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SMALL CAPS | COVER

Small-Cap Stocks Are Breaking Out. Here Are 10 Investments Poised to Win.

By Avi Salzman and John Coumarianos Dec. 6, 2019 9:15 pm ET

Illustration by Bomboland

Yes, you probably know that Apple has been a hot stock, surging 70% this year and blasting past a $1 trillion valuation.

But have you heard of EverQuote? This online insurance price-comparison business has also crossed an important threshold in 2019, with its market value multiplying by eight times, to more than $1 billion.

EverQuote (ticker: EVER) and the other small-caps that make up the Russell 2000—stocks little-known to many retail investors—are now getting their turn in the sun.

That's because the small-cap index, which has frequently trailed larger indexes in recent years, has started to rally this fall. The Russell—2,017 stocks with market caps of $5 billion or below—neared another 52-week high on Friday, long after larger indexes had passed previous records. The index is up 21.2% for the year, still behind the S&P 500 index's 25.5% gain, but starting to close the gap.

And what began as "kind of a lame breakout," according to Alec Young of FTSE Russell, could become one of the dominant themes of 2020.

For investors, the question of whether to ride the Russell rally comes down to their opinions on the economy. Buying a small-cap index now is a bullish bet on global growth.

"I think small is primed to outperform as the economy and earnings improve in 2020," says Jefferies equity strategist Steven DeSanctis. "That's going to be the whole ballgame." Jefferies sees the Russell rising to 1750 in 2020, a 7% gain.

Economic recoveries "tend to be the best phase for small-caps," says Jill Carey Hall, an equity and quant strategist at Bank of America Merrill Lynch. "That's one key reason we think we could be poised for a shift from large to small." Small-cap outperformance is one of Bank of America's biggest bullish predictions for 2020, strategists there said this past week.

Small-cap stocks will get creamed in a recession. But if the economy accelerates—which some recent data suggest is possible —they probably will rise more than the S&P 500.

For investors who think the economy will indeed speed up, the iShares Russell 2000 exchange-traded fund (IWM) allows for a broad bet on small-caps. Buying that benchmark, however, means betting heavily on financials and money-losing biotech stocks, which have a larger weighting in that index than in the S&P 500.

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To avoid some of that risk, investors can play a possible small-cap revival by purchasing individual stocks, as well as funds led by managers who have a record of outperforming. (Below, we identify three actively managed funds and two index funds, as well as five stocks.) That way, they might have a better chance of buying the next Apple when it's still just two guys tinkering in a California garage.

Small-cap stocks differ from large-caps in several ways, aside from being smaller, of course. They are more likely to make more of their money in the U.S. than large-caps, with only 21% of revenue from overseas, versus 33% for their bigger brethren.

And the Russell 2000 has a very different mix of sector exposure than the large-cap indexes. While the S&P 500's largest sector is technology, at 23%, the Russell's biggest is financial services, at 26%, with tech making up only 12%. When interest rates are falling—as they have been for much of this year—financial-services stocks tend to struggle because they can't make as much money on their capital.

That sector mix has played out poorly for small-caps this year. Earnings per share for the Russell 2000 have fallen 2.5% this year, according to Citigroup—meaning that all of the group's gains, and then some, have come from the expansion of multiples.

Going Big on Small Stocks

A sampling of small stocks.

Company / Ticker	Recent Price	Market Value (bil)	YTD Change	Forward P/E	Dividend Yield
Darling Ingredients / DAR	$23.66	$3.90	23%	28.5	None
Compass Diversified Holdings / CODI	23.43	1.4	88	19.9	6.10%
Qualys / QLYS	85.77	3.3	15	35.5	None
Lincoln Electric Holdings / LECO	91.85	5.6	16	18.7	2.10%
Hannon Armstrong Sus. Infra. Cap. / HASI	29.26	1.9	54	20.3	4.60%

Data as of Dec. 5

Source: Bloomberg

Worse yet, a larger-than-usual number of small companies are in the red. Over the past year, 26% of small-caps have reported losses, three percentage points higher than at the start of the year.

The Russell 2000 includes a large number of biotech firms that haven't turned a profit because their products are not yet on the market. Biotech's percentage of the index stands at 8.7%, up from 4% in 2009. In comparison, biotech makes up just 2.1% of the S&P 500.

