Equity-Market Outlook

Upside potential in smaller-cap stocks

Pandemic shutdowns have fallen particularly hard on the small-business sector of the economy, an area of intense competition in which most firms are habitually close to the edge of failure. But the economic resilience of this sector is legendary. As an Invesco report points out, small-cap stocks have historically outperformed after recessions. ¹

The small-cap universe is a place in which the rates of both creation and destruction are much higher than elsewhere. Even in much more normal economic circumstances, only 50 percent of small businesses survive more than five years — yet, according to a famous statistic, they are the originators of more than half of all new jobs. ² Where the struggle to restore the economy’s vitality is concentrated they are the dynamic core of the economy.

During the meltdown, between January 17 and March 20, the plunge in the small-cap Russell 2000 index of stocks was 40%, greatly exceeding the 31% plunge in the large-cap Russell 1000. Figure One illustrates.

Although the pandemic hit small caps much harder, the chart shows that their cumulative rebound has been somewhat more vigorous than that in large caps: 56% for small caps and 49% for large caps, March 20 to date. As a result, while the Russell 1000 has recovered all of its lost ground, the Russell 2000 has recovered to the extent of only 84 percent. What’s the likelihood that small caps will enjoy a complete recovery in the weeks ahead? This report assesses their upside potential, following the same methodology adopted earlier for the relative performance of the stock and high-yield bond markets. ³

The 2009 recovery in large- and small-cap stocks. It’s natural to interpret a divergence in speed of rebound

Historically, when stock markets sell off, the prices of small-cap stocks are much more vulnerable than large caps. But once the rebound is under way, they out-perform.

Figure One

The Plunge and Rebound in Small- and Large-cap Stocks

weekly data from the beginning of 2020

Data: Daily total returns for the Russell 1000 large-cap index and the Russell 2000 small-cap index.

as resulting from differences in market resilience. Markets for small caps are simply less large, liquid, or deep than those for large-caps.

Figure Two shows the path of the small/large cap price ratio year to date. It’s clear that investors would have been far better off in large-cap stocks in the weeks running up to the general low point in capital markets. And that continued for four weeks more. For six or seven weeks after that small caps climbed back relative to large caps, but they have made little or no further progress since.

Figures One and Two leave it unclear whether it would make sense to switch now from large to small caps. For more input in addressing this question, we turn to the capital-markets recovery during the 2008-09 recession and recovery. Figure Three traces the way the rebound paths of these indices evolved over a five-year period.

After the market bottomed in early 2009, the recovery in small caps slightly outpaced that in large caps straight away. To see what happened in subsequent months, the chart also includes a third line, showing the relative price of small- and large-cap stocks. This shows that small caps were the place to be until early 2011, about two years altogether. After that, large caps regained the ascendancy, at least temporarily.

Does history show when or whether to switch between large- and small-cap stocks? As with any two similar assets, the relative performance of large- and small-cap stocks no doubt varies from episode to episode. The Great Recession was a major source of evidence about the relative capacity of small and large companies to recover from an economic shock, but it was just one such episode.

To develop a more confident picture of when large-cap investors should shift to smaller caps, it’s a good idea to check out what the collective historical record of capital-market selloffs can tell us. This can be done by compiling a list of the calendar months in which the stock market plunged by, say, five percent or more. During the past quarter century, prior to this year’s pandemic, there have been 42 such occasions. We then check to see how small caps subsequently performed relative to large caps using the ratio between the Russell 2000 and 1000 indices. Average month-to-month outcomes following these selloffs are plotted over a subsequent ten-month period in Figure Four.

Figure Three
How Small- and Large-cap Stocks Recovered from the Great Recession
month-end data from mid-2008

The chart shows that there is not much in it for two to three months following a plunge. After that, small caps consistently outperform large caps for at least another six months. So, after a plunge, the time to switch from a large- to a small-cap style would be a couple months into the general stock-market rebound.

Also plotted in Figure Four is the path of the small-large cap price ratio in periods when no market plunge takes place. By a small margin, but consistently, large caps outperform small caps. Generally, then, market stability is slightly more favorable for large-cap stocks. In volatile markets, small caps fall substantially faster during a plunge, but out-perform after the market has bottomed.

**Investment conclusions.** The current stock-market crisis and that of 2008-09 confirm a pattern observed historically. Large-cap stocks are much less vulnerable than small caps when the market plunges, and they also outperform slightly during stable stock-market periods. So large-cap stocks make most sense as a default. But there is a time when it is better to be in small caps: they outperform substantially after the market is a couple of months into a climb back from a plunge.