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FINDING OPPORTUNITY

In the Small vs. Large Cap Valuation Disparity

Nancy Prial, CFA
Co-CEO
Senior Portfolio Manager

In the current investment environment, it is rare to go more than a few days without reading or hearing about the significant current valuation differential between small cap and large cap stocks. The conversation surrounding this topic is not just market chatter. Perhaps the biggest "takeaway" from this discrepancy is that experienced investors know there is solid evidence and historical data documenting the unique opportunities offered by exploitation of this dynamic.

How does the market define 'small' vs. 'large' capitalization?

First, it is essential to clarify what we mean by small cap and large cap. Typically, 'small cap' companies have a market capitalization between $300 million and $2 billion, while 'large cap' companies usually boast a market capitalization of over $10 billion.

The Stark Contrast: Russell 2000 vs. One Mega-Cap Company

To understand the scale of the difference, consider this: The entire Russell 2000, an index representing 2,000 small-cap companies, has a market capitalization comparable to that of one single mega-cap company. Companies like Apple or Amazon, each individually, have market caps that rival the collective value of these 2,000 small companies. This comparison illustrates the vast disparity in valuation and attention between the giants of the industry and their smaller counterparts.

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Historical Evidence for profiting from the Anomaly

At specific points in market history, when the valuation disparity between small and large caps has been this extreme, small caps have gone on to significantly outperform large caps in the subsequent years:

- For instance, during the late 1970s, small caps were glaringly "cheaper" compared to large caps. This period was followed by the 1980s, where small caps experienced a significant bull run, outperforming their larger peers by a wide margin.
- Similarly, in the early 2000s, after the dot-com bubble burst, many large cap tech companies experienced steep declines. Small caps, which were less involved in the bubble, rebounded faster and posted superior returns over the next several years.investments.

What causes these valuation irregularities?

Several factors contribute to these variances. Large caps, due to their visibility and significant weight in indexes, often become the primary focus of institutional investors and the media. When market sentiment is strongly positive, these giants can get overvalued, leading to potential underperformance when corrections occur.

Small caps, on the other hand, might be overlooked and under-researched. This lack of attention can lead to mispricing opportunities. When investors recognize these opportunities, a rush to buy can result in substantial gains for those holding small-cap stocks.

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How investors can exploit this opportunity and minimize risk

For the investor, recognizing such valuation discrepancies can be a potential goldmine. However, it is essential to approach this space with care:

1. **Diversification:** While small caps can offer impressive returns, they also come with increased volatility. Diversifying your portfolio can mitigate potential risks.

2. **Research:** Not all small caps have enormous potential. It is crucial to research and select companies with solid fundamentals.

3. **Patience:** Historically, after extreme valuation disparities, small caps have outperformed, but this outperformance may not be immediate. Patience can be an asset in such scenarios.

Conclusion

While the valuation differential between small and large caps is an intriguing aspect of the financial landscape, it is also a potential indicator of future market dynamics. By understanding and leveraging this information, informed investors can make thoughtful decisions and potentially reap significant rewards.

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