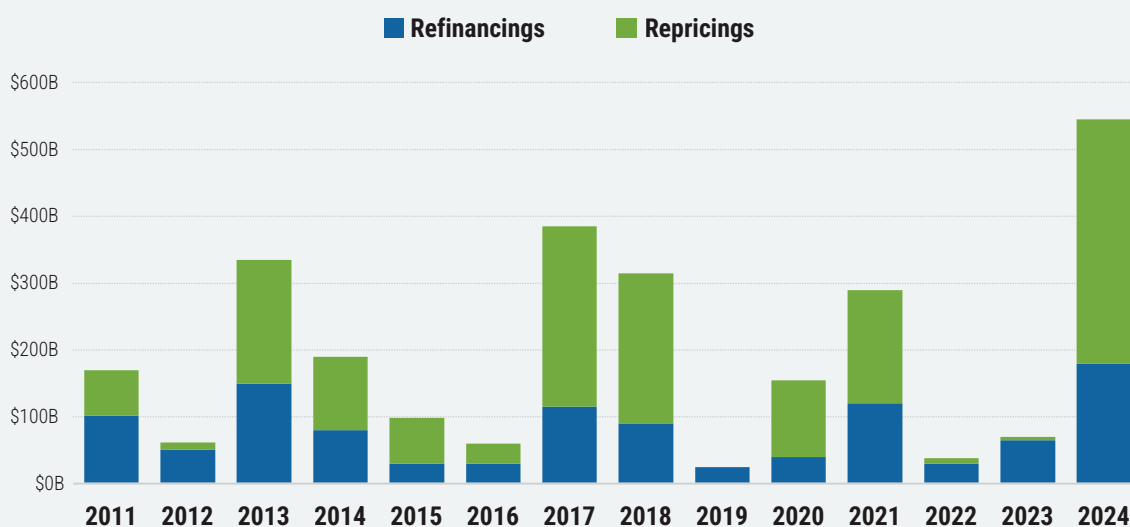
For example, one series of Apple bonds with 30-year maturities (due in 2047) were issued with 4.25% coupons—for context, that’s a rate below the current yield on 30-year U.S. Treasuries.¹ Dish Network, meanwhile—one of the largest positions in many high-yield bond indexes—issued five-year debt due in 2027 with a coupon of 11.75%. Both are publicly traded companies, but Apple’s market cap is currently in the neighborhood of \$3.5 trillion versus around \$3 billion for Dish.

While this is just one such example, the point illustrated is that lower prevailing interest rates disproportionately benefit smaller firms, which must often deploy a greater percentage of their working capital toward interest repayments.

Even before the Fed’s recent rate cut, this year has seen an unusually high volume of refinancing of existing debt. To the extent that smaller companies have been able to participate in lowering their cost of capital, those savings directly impact their bottom lines.

U.S. Institutional loan activity

First half of each year, 2011 to 2024



Source: Adapted from PitchBook LCD; Chart: Axios Visuals. Data is as of July 3, 2024. Past performance is not an indication of future results.

Stock valuations and multiples tend to expand during easing cycles

With greater profitability, small cap valuations naturally tend to expand, which can kick off something of a virtuous cycle. Higher stock multiples (higher price/earnings or price/free cash flow multiples, for example) generally lead to higher market caps. Higher market caps, all else being equal, facilitate increased trading volume, more liquidity, and ultimately a narrowing of any built-in liquidity discount—i.e., higher prices. This cycle is, of course, predicated on a relatively stable economy, but even in the event of a recession, equity funds can often serve as a kind of backstop, setting a floor for small-cap multiples when investors dial down risk.

¹ United States Department of the Treasury, as of November 1, 2024

There are other tailwinds to valuations: Falling interest rates tend to have beneficial effects on many inputs that ultimately determine a company’s profitability—and therefore its share price—including financial statement line items like the cost of goods and services (COGS) and selling, general, and administrative (SG&A) expenses.

