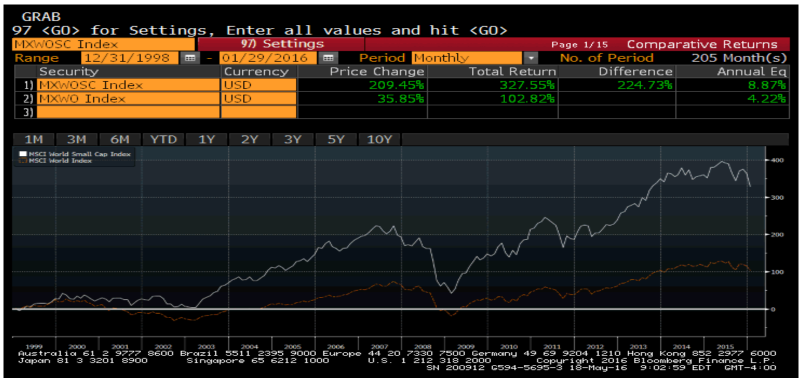
COMMENTARY

May 20, 2016

Dear clients and colleagues,

Common wisdom says that large cap stocks are safer than small cap stocks. What do the facts tell us?

Small caps perform better in up and down markets



Source: Bloomberg

For the last 17 years, going back to the late 1990s before the tech crash, global small caps have outperformed their larger peers by over 4% annualized. Were they more risky?

Source: Bloomberg

During the tech crash of 2000-2001, large caps dropped a lot more than small caps.

During the global financial crisis of 2008-2009, small caps dropped about the same as large caps, but rebounded much more quickly.

Source: Bloomberg

In fact, in 3 of the last 5 large down markets, small caps performed better than large caps. So the outperformance of small caps is not achieved by taking on more risk. Why? Mega cap bubbles and banking crises often lead to market corrections. Small cap indices are much more diversified. The biggest weight in a single stock in the MSCI World Small Cap Index is 0.17%, and while banks make up over 20% of large cap indices, they account for less than 5% of small cap indices.

At present, global small caps are selling at a hefty discount to large caps on a price to sale basis, 1x sales for small cap versus 1.45x for large cap, a 30% discount despite their faster growth. In the US, the discount is even more pronounced. Large caps (S&P500) are selling at 1.8x sales versus small caps (Russell2000) at 1.1x sales. This is the largest discount seen since 2003.

Some of the reasons given for this are: the massive inflows into passive index strategies, which favour the mega caps; many large cap managers use a barbell strategy to overweight the mega cap tech sector, which has high multiples (Facebook, Amazon, Netflix, Google, Microsoft); and buying consumer staples (P&G, Kellogg, Campbell Soup, etc.) deemed safe but which are now at their highest valuation on record.

This gap is not justified as large cap US multinationals have had no sales growth for approximately 2 years, whereas the small caps have had double-digit sales growth.

This market resembles the Nifty Fifty of the 1970s or the tech bubble of the late 1990s. Both of these were followed by the biggest period of outperformance for small caps.

Big headwinds for large cap multinationals. Buyers beware

Not only do we think large caps are overpriced, we also believe investors are underestimating the challenges they face, and this will depress future earnings. Small caps will face these same challenges; however, the impact will be a lot less severe.

Higher taxes for multinationals

The first major headwind large multinationals are facing is higher taxes. Globally, the blended statutory tax rate is around 30%, and the effective tax rate paid by large multinationals is around 20%, but it will go higher! For example, Australia is raising hundreds of millions of dollars from 1,000 multinational companies by adjusting the rules for taxing profits made in Australia but accounted for overseas. In the UK, who has not heard of the Google or Starbucks tax? In the US, the recent Pfizer-Allergan tax inversion deal was blocked. Last year an agreement was reached on how to reform the world's corporate tax system. Sixty countries representing 90% of the world's economy agreed to a detailed package of reforms, drawn up by the OECD, which they promised would curb the worst excesses of tax avoidance by multinationals.

More regulations

In its last fiscal quarter, Goldman Sachs, the most profitable investment bank historically, saw ROE in the low teens — it used to be above 25%. In fact, last year the world's top investment banks managed a return on equity of 6.7%, below their cost of capital. Companies in the wider banking group have seen their ROEs drop too. For example, JP Morgan had an ROE of 13% last year. Banks are facing more regulations, from governance and risk management to stress testing. They also have to deal with higher capital ratios, consumer protectionism, cyber threats and FinTech threats. Costs are rising, balance sheets are shrinking, and capital is raised. All this will impact earnings. As mentioned, banks are around 20% of large cap indices, but less than 5% of small cap indices.

Another sector that will face increased regulation is the pharmaceutical sector. Health care is the largest government expense for many countries, and with an aging population, it will only get worse. Drug pricing is out of control and is not facing increasing scrutiny. For example, a popular skin medication that sells for 9 Euros in France is billed at US$250 to insurers in the US. Large pharm makes up 15%-20% of large cap indices.

So we have 30%-40% of large cap indices that will have little or no profit growth going forward.

Pension deficits

Aon Hewitt estimates that the funded status of S&P500 companies' defined benefit pension plans is currently at 77%, a shortfall of US$477 Billion. According to Mercer, in the UK the pension deficit of FTSE350 companies was £92B at the end of May 2015. Japan is in no better shape.

Last February, GM announced a $2B debt issue to fund its DB pension plan. International Paper, AT&T and many more did the same in 2015. All that money is not financing growth. Also, many companies have a pension fund greater than their market cap. BHS, one of largest UK retailers, declared bankruptcy last week, dragged down by its pension fund. A recent annual survey from CFO Research and Prudential underscores the importance of funding pension plans and reveals many companies are increasing contributions to close their funding gaps. Sixty-four percent of survey respondents reported that their companies have either already increased contributions (15%) or are likely to do so within two years (49%). Again, this will depress earnings.

In conclusion, despite evidence of higher risk-adjusted returns historically, the risk of passive investing driving mega caps valuations higher and the lower future growth rate for large caps, we still see many investors hesitating over small caps. We hope this update will be insightful and useful.

Have a good week,

The Global Alpha Team