

Small Cap Stocks

It's Their Time to Shine

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YOU MIGHT NOT RECOGNIZE THE NAMES of these companies or hear them talked about on the financial news networks, but small capitalization stocks (“small caps”) are an important part of an investment portfolio, and history is telling us that now is a particularly good time to add them to yours.

WHAT IS A SMALL CAP?

By definition, a small cap stock is a publicly traded company with a market capitalization — the value of its common shares calculated by multiplying the number of shares by the current stock price — of between \$300 million and \$2 billion. Market capitalization is how publicly traded companies are categorized and compared as small, mid-sized, or large. In comparison to small caps, large caps — Apple, Microsoft, Coca-Cola, etc. — have a market capitalization of \$10 billion or greater. They are typically well-established, mature companies with proven cash flow and low volatility.

Small caps might be small in size but are large in numbers — approximately 3,700 of the 8,700 publicly traded companies. The Russell 2000 Index, launched in 1984 by Russell Investments, includes 2000 small cap companies. As the S&P 500 Index does for large caps, the Russell 2000 measures the performance of small cap stocks.

COMMON CHARACTERISTICS

Small cap stocks are an important part of your portfolio in terms of exposure and diversification. Common characteristics include:

- The companies’ business lines focus on domestic markets.
- They typically offer low-to-no dividends.
- They are less transparent; less information is available compared to large caps due to a lack of coverage by market analysts.



If you can withstand the ups and downs, you will be rewarded for investing in or holding on to the small cap position in your portfolio.



- There is low correlation to large caps in their market behavior.
- They are not as liquid as large caps because they are not as frequently traded.
- They offer more potential for growth and expansion.
- They are more sensitive to higher interest rates because to grow they typically borrow, so expansion is slower during periods of higher interest rates.

WHY INVEST IN SMALL CAPS?

The reward for investing in small cap stocks is potential for accelerated growth. A small cap company — and its market price — can double in size, which is very unlike large caps. But you have to be able to withstand greater volatility and risk of loss; higher highs can be offset by lower lows.

Over the past 10 years, and especially in recent years, the stock market has been dominated by the so-called Magnificent 7, a group of seven stocks that have outpaced all others on the S&P 500. Small caps, on the other hand, have been summarily dismissed. But history shows that, like large caps, small caps tend to move in cycles; they tend to do well during periods of recovery, in particular, as interest rates decline. And they move quickly; when they take off, they can soar.

Large caps outperformed small caps for the 14 years leading up to the late 1990's dot-com bubble. Then from 2001 to 2010, small caps outperformed large caps. Since then, large caps have again been the better performers. In fact, the difference in valuation between large and small caps rarely has been as wide as it is now as we enter the fourth quarter of 2024. S&P large caps are trading at 20 times earnings; small caps at 13 times earnings. As such, the prices of small caps are attractive.

Most importantly, a declining interest rate environment is historically a favorable time for small caps to outperform large caps. That increases their importance to your portfolio today, an opportunity for accelerated growth as well as for diversity. You could acquire companies in their beginning stages, gaining exposure to a favorable market cycle and innovation. If you can withstand the ups and downs, you will be rewarded for investing in or holding on to the small cap position in your portfolio.

You can own small caps through an exchange traded fund (ETF), such as the Russell 2000 Index or through an active manager who reviews small cap companies to determine best in class. Talk to your advisor to ensure you have the appropriate exposure to these young, up-and-coming companies. The returns have the potential to be enormous compared to the big stocks, and with falling interest rates, now may be the time to own them as they have historically taken off in such an environment. Now may be their time to shine.

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