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Small Cap Value vs. Large Cap Core

Mark F. Toledo, CFA
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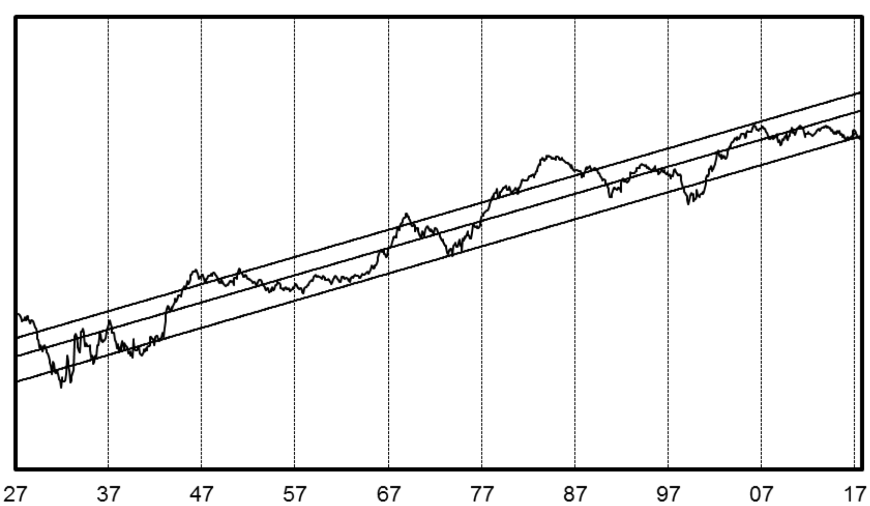
During the second half of 2016, Dimensional's US Small Cap Value ("SCV") Index advanced 24.2% compared to 7.8% for the S&P 500 Index of large cap core stocks. Investors who anticipated that superior SCV relative performance would persist have been disappointed in 2017. Through November, the total return for the SCV index of 7.2% has lagged the S&P 500's total return of 20.4%. Despite this under-performance in 2017, the SCV index has out-performed from June 2016 through November 2017, gaining 33.2% vs. the S&P 500's total return of 29.8%.

Small Cap Value Superior Performance

Exhibit 1 shows the relative performance of the SCV Index to the S&P 500. A rising line represents periods of superior performance for SCV stocks, and a falling line shows periods of inferior SCV relative performance. The line drawn through the middle of the data denotes the central value. The chart also contains lines at plus and minus one standard deviation from the central value to represent upper and lower extremes. The superior long-term return for SCV stocks accounts for the secular up-trend of the channel.

Exhibit 1: Small Cap Value vs S&P 500



Data Source: Dimensional Fund Advisors & Chicago Partners

This exhibit shows that the SCV relative price index fell farther below the undervalued line in the 1998 to 2000 time frame than any other time in the 91-year history. From the bottom in March 1999, the SCV Index dramatically out-performed the S&P 500 for the next 7 years until March 2006.

From March 2006 to July 2016, SCV under-performed, dropping the relative price index to the lower bound. This 10.3 years of under-performance for SCV exceeds the average duration of 8.7 years, but falls within a normal range of 4.0 to 13.5 years.

The superior performance of SCV stocks since mid-2016 scarcely shows in Exhibit 1. The past year-and-a-half could be the beginning of the next long-term period of superior small cap value stock relative performance. If so, it would represent the sixth major advance over the past 91 years. The following table summarizes data for the five previous periods.

In four of the five prior periods of superior SCV returns, the S&P 500 produced annual returns near or above its long-term average of 10%. In contrast, large cap stocks generated only a modest annualized return of 2% in the most recent period (Mar-99 to Mar-06). During the approximately 40 years of superior SCV returns, the average annual return for S&P 500 stocks of 12% exceeded the 91-year average of 10%. In other words, both large cap and small cap stocks rewarded investors during these periods.

Exhibit 2: Periods of Superior Small Cap Value Returns

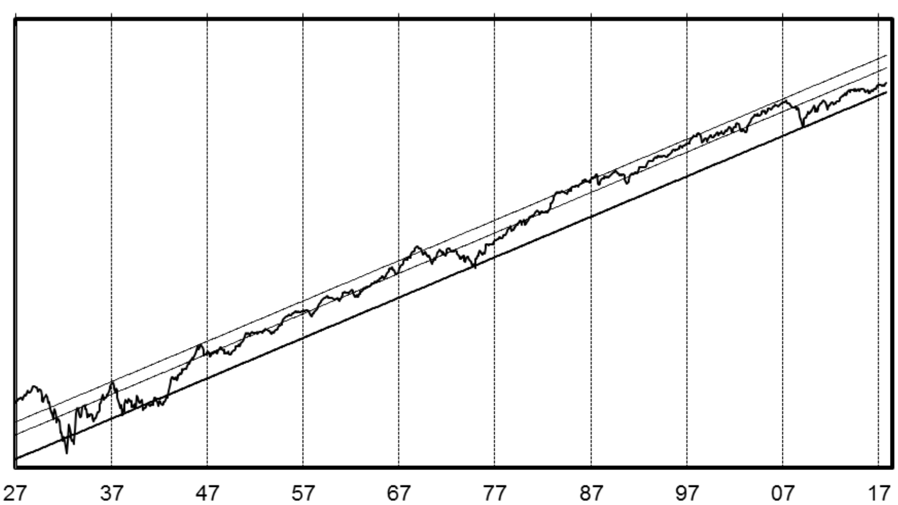
			Annual Return	
Start	**End**	**Duration in Years**	**S&P 500**	**Small Cap Value**
Dec-32	Mar-37	4.3	31%	65%
Mar-39	May-46	7.2	14%	37%
Dec-57	Dec-68	11.0	13%	26%
Jun-73	Jan-84	10.6	9%	26%
Mar-99	Mar-06	7.0	2%	21%
Jun-16				
Average		8.0	12%	31%

