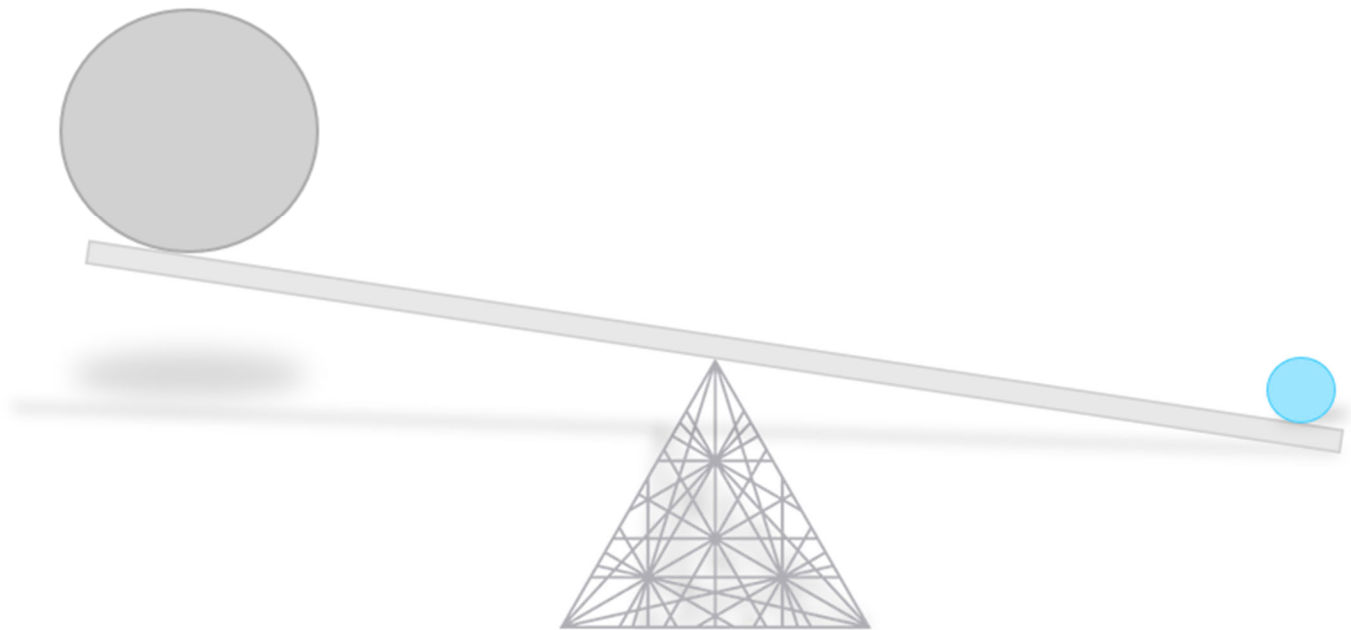


Small Caps Are Beautiful

2024++



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SMALL CAPS ARE BEAUTIFUL: 2024++

INTRODUCTION

In 2024, much like the previous year, the dominance of select mega-cap "tech" stocks continues to shape the returns of the major market indices. These market darlings of the last decade, 'The Magnificent Seven' (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta and Tesla), have emerged as a central focal point within the realm of passive investments, commanding a significantly larger concentration in equity portfolios.

Within this whitepaper, we highlight the opportunities arising from the market's top-heavy structure and articulate how small-cap companies stand to leverage this market dynamic to their advantage. We underscore the role of active management in generating alpha within portfolios, while also emphasizing how small cap companies are uniquely positioned to thrive in a declining interest rate environment.

MARKET CONCENTRATION

As of the end of 2023, the total stock market capitalization of the United States stood at \$50.8 trillion¹. Of the \$50.8 trillion in US domestic market capitalization, the companies held within the S&P 500 equated to \$44.3 trillion of the total market capitalization (~87%) and within the S&P 500, the 10 largest companies total \$15 trillion in market cap or 29% of the total US market cap and 31% of the S&P 500 index.