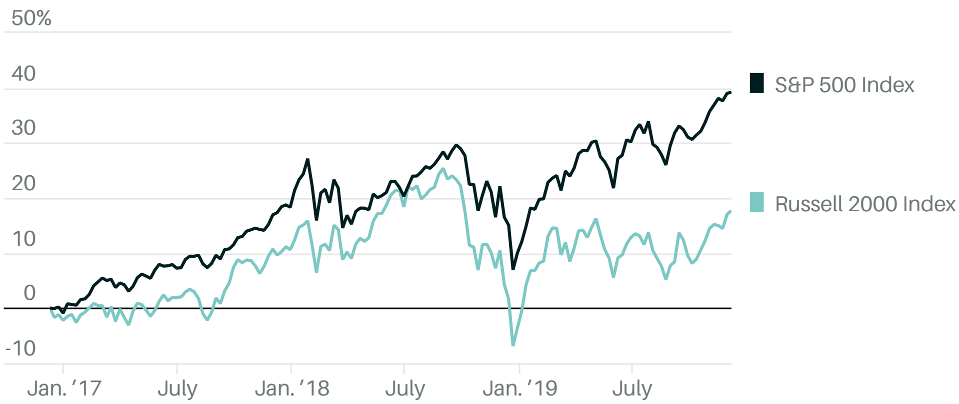
Small-cap valuation is tricky to pinpoint, because forward-looking data tend to vary widely, based on the source. The stocks are not covered by many analysts, and future earnings for start-ups are harder to pinpoint than they are for established companies. After some adjustments, Bank of America Merrill Lynch says that analysts expect earnings to grow by about 14% in 2020, while I/B/E/S estimates from Refinitiv say the bottom-up consensus is for 37% growth, although this is likely to change. "No serious investor takes these numbers seriously in December," FTSE Russell's Young says. "They are going to go down."

Valuations are similarly inexact, with Bank of America saying the Russell trades at 16 times forward earnings expectations, while Jefferies says it fetches 20.9 times.

Davids vs. Goliaths

A year ago, the small-cap Russell 2000 fell more sharply than the large-cap S&P 500, but the small-cap index has hit a 52-week high this past week. Will that be enough to close the gap?

S&P and Russell 2000



Source: FactSet

In general, the index isn't cheap on an absolute basis. Steven Scruggs, manager of the Queens Road Small Cap Value fund (QRSVX), says it has 18% of its assets in cash, "due to valuations not being attractive enough for us."

Nonetheless, both Jefferies and Bank of America believe that the Russell looks inexpensive on a relative basis, based on the spread between its valuation and those of the S&P 500 and other large-cap indexes. At a time when "nothing in the market looks cheap," small-caps are relatively inexpensive, Jefferies' DeSanctis says.

By Carey Hall's estimates, small-caps are at a 17-year valuation low in relation to large-caps. "Small-caps are historically very inexpensive relative to large-caps, even though both are trading above their own histories," she says.

During economic recoveries like the one that Bank of America expects to see in the coming months, small-caps outpace large-caps 90% of the time. And they tend to do best in the period from November to March.

A bet on small-caps is never so straightforward. For those looking to make a more targeted investment, several mutual funds run by experienced managers and ETFs offer a way in. Here are some to consider:

"Small-caps are historically very inexpensive

Brown Capital Management Small Company (BCSIX)

A technology-heavy small-cap fund, Brown Capital Management Small Company has posted a 16.9% annualized return for the 10-year period ending in November. That compares well with the 12.4% annualized return of the Russell 2000.

The six-person management team, led by Keith Lee, focuses on companies with $250 million or less in operating revenue and with durable competitive advantages. The fund takes concentrated bets—it holds 38 stocks—and does not sell often, with a turnover rate of just 17%. Technology stocks account for 60% of the portfolio; 90% is tech and health care.

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—Jill Carey Hall, Bank of America

iShares Core S&P Small-Cap (IJR)

For those interested in making a broader bet, with lower fees, the iShares Core S&P Small Cap ETF could be appealing. It tracks the S&P SmallCap 600 Index, which has outpaced the Russell 2000. The fund has delivered a 13.9% annualized return for the 10 years through November, while the Russell 2000 index has returned 12.4% over that period. Its expense ratio clocks in at a pleasing 0.07%.

Inside the Russell 2000

10 Best Performers

Company / Ticker	YTD Change
Axsome Therapeutics / AXSM	1581.90%
Constellation Pharmaceuticals / CNST	1047.1
Kodiak Sciences / KOD	933.9
EverQuote / EVER	789
Cardlytics / CDLX	490.4
Arrowhead Pharmaceuticals / ARWR	435.1
Enphase Energy / ENPH	413.1
Conformis / CFMS	377.7
Digital Turbine / APPS	351.4
Medicines Co. / MDCO	339.2

Data as of Dec. 4

Source: Bloomberg

10 Worst Performers

Company / Ticker	YTD Change
Waitr Holdings / WTRH	-95.4%
LSC Communications / LKSD	-94.8
Unit Corp. / UNT	-93.9
Exela Technologies / XELA	-92.8
Tocagen / TOCA	-92.3
TransEnterix / TRXC	-91.6
Phunware / PHUN	-91.3
Contura Energy / CTRA	-91.0
Mammoth Energy Services / TUSK	-90.6
Seadrill / SDRL	-88.6

Data as of Dec. 4

Source: Bloomberg

The S&P Index is arranged by a committee. It avoids initial public offerings and picks only companies that have been profitable in the past year. That gives it a slight quality tilt that has helped it outperform. It has less health-care exposure than the broader small-cap universe (13% versus 18%), but more consumer-discretionary exposure (14% versus 13%).