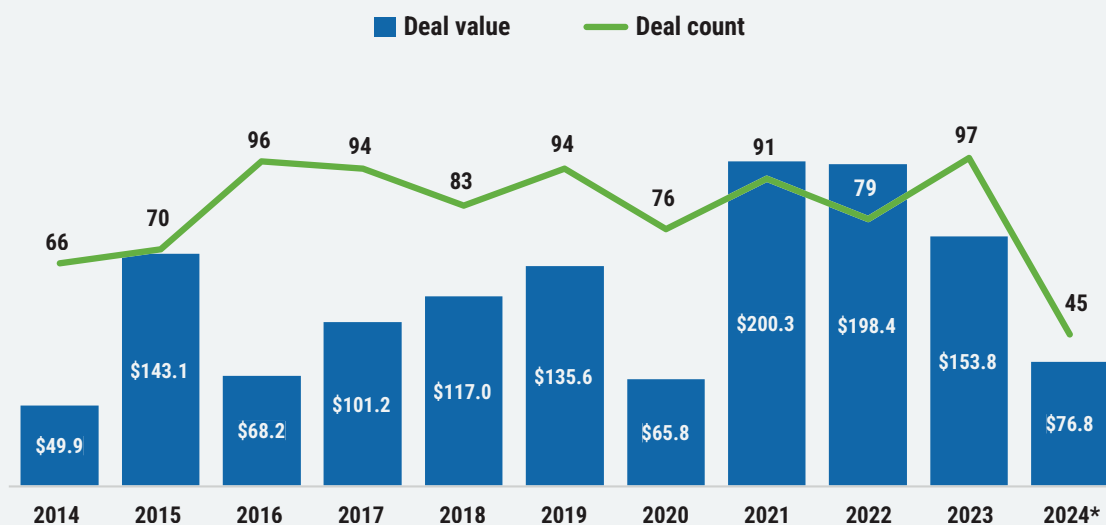
M&A activity typically accelerates as interest rates fall

Another byproduct of an easing cycle is greater merger and acquisition (M&A) activity. Higher stock multiples lead to deeper pockets for firms, meaning acquisitions can be achieved with either less dilution to book values and/or more accretion to earnings. Also, acquisitions lead to larger firms, which as discussed above, often leads to greater liquidity for the stock and higher valuations.

The benefit of higher M&A activity for small-cap investors is that shares of smaller companies are typically bought out at a premium, potentially delivering a profit for shareholders.

Private equity take-private deal activity

As of June 30, 2024



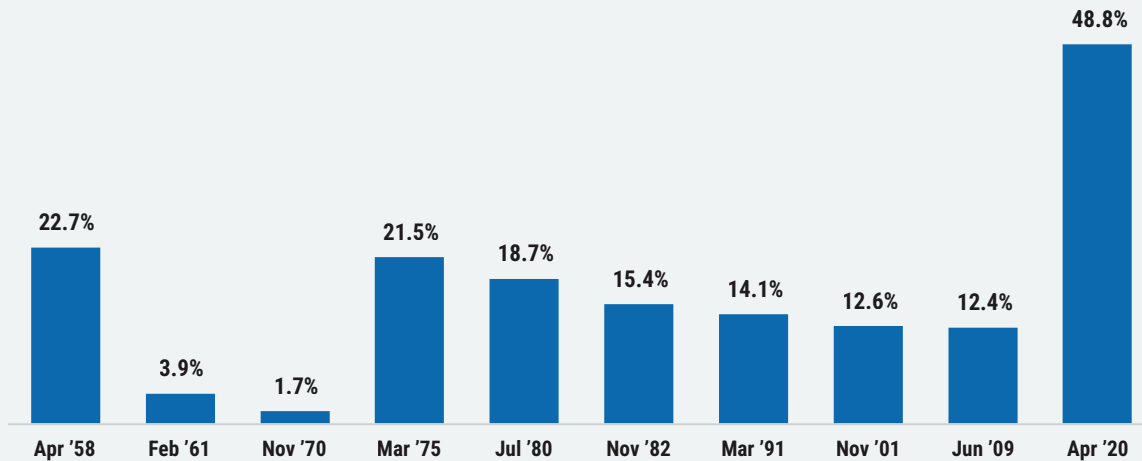
Source: PitchBook LCD, "U.S. PE Middle Market Report," as of June 30, 2024.