In our 2023 whitepaper, "[The Magnificent Seven vs The Market Bandits](#)", we addressed market concentration dynamics in the US stock market. The rise of the M7, driven by cloud computing, AI, and low interest rates, alongside flows into passive investments, has led to historically elevated levels of concentration. This phenomenon sparks ongoing debate among financial circles regarding its origins and sustainability.

The 25 largest domestic ETFs currently consist of approximately \$3.4 trillion in AUM (~7% of total US market cap). While the average number of securities held in the largest ETFs is ~700, they tend to skew towards a top-heavy position sizing with an average top 10 portfolio concentration of 31%. Position sizing within these ETFs is often dictated by the market capitalization of the underlying companies, leading to a reinforcing cycle where the largest companies garner more investment, driving up their market capitalization further.

Table 1 **Top 25 Largest Domestic Equity ETFs - Concentration in Magnificent 7 Securities**

	AAPL	MSFT	NVDA	GOOG/L	META	AMZN	TSLA	M7 % Total
# Funds Where Held:	16	16	15	13	13	12	12	
Avg. Weight (Where Held):	7.7%	8.9%	6.0%	4.5%	2.9%	4.3%	1.3%	35.6%
Avg. Weight (All Funds):	5.0%	5.7%	3.6%	2.3%	1.5%	2.1%	0.6%	20.8%

Source: VettaFi

While the concentration in large-cap stocks and the dominance of major indices like the S&P 500 are widely acknowledged, it's crucial not to overlook the significance of small-cap stocks in the market ecosystem. Small-cap stocks are typically defined as companies with a market capitalization of less than \$2 billion². Despite their size, these smaller companies play a vital role in driving innovation, economic growth, and diversification within portfolios.

¹ "The total market capitalization of the U.S. stock market," Sibilis Research, accessed May 15, 2024, <https://sibilisresearch.com/data/us-stock-market-value/>

² "Market Cap Explained," FINRA, accessed May 15, 2024, <https://www.finra.org/investors/insights/market-cap>

The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe. As a subset of the Russell 3000 Index, the Russell 2000 Index includes ~2,000 of the smallest securities based on their market capitalization and current index membership. As of 4/30/24, the average market cap (\$-WTD) of the Russell 2000 Index is \$4.3 billion and the median market cap is \$0.9 billion³. More interestingly, the largest market cap for a single security in the index is \$50 billion. Although the Russell 2000 Index undergoes annual reconstitution, short-term distortions may occur in the representation of small-cap opportunities, potentially veiling their true characteristics.

ACTIVELY MANAGED PORTFOLIOS & ALPHA GENERATION

Investing in mega-cap companies has yielded great results, especially when its performance has been dominated by a select concentration of companies – ‘The Magnificent Seven’. However, there are opportunities to generate alpha with small-cap stocks. Many of the features that attract money towards smaller sized companies and make them a compelling investment can be best unlocked by active management.

As an example, we compare two industry standard market cap-based benchmarks, the Russell 1000 Index (Large Cap) and the Russell 2000 Index (Small Cap) to each respective universe of active managers. Benchmark percentile peer ranking indicates that it is significantly more challenging for an actively managed large-cap strategy to outperform its benchmark compared to a small-cap strategy.

The dynamics of an expansive investment universe, a significant proportion of negative earners, and limited Wall Street coverage are contributing factors that allow active managers to generate alpha.