Vanguard Small Cap Index (VSMAX)

Vanguard's Admiral share class of its Small Cap Index fund has delivered a full percentage point of annualized outperformance (13.4% versus 12.4%) over the Russell 2000 index over the past decade. It requires a $3,000 minimum investment and carries a rock-bottom 0.05% expense ratio. This fund has 27% in financials and 21% in industrials. It could be a bit more sensitive to the short-term twists and turns of the economy as a result.

Royce Special Equity (RYSEX)

Charles Dreifus has been at the helm of this deep-value small-cap fund for more than two decades. Dreifus is an accounting stickler who, following Benjamin Graham, demands clean balance sheets and a margin of safety in the price he pays for stocks. That can cause him to hold dry powder sometimes, and the fund currently has nearly 20% of its assets in cash. The strategy tends to hold up well in bear markets, and do well enough in bull markets that long-term returns are solid. The fund has looked sleepy over the past decade, with a 9% annualized return, versus 12.4% for the Russell 2000. But for the 20-year period, Dreifus has delivered a 10% annualized return, versus 8% for the index, and with less volatility, too.

Dreifus avoids financials and prefers industrial companies. He has bought defense and kitchen-appliance maker National Presto Industries (NPK), a company that Graham himself mentioned in *The Intelligent Investor,* at various times when Dreifus has deemed it cheap enough. Steven McBoyle became a co-manager of the fund in late 2014.

Janus Henderson Small Cap Value (JSCVX)

This fund is run by Perkins Investment Management, a subsidiary of Janus Henderson Group with a long history of investing in small-value and mid-value companies. Like Royce Special Equity, this fund has lagged behind the Russell 2000 index during the decade, but over 15 years, it has delivered an 8.6% annualized return, compared with 7.9% for the index.

The fund has nearly a third of its portfolio in financials now, so it isn't afraid to make significant sector bets. Among its top holdings are property-casualty insurer Hanover Insurance Group (THG), and Equity Commonwealth (EQC), a real estate investment trust focused on offices.

For investors interested in picking individual stocks with the potential to ride a small-cap rally—and benefit from their own distinct attributes—here are five that have received positive attention from some investors and analysts.

Darling Ingredients (DAR)

This company recycles what other businesses consider waste—including restaurant grease and animal carcasses. Darling transforms the products into useful items and sells them as fertilizer, biofuel, and other products. "There are a lot of incentives to do that, both tax credits and market incentives that are requiring companies to buy this," says Scruggs, the portfolio manager at Queens Road Small Cap Value, which owns a stake. Darling's earnings are set to jump nearly 50% next year, making its forward price/earnings ratio of 28 times look reasonable. And Darling is teaming up with the large refiner Valero Energy (VLO) on some biodiesel initiatives that could vault profits even higher in the years ahead.

Compass Diversified Holdings (CODI)

Compass gives investors a way to play a variety of industries, and it pays a substantial dividend. It is a holding company that works like a private-equity firm, buying small and midsize companies, improving them, and then selling or spinning them off. Among its current subsidiaries are manufacturers of baby carriers, circuit boards, and food-warming devices for restaurants. With big gains in 2019, the stock trades at a forward multiple of 19.9 times and has a 6.1% dividend yield.

Funds That Think Small

A sampling of small caps funds.

Fund / Ticker	YTD Return	10-Year Annualized Return	Prospectus Net Expense Ratio
Brown Capital Mgmt Small Co. / BCSIX	32.20%	16.90%	1.26%
iShares Core S&P Small-Cap / IJR	19.2	13.9	0.07
Vanguard Small Cap Index / VSMAX	24.6	13.4	0.05
Royce Special Equity / RYSEX	10.1	9	1.18
Janus Henderson Small Cap Val / JSCVX	22.4	10.4	0.92
Russell 2000 Index	22	12.4	

Returns through Nov. 29

Source: Morningstar Direct

Qualys (QLYS)

This cybersecurity company protects large business networks, with a particular focus on cloud computing. "The revenue is 98% recurring," says Randy Gwirtzman, whose Baron Discovery fund (BDFFX) owns the stock. "It's got nice steady growth; it's very high-margin." The company's price/earnings multiple of 35 times might look rich, but it is below its historical average as well as other cybersecurity stocks like Palo Alto Networks (PANW). Gwirtzman thinks it could double in the next few years.

Lincoln Electric Holdings (LECO)

This industrial company specializes in products related to welding. It also has a growing business in automation, an area that is likely to accelerate in the coming years. "We believe the long-term demand profile for automation remains in place, as customers look to increase productivity and struggle with a lack of skilled labor," wrote Jefferies analyst Saree Boroditsky, who rates the shares a Buy, with a $105 price target. For investors looking to profit off a global economic rebound, Lincoln is the kind of cyclical company that should benefit.

Hannon Armstrong Sustainable Infrastructure Capital (HASI)

Hannon is a real estate investment trust that finances alternative energy projects, buying both equity and debt. The company's results should benefit from continued government support for alternative energy. Hannon has made more investments in residential solar projects as that industry continues to grow. It isn't boosting earnings very quickly, but its 4.6% dividend yield is particularly strong for a small-cap. Oppenheimer analyst Noah Kaye notes that the company has a "track record of earnings and dividend growth," and sees the shares rising to $35 from a recent $29.

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