

Mitch on the Markets

Should Your Portfolio Weight to Small-Cap Stocks?



By Mitch Zacks
Portfolio Manager

Small cap stocks have been on a tear in 2016. As of this writing, the Russell 2000 Growth Index (as measured by the ETF ticker: IWO) is up over +6% for the year, while the Russell 2000 Value Index (ETF ticker: IWN) is up close to +12%. Compare that to the S&P 500 Index's +5% year-to-date rise, and you see a pretty wide performance gap.

Historically, small-cap stocks have tended to outperform very early-on in economic expansion cycles, as capital and liquidity return to the marketplace. Since small-cap stocks are more sensitive to shifts in demand, even an incremental rebound can mean a big impact on earnings. For the same reason, small caps tend to underperform larger cap stocks late in economic cycles and during recessions.

With this economic cycle in its 8th year, it is curious that small cap stocks would be outperforming now. Economic growth in the U.S. and other developed markets (like

Europe and Japan) has been middling at best, and there are few signs of growth acceleration in the works.

So what gives? The answer, I believe, is one that we encounter often in equity investing: *reality is exceeding expectations.*

The U.S. Economy: Not as Bad as Everyone Thought

Generally speaking, economists and analysts are not optimistic about the U.S. economy now or at any time this year. In the wake of the commodities slide and with campaign season in full swing, it's been in vogue to think of the economy as in dire need of fixing. That has created a very dour, pessimistic set of *expectations.*

Enter reality: stabilizing crude oil prices, firming wages, rising personal incomes, (close to) full employment, improving consumer balance sheets, rising home prices, and steadily positive consumer confidence, amongst others. I'm not arguing that the economy is in its healthiest shape, it certainly isn't. I'm arguing that the economy is in much better shape than most expected it to be,

and that's what it takes to move stock prices.

Small-caps appear to be benefiting the most from this 'perception gap,' probably because there is a market expectation that the economy could accelerate going into the back half of the year. I wouldn't bet against it.

Does this mean you should go out and completely re-allocate your portfolio to heavily weight small cap stocks? Not necessarily. How much small cap exposure you have in your portfolio depends on your risk tolerance and your long-term objectives. But at Zacks Investment Management we believe almost all portfolios with equity allocations should have at least some small cap exposure, and in a year like 2016, it could have made a positive difference.

Introducing Two New Zacks Small Cap Strategies

We're pleased to be rolling out two new small-cap strategies here at Zacks Investment Management (ZIM). One is focused on small-cap growth stocks and the other on small-cap value stocks. Relatively speaking, we're looking to outperform the Russell 2000 Growth and the Russell 2000 Value. It's our belief we can do so by applying similar rules and approaches that we do across other ZIM strategies, where we have track records of outperforming over longer stretches of time.

The small-cap space is unique, in that

some of the anomalies that exist—like the price/book value quality measures—tend to work better and more consistently than they do in the large cap world. By applying these and other valuation factors and analyzing short interest relative to shares outstanding, we assign each of the 2,000 stocks a Zacks rank and further optimize it to determine which ones end up on our buy and sell lists. This approach has served us well in our testing of the strategy as well as in other strategies, and we're confident it will generate attractive long-term results for our clients. As a portion of an overall portfolio, exposure to small cap value and/or small cap growth can potentially create better risk/return positioning.

Bottom Line for Investors

The resurgence of small-cap performance this year, in my view, speaks to the underlying resilience of the U.S. economy and signifies a low risk of recession for 2016. It's not important for investors to know exactly when small-cap stocks are going to outperform, or for how long. What's important is having exposure to small-caps in your portfolio so you can participate in the upside when it happens. That's why I titled this article, "Should Your Portfolio Weight to Small Cap Stocks?" It makes sense to check.

-Mitch

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.



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