Table 2 eVestment Universe of Active Managers – Large Cap vs. Small Cap

		<u>Large Cap Managed Fund Performance Peer Universe</u>						<u>Small Cap Managed Fund Performance Peer Universe</u>						
		<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>15-Year</u>	<u>20-Year</u>	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>15-Year</u>	<u>20-Year</u>	
5th Percentile		44.5	13.6	18.1	15.3	17.5	11.9	30.5	10.3	15.2	12.1	17.1	11.2	
25th Percentile		33.7	11.4	15.3	12.9	15.8	10.6	23.3	6.1	11.7	9.7	15.0	9.9	
Median		26.8	9.7	13.3	11.3	14.5	9.7	19.0	3.7	9.9	8.5	14.0	9.1	
75th Percentile		21.0	7.9	11.3	9.6	13.3	8.7	14.4	0.4	8.4	7.4	12.8	8.4	
95th Percentile		14.0	4.6	8.5	7.8	11.3	7.3	7.4	(6.9)	6.1	5.5	11.2	7.3	
Performance Peer Rank	R.1000	29.9	10.5	14.8	12.7	15.6	10.2	R.2000	19.7	(0.1)	8.1	7.6	12.9	8.1
		38%	35%	32%	29%	28%	38%		46%	77%	78%	72%	74%	85%

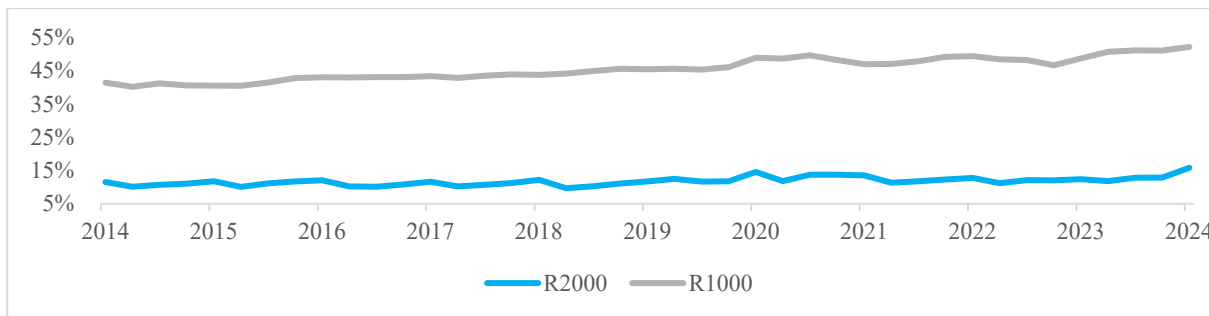
Source: eVestment – as of 3/31/24

- Investment Universe:** As we highlighted earlier, large-cap index performance is often dominated by a select few companies (the ‘M7’). Consequently, investing directly in these seven stocks has proven to be as good as, if not better than, passively buying a large-cap index.

The concentration for small-cap indexes is considerably lower and more diverse. Over the past 10 years, on average, the Russell 1000 Index had nearly half its weight in the 50 largest companies. By contrast, the Russell 2000 Index had only 10% of its weight in its top 50 holdings.

³ "Russell 2000 Index factsheet," FTSE Russell, accessed May 15, 2024, <https://www.lseg.com/ftse-russell>

Exhibit 1 Top 50 Holdings Concentration – Russell 1000 vs. Russell 2000



Source: Bloomberg

When a few successful large names dominate the index, generating alpha in a large-cap universe becomes challenging. In contrast, in a less concentrated investment space like small-caps, active managers have a larger pool of opportunities to find better investments.

- 2) **Negative Earners:** The small-cap stock universe teems with companies reporting negative earnings – a blend of fading stalwarts and budding contenders. Increased exposure to these struggling and declining entities can encumber a passive investment approach in small caps.

Active managers have the discretion to avoid these unprofitable businesses and carefully research opportunistic growers. Above all, active managers can source ideas from a broad, index-agnostic research universe and leverage accumulated, compounded knowledge of companies/sectors.