Source: Dimensional Fund Advisors

The last column of Exhibit 2 shows the exceptional returns for small cap value stocks during the five periods of superior SCV returns. The SCV average annual return of 31%, during the 40 years of superior SCV returns, substantially exceeded the 12% average return for the S&P 500. Investors who maintain SCV equity positions periodically experience exceptional returns, often when least expected.

Exhibit 3 shows a total return index for the Dimensional US Small Cap Value (SCV) Index. Similar to the SCV vs. S&P 500 relative performance chart, a central value line is drawn through the middle of the data and lines at plus and minus one standard deviation from central value represent boundaries.

Exhibit 3: Small Cap Value Total Return



Data Source: Dimensional Fund Advisors & Chicago Partners

The SCV Total Return index has fallen to the lower bound four times during the past 91 years- 1932, 1939, 1974 and 2009. Following each of these lows, the index eventually moved above the central value line to the upper bound. Since the 2009 low, the SCV Total Return index has advanced, but remains in the bottom half of the channel. Both the relative performance and total return charts show that SCV stocks have the potential for superior returns over the next five to ten years.

Abundance or Scarcity of Earnings Growth

The abundance or scarcity of corporate profit growth influences when SCV or large company based investment styles produce superior returns. During periods of decelerating profit growth, the market tends to reward companies that dependably maintain growth rates, while penalizing those that have inconsistent advances. In these periods, the S&P 500 often outperforms SCV. In contrast, investors tend to reward companies that drive increased levels of profits during periods of earnings acceleration and penalize firms that merely maintain growth rates. The most rewarding style during periods of earnings acceleration tends to be SCV.

Corporate profits, as measured by operating earnings for the S&P 500 companies, have grown at an annual rate of near 6.5% over the long-term. During the last period of superior SCV returns (Mar-99 to Mar-06), profits grew at an above average annual rate of 8.4%. Subsequently, earnings grew at a very modest annual rate of 2.1% during the most recent period of inferior SCV returns (Mar-06 to Jul-16). Since mid-2016, corporate profit growth has accelerated to an annualized rate of 17.2%. The superior SCV returns suggests that corporate profits may grow at an above average rate over the next several years.

Inflation, Interest Rates & Taxes

Equity investors pay for nominal (not inflation adjusted) growth in earnings. Nominal earnings benefit from inflation through rising prices for goods and services. A secular up-trend in inflation positively correlates with rising stock prices and superior SCV performance. During the past five years, the annual rate of change for the CPI has fluctuated between 0% and 2%, well below the long-term norm of 3% to 4%. The Wall Street Journal Economic Forecasting Survey expects that inflation will modestly advance to the 2.0% to 2.5% range in 2018.[1]

The Treasury yield curve is a good leading indicator of economic activity and SCV relative performance. A flat or inverted curve suggests a forthcoming slowdown, while a positively sloped curve signals future growth. The yield curve inverted in July 2006 and remained so until mid-2007, signaling the slowdown in economic activity that eventually turned into a deep recession. The Fed’s aggressive easing over the past several years has produced a positively sloped yield curve that remains bullish for the economy and SCV stocks.

Rising long-term interest rates also tend to correlate positively with superior SCV relative performance. Long-term rates often rise in anticipation of accelerating inflation and economic growth. The 10-year T-note yield has risen from 1.4% in mid-2016 to 2.4% recently. The rise in long-term rates and the Fed’s continued movement to a neutral monetary policy both show confidence in the level of economic activity.

Finally, lower corporate and individual tax rates positively impact the relative performance of small cap value stocks. Lower corporate tax rates increase the after tax earnings for businesses. Lower capital gains and income tax rates may encourage investors to accept more equity risk in anticipation of greater after tax gains. Tax policy changes could also positively impact small company value stocks over the next several years.

Conclusion

Small cap value stocks may reward investors with significantly higher returns than large company stocks as represented by the S&P 500 over the next several years. The higher returns represent compensation for the greater level of risk associated with providing capital to smaller companies. Investors may enhance the risk/return profile of their portfolio by maintaining an allocation to SCV equities over time.

The position of both the relative performance index in Exhibit 1 and the SCV Total Return index in Exhibit 3 suggest that the last year-and-a-half could represent a transition in favor of SCV stocks. However, the performance of SCV stocks during this time period highlights the fallacy of "market timing." Almost half of the 33% return form SCV stocks over the past 18-months occurred during 15 trading days from November 3, 2016 to November 25, 2016.

The long-term nature of this analysis means that investors should expect intermediate-term setbacks in both the relative performance of SCV stocks and the total return for small cap and large cap stocks along the way. The equity market typically experiences 3 to 4 declines of greater than 5% per year with one of these exceeding 10%. The higher expected returns for equity investors represents compensation for assuming uncertainty about the timing and magnitude of returns.

[1] Wall Street Journal Economic Forecasting Survey, accessed 12/13/17