BELOW THE SURFACE – SMALL CAP ROTATION HAS STARTED

With many global stock markets hitting all-time highs, investors feel optimistic despite the negative news of rising daily COVID-19 cases. To better understand what is happening, we need to look below the surface to see how professional investors position their portfolios.

Since the stock market low on March 23rd, global markets have moved higher, led by large technology companies that benefit from the pandemic. Technology sector returns are led by the FAANG (Facebook, Amazon, Apple, Netflix, and Google) stocks in the U.S. and Shopify in Canada. These are all companies that benefit from the stay/shop/work from home economy.

In November, we saw the start of a significant rotation by investors. There were three major vaccine candidate announcements by Pfizer/Biotech, Moderna, and AstraZeneca. As expected, global stock markets rallied on each announcement day. However, looking under the headline market rally each day tells us a different story. Over those three days on average, the S&P 500 Index was up 0.97%, while the U.S. small cap index (as measured by the Russell 2000 Index) was up 2.64% or 2.7 times more. From November 1st to 27th, the Russell 2000 Index was up 21% while the S&P 500 Index was up 11%.

For our analysis, we are using the US Russell 2000 Index as our proxy for small cap stocks, rather than the S&P/TSX Small Cap Index, for a few reasons:

1. The S&P/TSX Small Cap Index is heavily weighted towards resource stocks (about 40%).
2. The U.S. small cap index has been in existence longer, so we can examine longer-term performance.
3. In terms of investing style or sector rotation, what happens in the U.S. stock market typically occurs globally.

So why are professional investors rotating into small cap companies?

- Investors are looking out over the next 12-24 months since the quicker a vaccine gets approved and rolled out, the faster the domestic economy can get back to pre-COVID-19 levels and resume its growth trajectory.
- A stronger U.S. and Canadian economy will favour small cap companies since they have more domestic exposure than large cap companies with more global exposure.
- Small cap stocks are trading at lower valuations than large cap companies. Also, smaller companies have room for earnings growth, which are expected to lead to higher valuations and faster stock price capital appreciation.
- Globally, year to date, small cap stock returns have significantly lagged their large cap peers; thus, investors are trimming their winners and buying the laggards.

- According to Citigroup's research, the Russell 2000 Index's average return is 15% in the year after a presidential election since 1980. This is about four percentage points better, on average, than large-cap stocks.
- U.S. data since 1932 shows after a bear market low (defined as a stock market correction of 20% or more), small cap stocks have the probability of outperforming large cap stocks by 87% and 67% on a one and two-year basis, respectively. See the table below:

US Equities: Total Return Performance Post Bear Markets

Bear Market -	Return Year-1		Return Year-2	
End Date	Large Caps	Small Caps	Large Caps	Small Caps
Jun-32	162%	316%	-7%	2%
Mar-35	84%	143%	24%	44%
Apr-42	61%	148%	7%	16%
Jun-49	35%	35%	28%	30%
Oct-57	31%	47%	16%	19%
Jun-62	31%	31%	22%	19%
Oct-66	21%	75%	14%	39%
May-70	35%	43%	13%	8%
Oct-74	26%	33%	20%	37%
Mar-78	20%	29%	6%	7%
Aug-82	44%	73%	6%	-6%
Dec-87	17%	25%	32%	16%
Oct-90	33%	59%	10%	9%
Oct-02	21%	43%	9%	12%
Mar-09	50%	63%	16%	26%
Average	***45%***	***78%***	***14%***	***19%***
Prob. of outperformance		***87%***		***67%***

Source: Scotiabank GBM Portfolio Strategy, Morningstar, Shiller.

Bottom Line

We believe that small cap companies will outperform large cap companies over the next 12-18 months, and therefore investors should have exposure to a diversified small cap portfolio. Over the last month, in Matco client portfolios, we have increased small cap exposure: First, we have increased the Matco Small Cap Fund weight within the Matco Balanced Fund. Second, we have increased exposure to U.S. small cap stocks within the Matco Global Equity Fund.

The Matco Small Cap Fund remains well-diversified across sectors and has a dividend yield of 4.3% (as of November 26th). On a Fund holding level, approximately 34% of our portfolio companies' revenues come from outside Canada; consequently, the Fund is in a position to benefit from a stronger Canadian and U.S. economy in 2021.

Please contact me if you have questions about the Matco Small Cap Fund or the Matco Canadian Equity Income Fund.

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Our mission is to simplify the investment world for our clients by understanding their needs and providing exceptional investment solutions that preserve and grow capital.

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