If all else fails, small caps have significantly outperformed large caps coming out of recessions as well

The chances that the Fed engineers a so-called soft landing are far from certain. Conventional wisdom suggests the size of the cut—50 basis points rather than a less aggressive 25—indicates the Fed has become focused on propping up the economy and helping to insulate it against a possible looming slowdown. With that in mind, it’s prudent to look at how small caps have performed around recessions. While studies from CRSP have shown that small caps tend to underperform large caps during the initial months of a recession (both segments of the market have historically recorded losses, unsurprisingly), they’ve significantly outperformed on the other side.²

² Center for Research in Security Prices, as of November 1, 2024.

The degree of small cap outperformance 12 months after recessions end has been significant



The exhibit shows the active performance of a U.S. small-cap (size-sorted bottom 30%) cap-weighted portfolio over a U.S. large-cap (size-sorted top 30%) cap-weighted portfolio for the 12-month period following recessions. Source: Kenneth R. French Data Library, as of November 1, 2024.

Once macroeconomic conditions bottom and risk appetites return, small caps historically have outperformed—and usually by a wide margin. Looking at the one-year period following the end of the past 10 recessions, small caps have outperformed large caps every time—and led by 12% or more 8 out of 10 times. Whether or not this somewhat atypical Fed easing cycle eventually coincides with an economic contraction, one thing is clear: Small caps have historically been an attractive asset class both as rates fall and then as economic conditions improve.

In a rotation to small caps, not all investment options are created equal

In a final cautionary note, investors bullish on small caps should take care to know what they own. A recent study by Raymond James looked at nearly 300 actively managed small-cap mutual funds and 31 ETFs and found that in aggregate the funds had a sizable underweight to small-cap securities (defined as securities with market caps between \$250 million and \$3 billion). Strikingly, these funds on the whole had a nearly 14% overweight to large-cap stocks (defined as those with market caps greater than \$11 billion); the Russell 2000 Index has approximately 2% of assets in securities of that size, mostly due to appreciation between scheduled index reconstitutions.³

All told, we see no shortage of tailwinds for small caps in the early phases of the Fed's new easing cycle. The one key risk on the horizon is the possibility of a material economic slowdown or an outright recession. Time will tell whether the Fed ultimately achieves its soft landing—but if it does, we could see investor interest in small caps begin to really take off.

³ For reference, stocks with market capitalizations greater than \$3 billion and less than \$11 billion are generally considered mid caps.

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WPG Partners takes a unique research-driven approach to the small and microcap markets: The team targets undervalued companies with improving capital structures that are near an inflection point in the business cycle with a catalyst for positive change.



Eric A. Gandhi, CFA

Mr. Gandhi is Lead Portfolio Manager of the WPG Partners suite of strategies. He joined WPG Partners in July 2012 as a research analyst with a concentration in the technology, media, telecom, and consumer sectors. Prior to joining the firm, Mr. Gandhi was an Associate in the investment banking division at Needham & Company. He graduated with a B.S. from the University of Maryland and received an M.B.A. from Columbia Business School, where he currently teaches Applied Value Investing as an adjunct professor. Mr. Gandhi holds the Chartered Financial Analyst designation. He began his career in the investment industry in 2007.

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Index definitions

The **Russell 1000 Value Index** tracks the performance of those large-cap U.S. equities in the Russell 1000 Index with value style characteristics. The **Russell 2000 Index** tracks the performance of 2,000 of the smallest companies traded in the United States. It is not possible to invest directly in an index.

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