Table 3 Positive & Negative Earnings – Russell 1000 vs. Russell 2000

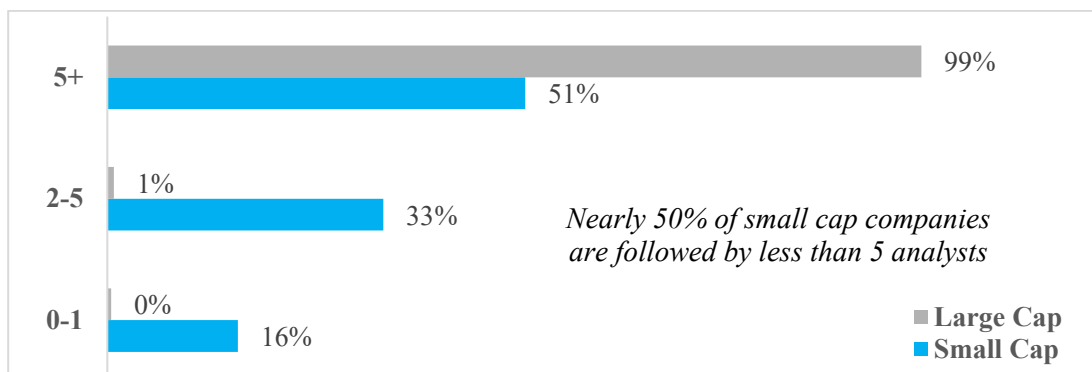
	<u>+ vs. - EPS Companies (LTM)</u>		<u>Forward P/E Ratio (NTM)</u>		
	<u>Positive EPS</u>	<u>Negative EPS</u>	<u>+/- Earnings</u>	<u>+ Earnings</u>	<u>Delta</u>
Russell 1000	842 84%	158 16%	21.1	20.8	0.3
Russell 2000	1,098 57%	839 43%	26.6	15.0	11.6

Source: Factset

- 3) **Wall Street Coverage:** An uncovered company may offer more opportunities than the general market is aware of. The lack of Wall Street coverage creates opportunities for active managers to find hidden gems.

Nearly 50% of the names in the Russell 2000 Index are covered by fewer than five analysts. In contrast, 99% of the names in the Russell 1000 Index are covered by more than five analysts. These stocks may be overlooked and 'unloved,' but more importantly, they could be significantly undervalued.

Exhibit 2 Analyst Coverage – Russell 1000 vs. Russell 2000



Source: Factset

SMALL-CAP COMPANIES BENEFIT FROM A LOWER INTEREST RATE ENVIRONMENT

Small-cap companies are poised to benefit from interest rate relief in 2024/2025. Interest rate cuts can lead to lower borrowing costs, increased consumer spending, renewed investor risk appetite, higher valuation multiples for small-cap stock and robust M&A activity.

- 1) Borrowing Costs:** Compared to larger companies, smaller companies typically face higher borrowing costs due to their higher perceived risk. Lower interest rates allow these companies to borrow at cheaper rates, reducing their cost of capital. Access to low-cost funds can help these companies finance additional investments and manage debt more efficiently, potentially leading to higher growth rates.
- 2) Consumer Spending:** Lower interest rates benefit consumers by making loans and credit more affordable, leading to increased consumer spending. This directly boosts revenues for companies. Smaller companies, being more domestically focused, are typically more sensitive to changes in local consumer behavior compared to larger multinational corporations.
- 3) Valuation Multiples:** As interest rates decline, the present value of future earnings increases due to the lower discount rate. A lower discount rate leads to higher valuation multiples for stocks. For small-cap stocks, which are generally more reliant on earnings growth, the increase in valuation multiples is even more pronounced, as a significant portion of their value is based on future growth expectations.
- 4) Investor Risk Appetite:** In a low interest rate environment, returns on fixed-income investments like bonds are lower. This often drives investors to seek higher returns in equities, including small-cap stocks, which are generally more volatile, but may offer the potential for higher returns.
- 5) Mergers & Acquisitions Activity:** After more than a year of sluggish M&A activity, the combination of declining inflation and anticipated rate cuts is expected to rejuvenate deal-making. Companies utilize M&A to stimulate growth, gain competitive advantages, or influence supply chains. Small-cap companies are natural beneficiaries of increased deal activity and are often prime targets for private equity investments.

As active managers with our Private Market Value with a Catalyst™ methodology, we believe the current environment is particularly favorable for our approach for investing in small-cap stocks. We leverage our global research capabilities to identify and purchase excellent businesses that are trading at a discount to their Private Market Value, focusing on those with catalysts in place to unlock their potential value.

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