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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2. Thune, Kent. "When is the Best Time to Invest in Small-Cap Stocks?" *The Balance*. Updated march 21, 2018. Accessed July 20, 2018. https://www.thebalance.com/when-is-the-best-time-to-invest-in-small-cap-stocks-2466854.

Additional References:

Hugo, Ethan and Benjamin D. Tracy. "US Small Caps: Outperformers during Rising Rate Environments." *Fidelity Worldwide Investment*. March 2013. Accessed July 20, 2018. https://docplayer.net/16949588-U-s-small-caps-outperformers-during-rising-rate-environments.html

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Disclosures:

Capstone Global Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards for the period December 1, 2015 through March 31, 2018. Capstone has not been independently verified for GIPS compliance.

1. Capstone Global Investments is an independent investment adviser registered with the State of Georgia. Capstone was founded in December of 2015 and manages small-cap equity strategies. For composite reporting purposes, the Firm is defined as all equity portfolios managed by Capstone.
2. Beginning December 2015, the composite includes only (SMA) portfolios benchmarked to the Russell 2000 Small Cap Index.
3. The Capstone High Quality Small Cap Equity SMA Composite is composed of portfolios invested in US equities which have a market capitalization greater than $50 million and less than $10 billion. The investment goal is to find high quality investment opportunities that are trading at a discount to the market and have a catalyst to help propel their relative valuation up to fair value. A complete description of the composite is available on request.
4. The composite was created in January 2016. A complete list and description of firm composites and performance results are available upon request.
5. All returns are expressed in US dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
6. The primary benchmark for the Capstone High Quality Small Cap Equity composite is the Russell 2000 Small Cap Index (Net). The Russell 2000 Small Cap Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs. Index returns have been taken from published sources.
7. Gross returns presented above as supplemental information. The SMA fee includes all charges for trading costs, portfolio management, custody, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (1.00% on an annual basis, or 0.083% monthly) on a monthly basis from the gross composite monthly return. The standard fee schedule in effect is as follows: 1.00% on total assets.
8. The minimum portfolio size for the U.S. High Quality Small Cap Equity composite is seventy-five thousand dollars.
9. Past performance is not indicative of future results and no investment is guaranteed for the return of principal and/or return on investments. All information provided and used in calculations is believed to be correct, but accuracy cannot be guaranteed. Please consult with a financial professional before investing.
10. Composite dispersion is measured as the average of monthly standard deviations for the periods shown.