The Argument for Small-Cap Stocks During Periods of Rising Interest Rates

By Chad Deakins & Malon Courts | July 3, 2018

At Capstone Global Investments, we bring a unique approach to building high-quality small-cap equity portfolios. As small-cap specialists, we are often asked: "How do small-cap stocks perform in a rising interest rate environment?" We have spent a considerable amount of time researching this vital question. Fortunately, we have not been alone in seeking the answer. Conventional wisdom suggests that small-cap companies are overly penalized by a rising interest rate environment, thus increasing the cost of capital upon which small companies are more dependent and leading to underperformance, compared to large-cap companies. Ironically, the historical data reveals just the opposite. Research has shown that in a Period Analysis of 10-Year Rate Changes and Performance of Broad Market Equity Indices, the Russell 2000 index of small-cap stocks outperformed the S&P 500 index by 8%. The Median return of the Russell 2000 was 16.76% vs. the S&P 500 at 8.77%. [1]

What conventional wisdom likely misses about small-cap outperformance in a rising rate environment is that higher interest rates signal a stronger and growing organic economy. If the economy is healthy, growing, and creating jobs, additional economic stimulus of lower interest rates by the Federal Reserve is not needed. Additionally, small-cap companies raise most of their capital from investors by selling equity (shares of stock), as opposed to borrowing from a bank or issuing bonds. Higher interest rates have less of a negative impact on small-cap companies than they do on larger-cap companies with more leverage as part of their capital structure.[2] Lastly, since higher interest rates signal a healthy growing economy, small-cap companies move faster than large-cap companies when bringing new products to market and are more agile when adjusting to a changing business climate. Smaller companies are less burdened by multiple layers of management, centralization, and bureaucracy than larger companies. Regardless of the interest rate environment, we cannot forget that valuation also matters. Historically and intuitively, small-cap stocks, like all stock segments, perform better when purchased at a lower valuation.

As value managers, we at Capstone believe it is always better to buy more earnings growth for less vs. buying less earnings growth for more. At Capstone, we build High-Quality Small-Cap portfolios. There are three main building blocks of our investment process, small-cap, high quality and attractive valuation. We invite you to learn more about our process at www.Capstone.Global or by contacting us directly.

References:

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Disclosures: