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ALLIANCEBERNSTEIN®

CATCHING STARDUST

FINDING SMALLER STOCKS THAT CAN SHINE

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IN THIS PAPER: Smaller stocks offer diversification benefits and investment opportunities that can't be found in their larger brethren. But because large-cap stocks have been so popular for the last 10 years, many investors have missed out on the compelling stories and advantages smaller companies can provide. Our research aims to shine some light on the universe of smaller stocks by examining their perceived risks, performance drivers and return potential—particularly amid a recovery from the COVID-19 pandemic and recession. The time is right for investors to consider smaller investments that have the potential to sparkle.

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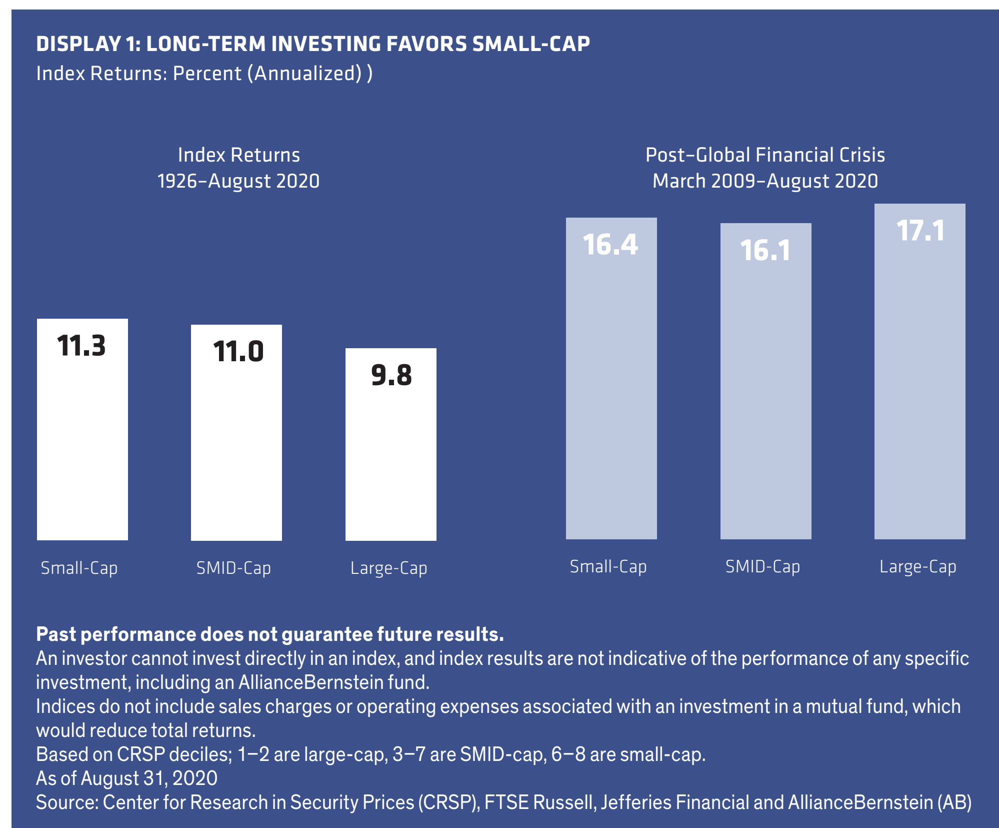
EXPLORING THE SMALL STAR UNIVERSE

Smaller stocks seem to have gotten lost in the US market's fascination with its giant stars. After all, when Apple and Microsoft combined are worth more than all 2,000 stocks in the small-cap index, it's hard to see the miniature companies that look like specks of dust in the equity investing universe.

But every small company is a world in and of itself. And ignoring smaller stocks is a big mistake, in our view. Small- and SMID-cap stocks can offer investors distinct advantages, such as powerful growth drivers, innovative businesses, compelling company-level improvements and attractive valuations. What's more, smaller companies aren't nearly as risky as widely perceived. When carefully selected with a disciplined investing process, we believe a portfolio of smaller stocks can offer strong long-term return potential—especially in today's environment.



DISPLAY 1: LONG-TERM INVESTING FAVORS SMALL-CAP
Index Returns: Percent (Annualized))

Past performance does not guarantee future results.
An investor cannot invest directly in an index, and index results are not indicative of the performance of any specific investment, including an AllianceBernstein fund.
Indices do not include sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
Based on CRSP deciles; 1–2 are large-cap, 3–7 are SMID-cap, 6–8 are small-cap.
As of August 31, 2020
Source: Center for Research in Security Prices (CRSP), FTSE Russell, Jefferies Financial and AllianceBernstein (AB)

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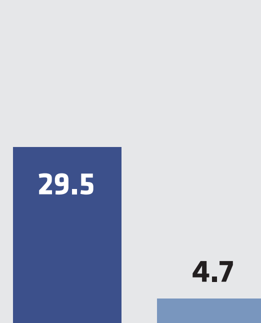
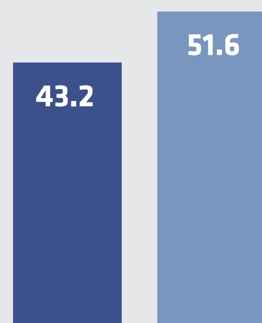
WHAT'S BEHIND THE SMALL-CAP MALAISE?

Performance patterns of smaller stocks can at times be difficult to explain, particularly over shorter time frames. Over the long run, however, smaller-capitalization stocks have delivered an annualized return of about 11%, outperforming their larger cohorts by at least 120 basis points a year on average (*Display 1, previous page*). While that doesn't sound like much of a difference, consider this: $100 invested in each of the three indices in 1926 would now be worth $2.3 million from small-cap, $1.8 million from SMID-cap and $0.7 million from large-cap.

But since 2008, market currents have shifted. Investment trends have favored larger-cap stocks, at least temporarily, while investors sought safety from the below-trend economic recovery following the global financial crisis (GFC), and now the COVID-19-induced recession. During market crises, investors tend to shun smaller stocks because they're widely perceived as riskier than their larger peers.

DISPLAY 2: SMALL-CAPS AREN'T AS VULNERABLE AS PERCEIVED





● Small-Cap ● Large-Cap

Current analysis does not guarantee future results.
Small-Caps represented by the Russell 2000 Index. Large-caps represented by the Russell 1000 Index.
As of August 31, 2020
Source: FactSet, FTSE Russell, Jefferies Financial and AB

Smaller-cap stock prices are more volatile than those of larger-caps, but this added volatility can create opportunity. Lower trading liquidity for small-caps can lead to inefficiencies and fundamental mispricing, especially in market crises. Trading liquidity is often a function of investor interest, and lesser-known investment stories are often overlooked in favor of larger, better-known entities such as mega-cap technology companies.

Those large-cap technology stocks have reshaped global equity markets this year as their prices and market caps rocketed skyward. While these companies have captured investors' attention and dollars, we believe that their rise makes the case for diversification across asset classes, such as smaller-caps, even stronger.

Lower technology exposure may be another reason for smaller-cap's relative malaise. The weight of the in-demand technology sector in the Russell 2000 small-cap index is less than half that of large-cap indices. By comparison, smaller companies have greater exposure to more economically cyclical sectors such as financials, real estate and industrials.

LESS RISKY THAN YOU MIGHT THINK

Beyond price volatility, smaller companies are considered riskier because they are believed to have less access to funding, financial stability and managerial depth than larger firms. They also usually lack the diversification of larger-cap firms, making their revenues more vulnerable to downturns. And 29.5% of Russell 2000 companies aren't profitable, versus 4.7% of Russell 1000 companies (*Display 2, left*).

Yet many smaller companies don't fit that stereotype. In fact, US small-caps have lower debt levels than US large-caps (*Display 2, right*). With the evolution of capital markets, smaller companies have greater access to capital and debt funding than they have ever had historically—even in a crunch. In many cases, smaller companies are unprofitable by choice because they're investing in research and development to fuel future growth.

For example, early-stage biotech companies make up 13% of the Russell 2000 and account for most of the unprofitable companies in the benchmark; many have no revenues or earnings because they're focused exclusively on developing new therapeutics for future growth.

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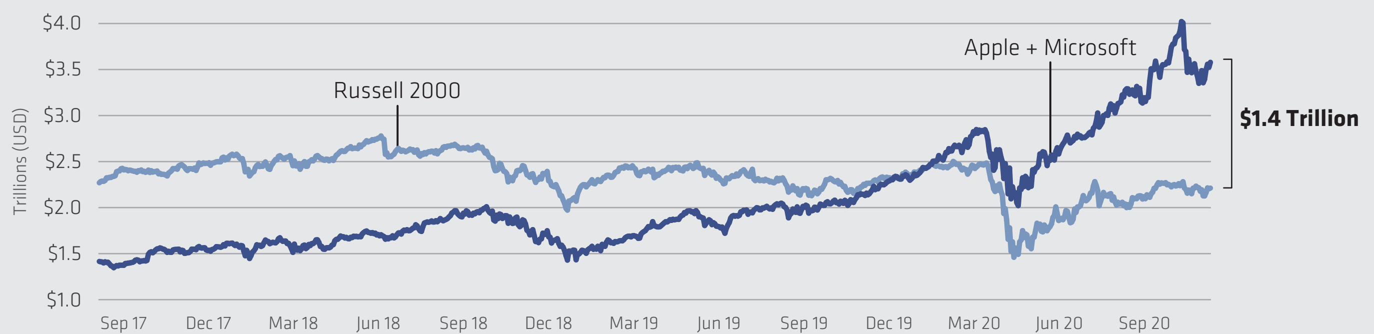
DISPLAY 3: THE $1.4 TRILLION SMOKE SCREEN: SMALLER-CAPS ARE WHERE THE FUTURE GIANTS ARE HIDING



Current analysis does not guarantee future results.
As of September 30, 2020
Source: Bloomberg, FTSE Russell and AB

SMALLER STOCKS MAKE BIGGER SPLASHES

So why have large-caps been so popular over the last decade? Governmental policies, global quantitative easing and even the rise of passive investing have fueled large-cap gains. Today it's as if the laws of physics have been suspended: the largest companies keep getting larger, like trees growing to the sky.

But the laws of physics aren't simply suggestions—they are laws. For example, the largest animals in the jungle aren't always the mightiest. Elephants are big and strong, capable of carrying 130 humans or up to 1.5 times their body weight. But the mighty ant can carry up to 5,000 times its body weight. Which offers the better long-term return: the big lumbering elephant or the tiny but relatively stronger ant? The largest targets are also easiest to take down. As we've seen in previous market bubbles, some of the elephants are eventually taken out by smaller, more nimble new products and competitors that undercut older business models and products.

Some of the largest US companies have made a pretty big splash year to date. For example, Amazon, one of the five largest companies in the S&P 500, has returned an incredible 70% through September 30, 2020. And by that day, the combined market cap of just Apple and Microsoft was $1.4 trillion greater than that of the entire Russell 2000 small-cap index (*Display 3*).

DISPLAY 4: MORE OPPORTUNITIES FOR EXPLOSIVE RETURNS IN SMALL-CAP STOCKS

Number of Stocks Returning More than 100%
Jan–Sep 2020

Past performance does not guarantee future results.
As of September 30, 2020
Source: Bloomberg, FTSE Russell, S&P and AB

The best-returning S&P stock, Etsy, was up 175% through the end of September. But only two S&P 500 stocks have returned over 100% so far this year. Smaller-caps have made bigger splashes—85 companies in the Russell 2000 have surged by over 100% (*Display 4*), and three of those returned over 1000%.

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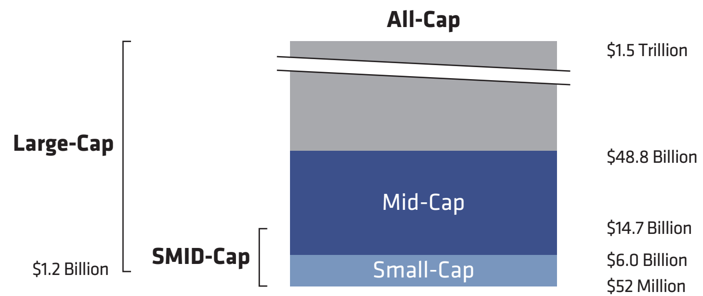
DEFINING THE MARKET

How do we define small- and SMID-cap stocks? We eliminate stocks that are too small to be considered investable by institutions—currently those under a $52 million market cap—and limit the small-cap universe to stocks under a $6 billion market cap. SMID-cap incorporates all small-cap stocks as well as the smallest third of the mid-cap universe, topping out at $14.7 billion.

DEFINING THE CONTOURS OF SMALLER-CAP STOCKS



For illustrative purposes only.
All-cap index represented by the Russell 3000 Index; large-cap stocks represented by the Russell 1000 Index; mid-cap stocks represented by the Russell Mid-Cap Index; SMID-cap stocks represented by the Russell 2500 Index; small-cap stocks represented by the Russell 2000 Index. Security size based on a combination of the security's market cap and current index membership.
As of June 30, 2020 (latest Russell Index reconstitution)
Source: FTSE Russell and AB

How can we explain these performance trends? Successful smaller companies can double or even triple their revenues and cash flows, but larger companies don't have the headroom to make leaps of that size. Passive investors might not always see these especially successful companies because benchmarks bury their returns in the overwhelming throng of constituents. But active managers can root out small companies with strong businesses and return profiles—even in a tough economic environment.

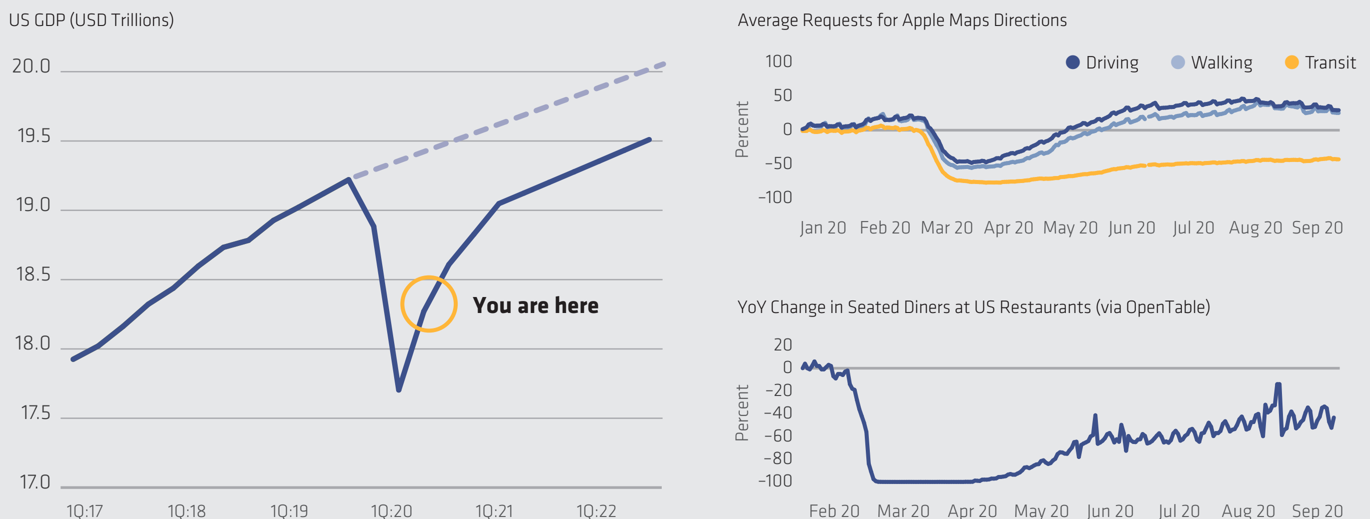
SMALLER-CAPS CAN SPARKLE IN MARKET RECOVERIES

The sudden, unprecedented and exogenous shock caused by the novel coronavirus pandemic and the ensuing economic shutdown is among the worst jolts the global economy has known. Policy response around the world has been swift and deep. In the US alone, monetary and fiscal stimulus is more than six times that of the GFC.

THE TIME IS RIGHT: FROM COVID-19 SHOCK TO RECOVERY

The beginning of the recovery has been equally impressive, as employment, personal consumption and new home sales have all started to rebound since the initial shock. By September, higher-frequency data such as US hotel occupancy, changes in seated diners at US restaurants and the increase in requests for Apple map directions were well off the lows of late March (*Display 5*),

DISPLAY 5: HIGH-FREQUENCY DATA CAPTURED THE ECONOMIC GREEN-SHOOTS OF REOPENINGS



Analysis provided for illustrative purposes only and is subject to revision.
Through September 30, 2020
Source: Apple, CNBC, CoStar, OpenTable, Transportation Security Administration and AB

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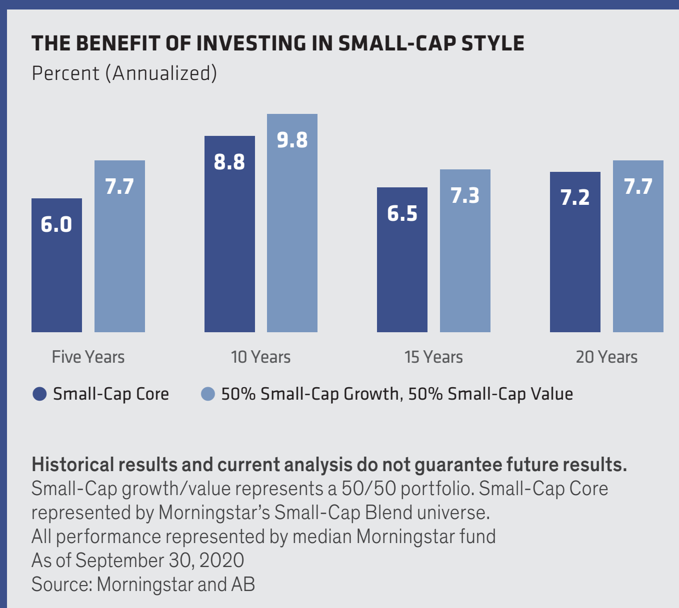
LOOKING GOOD: A FOCUS ON SMALL-CAP STYLE

How investors gain access to smaller-cap stocks can make a huge difference in their experience. We believe there is more benefit to be gained at either end of the smaller-cap spectrum—that is, look toward value or growth or both, rather than core.

Why? The tails of the growth–value continuum are chock-full of richer opportunities—either value stocks trading at attractive discounts or growth stocks with more explosive growth potential. In the middle of that range, core equities just don't offer the same potential. Our research suggests that over the last 20 years, a portfolio of half growth/half value would have regularly bested a simple core portfolio (*Display, left*).

THE BENEFIT OF INVESTING IN SMALL-CAP STYLE

Percent (Annualized)



Historical results and current analysis do not guarantee future results.
Small-Cap growth/value represents a 50/50 portfolio. Small-Cap Core represented by Morningstar's Small-Cap Blend universe.
All performance represented by median Morningstar fund
As of September 30, 2020
Source: Morningstar and AB

GAUGING UNAPPRECIATED GROWTH POTENTIAL

Growth investors search for companies where the market has bullish expectations about their future earnings growth. Companies with exceptional growth potential usually trade at a premium valuation; but if they disappoint investors, the punishment is swift and severe. Positive surprises, however, are usually cause for price spikes to the upside.

In smaller-cap growth stocks, we believe identifying business changes that will fuel greater earnings growth than the market expects is an effective strategy. These could be unexpected growth in a line of business, such as e-commerce success for retailers, or a new marketing approach, such as leveraging an education platform during a pandemic. Positive earnings surprises and revisions, as well as stock price momentum, are all strong growth indicators for smaller companies (*Display, below*).

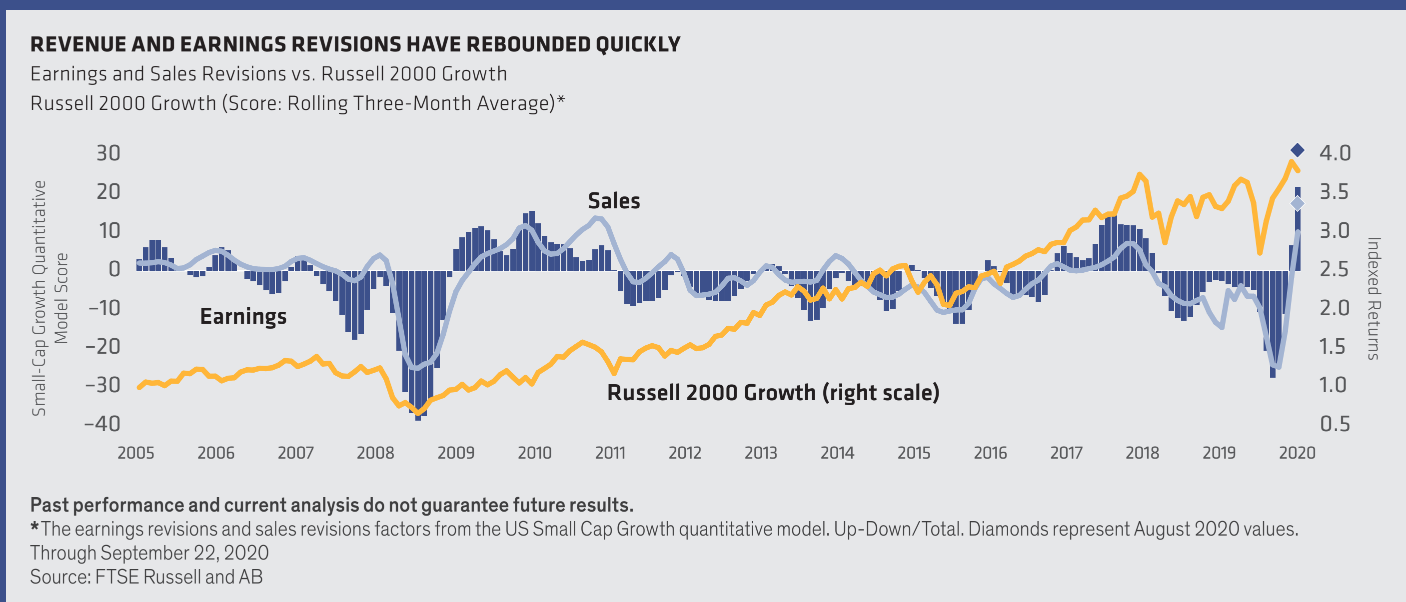
Coming out of the COVID-19 crisis, earnings, sales and estimates for the Russell 2000 Growth Index have all rebounded quickly and turned positive in the last few months—a huge change from the panicky depths of the pandemic—leading to strong performance for the index.

Additionally, growth stocks are valued on the discounted value of their future cash flows. In an environment where interest rates are expected to remain low for several years, this lends even more support to valuations. We believe the earnings yield (earnings/price) for smaller stocks is still a bargain compared to low US Treasury yields (*Display, next page, top*).

REVENUE AND EARNINGS REVISIONS HAVE REBOUNDED QUICKLY

Earnings and Sales Revisions vs. Russell 2000 Growth

Russell 2000 Growth (Score: Rolling Three-Month Average)*



Past performance and current analysis do not guarantee future results.
*The earnings revisions and sales revisions factors from the US Small Cap Growth quantitative model. Up-Down/Total. Diamonds represent August 2020 values.
Through September 22, 2020
Source: FTSE Russell and AB

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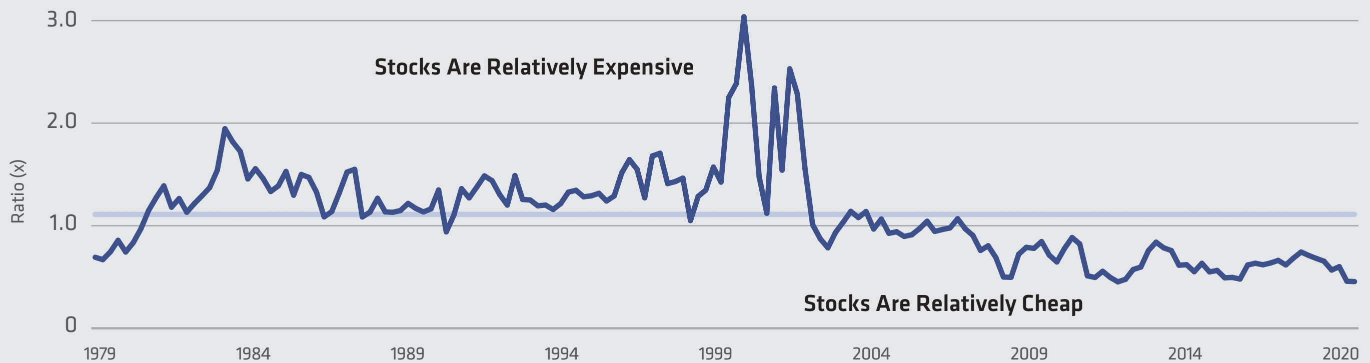
RELATIVE VALUATIONS ARE STILL ATTRACTIVE

Russell 2000 Growth: Earnings Yield/30-Year T-Bond Yield



Past performance, historical analysis and current forecasts do not guarantee future results.
Through June 30, 2020
Source: FactSet, FTSE Russell and AB

And finally, smaller growth stocks are often overweight some of the more exciting and innovative areas of the market, including health-care, technology and consumer discretionary.

FINDING VALUE IN VALUE STOCKS

Value investors can also reap strong rewards by exploiting inefficiencies in the smaller-cap universe, though their discipline will lead to companies with different stories, characteristics and catalysts.

Controversy defines value stocks. In value, investors seek stocks that have underperformed due to a controversy that creates uncertainty about the sustainability and value of a company's cash flows. The challenge is to correctly identify which companies have been unfairly punished and can eventually show strong and sustainable cash flows, and then determine when to get in position.

For over 25 years, through 2016, smaller-cap stocks with attractive price-to-free-cash-flow (P/FCF) multiples in the top quintile outperformed the rest of the market by over 10% per year. But since 2017, stock prices haven't followed cash flow; P/FCF multiples have contracted for smaller-cap stocks (*Display, right*). We believe this is an irrational market reaction that will eventually correct, especially as company fundamentals have continued to improve during this period of underperformance.

In smaller-cap value stocks, we think a combination of hard numbers and compelling catalysts spells opportunity. Attractive valuation based on metrics such as the free cash flow a company generates is only part of the story—it's just as important to look deeper into the fundamental story of each company to understand its competitive landscape, business environment and management capabilities. Then, investors should identify a catalyst such as a management change, stock buyback or other improvements that can drive a reassessment of the valuation of the company.

STOCK PRICES HAVE NOT FOLLOWED CASH FLOW

Price/Free Cash Flow: US Small-Cap Universe
First Quintile vs. Market: Excess Return (Percent)

Past performance and current analysis do not guarantee future results.
***Annualized**
Through September 30, 2020
Source: FactSet, FTSE Russell and AB

To pinpoint value or growth opportunities within the universe of smaller stocks requires the analysis of different types of metrics and different sources of return potential. Yet, both strategies have something in common: a highly selective and disciplined process for choosing smaller-cap stocks to be a part of a portfolio. By diversifying between smaller-cap value and growth strategies, we believe investors can gain from their uncorrelated performance patterns.

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DISPLAY 6: US SMALLER-CAPS HAVE LED US LARGE-CAPS FOLLOWING SEVERE CRISES IN THE PAST

Russell 2000 vs. Russell 1000 Relative Cumulative Performance (Percent)

Past performance does not guarantee future results.
Cumulative returns used for all time periods shown
An investor cannot invest directly in an index, and index results are not indicative of the performance of any specific investment, including an AllianceBernstein fund. Indices do not include sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
As of September 30, 2020.
Source: FTSE Russell and AB

though most haven't improved much after the initial surge, and some indicators still lag where they started the year.

But make no mistake, this is just the beginning of the recovery. What will a full recovery look like? We don't really know, and it's hard to predict how long it will take. But we believe the US economy will continue to make progress through at least 2021. Smaller-cap companies have generally outperformed during the early stages of economic recoveries (*Display 6*). And indeed, smaller companies have returned 53% since the trough of the coronavirus sell-off through September, outperforming the large-cap Russell 1000 by 8.4%.

Why do smaller-cap stocks outperform in the aftermath? To start, smaller-caps usually fall more in the downturn. Smaller stocks are also generally more economically sensitive due to their sector composition—with higher weights in industrials, consumer discretionary and financials than those seen in large-cap indices. These companies also receive the majority of their revenue from domestic sources, so they should benefit from the extraordinary US financial response to COVID-19 as well as the US economic recovery, in our view.

And finally, smaller-cap share prices have generally not reflected their underlying fundamentals for some time. So, we think they're likely to benefit when investors refocus their attention on stock valuations.

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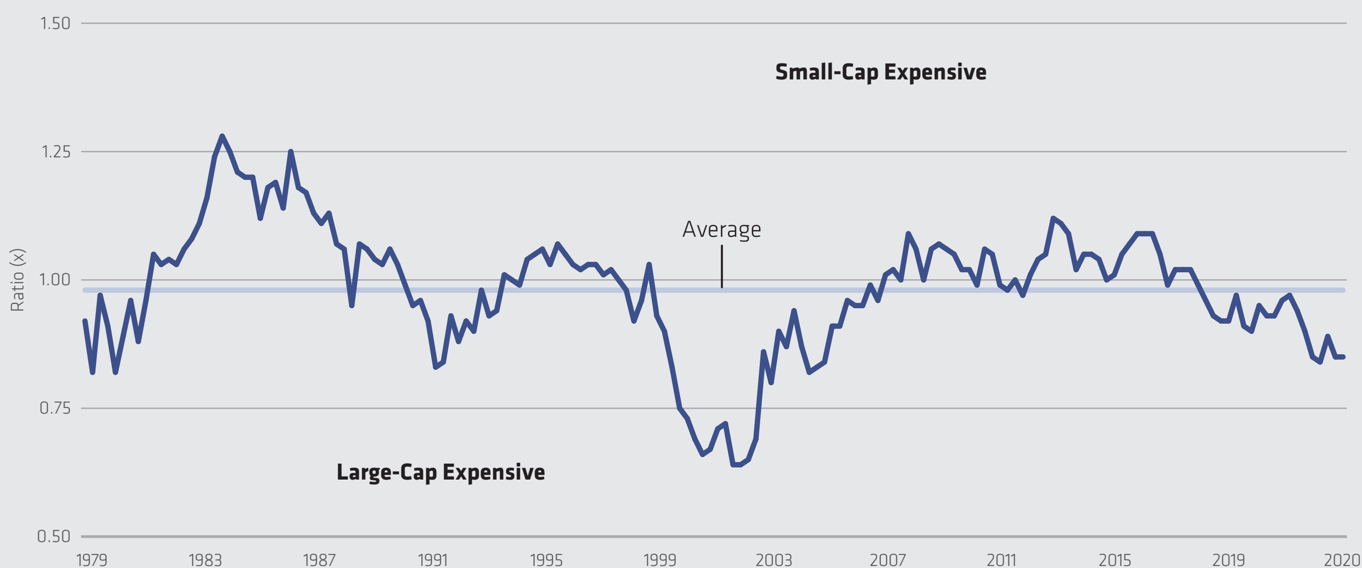
DISPLAY 7: VALUATIONS BELOW LONG-TERM AVERAGE
Relative Valuations (Russell 2000 vs. Russell 1000)*



Historical analysis does not guarantee future results.
***** Valuation composite is one-third price/forward earnings, one-third price/book and one-third price/sales. Period covered starts at the inception date for the Russell indices
Through June 30, 2020
Source: FTSE Russell and AB

VALUATIONS LOOK COMPELLING

Valuation metrics for smaller-cap companies are not being rewarded as they have in the past. Based on a blended valuation measure equally weighting price/forward earnings, price/book and price/sales, relative valuations of smaller-cap companies are as cheap as they've been in over 10 years (*Display 7*).

FINDING THE SHIMMERING STARS

To capture this recovery potential, some investors might consider a passively managed portfolio of smaller stocks. But we think that exchange-traded funds and other passive vehicles are particularly problematic for allocations of smaller-cap stocks.

Passive investing focuses on the opportunities of an entire index or asset class, which may include hundreds or even thousands of stocks. As a result, even though individual smaller-cap companies may outperform dramatically, their overall contribution to a passive portfolio's returns will hardly make a difference. But in a more curated portfolio, individual positions can make a much greater impact on performance.

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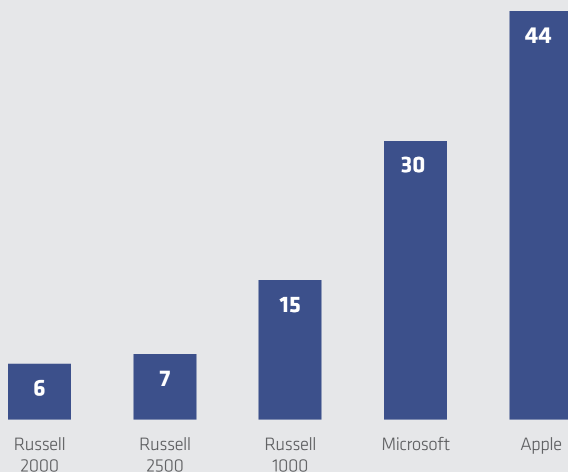
DISPLAY 8: HIDING IN PLAIN SIGHT
FEWER EYES = MORE OPPORTUNITY
Number of Analysts Covering Average Stock



Past performance and historical analysis do not guarantee future results.
As of September 24, 2020
Source: FactSet, Morningstar, FTSE Russell and AB

MORE OPPORTUNITY WITH LESS COMPETITION

As the market has tilted further toward passive investments, many Wall Street firms have reduced their analyst teams in favor of cheaper passive alternatives. Fewer analysts means fewer investment teams understanding business models, meeting with management teams, modeling future earnings, tracking suppliers and watching market trends for individual companies.

When analytical resources are scarce, focus tends toward larger companies. Smaller-cap companies tend to have less than half the number of analysts publishing on them than larger companies, and a fraction of the coverage that giants like Microsoft and Apple receive (*Display 8*).

We think this offers a great opportunity for investors who dedicate the time and resources to truly understand the businesses of smaller-cap companies. Smaller-caps are chronically underfollowed, which often leads to misunderstood fundamentals and mispricing of stocks that can be exploited by active investors.

SMALL-CAP STOCKS AS A REPLACEMENT FOR PRIVATE EQUITY?

Harvard and Yale universities made financial news headlines year after year for their endowment funds' noteworthy returns, and a lot of the credit went to their private equity investments. But for investors in the "under $100 million" in investable assets category, small-caps might provide competitive returns and similar diversification.

Private equity funds have been popular because they've historically outperformed large-cap equities. Their long-term investments are made to unlock what their managers perceive as hidden value in companies through operational improvements, making changes and then eventually selling to another company or public markets when that value is realized. For their efforts, private equity managers rake in high fees—often 1.5% to 2% plus carried interest—and have the benefit of time to watch their investments play out with a five- to 10-year lockup on capital.

Investors have flocked to invest. There was $1.45 trillion of cash sidelined at private equity firms at the beginning of 2020, more than double cash levels from five years ago. All that cash will be competing for the same deals, pushing prices paid upward and potentially leading to underperformance.

But is private equity really worth all the hype? For some investors, we think no. Researchers have suggested that an allocation to smaller-cap companies, managed with an environmental, social and governance (ESG) overlay (to encourage operational improvements) and a long-term perspective, might simulate future private equity returns, but with lower fees and no capital lockup.

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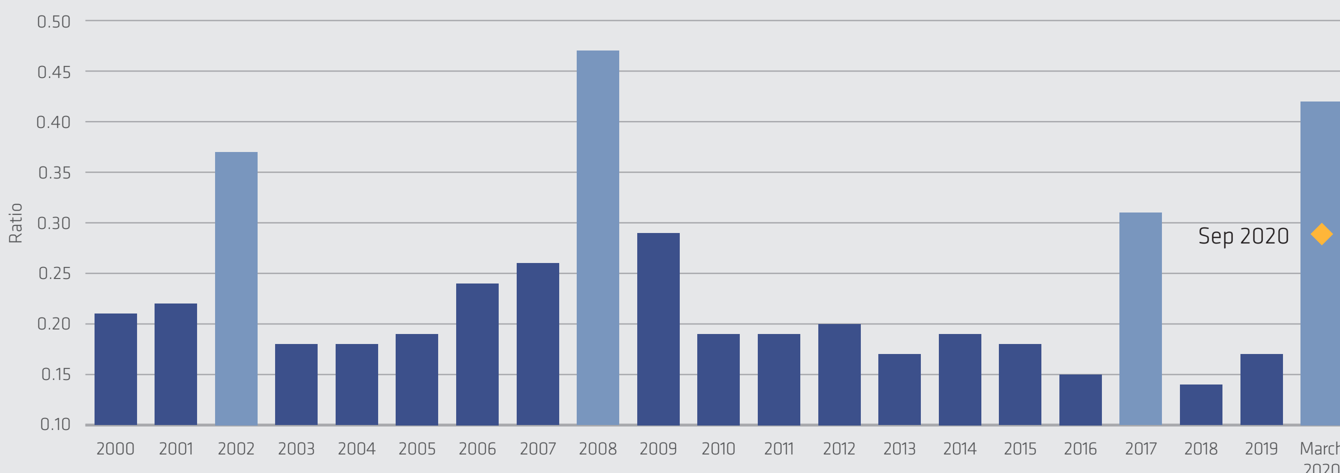
DISPLAY 9: HIGH ESTIMATE DISPERSION PROVIDES OPPORTUNITY

Earnings Estimate Dispersion (R2000)



Past performance does not guarantee future results.

Dispersion is the standard deviation of all earnings estimates for a company divided by the median of those estimates.

Through September 30, 2020

Source: FactSet, FTSE Russell and AB

Today, amid the coronavirus crisis, that advantage is even greater, in our view. Few corporate management teams have clear visibility to the future, and many have even completely withdrawn their guidance, creating an even greater dispersion of expectations. Smaller-cap companies have disproportionately had the earnings rug pulled out from under them.

When the COVID-19 economic shutdown began, earnings estimates fell almost 20% for S&P 500 stocks but collapsed by nearly 60% for the Russell 2000. Why the discrepancy? In part, because the small-cap index has greater exposure to cyclical sectors that were harder hit by the coronavirus shutdown. Hundreds of smaller-cap companies simply suspended guidance completely.

TURNING UNCERTAINTY INTO OPPORTUNITY

Without company guidance, estimate dispersion increases, as analysts with shorter time horizons have less certainty around their forecasts. And when estimate dispersion is high, it implies that there may be a wider range of earnings outcomes. In other words, positive and negative earnings surprises may be larger than normal, which usually leads to higher price volatility. Long-term well-researched investors can take advantage of weakness to purchase attractively valued long-term investments when earnings disappoint. But it's also an opportunity for outsized profit when earnings delight (*Display 9*).

As the economic recovery continues, we believe investors will become more comfortable with the post-pandemic normal. The overwhelming popularity of larger stocks may run its course, in our view, and investment treasure hunters will seek companies with growth catalysts, interesting and ingenious business models, and tempting valuations. Active investors who understand smaller businesses and can seek out assets that have been mispriced have a significant advantage following market disruptions.

While the dust still hasn't fully settled on the COVID-19 crisis, the smaller-cap universe offers investors the opportunity to find emerging stars that can shine for years to come.

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The value of an investment can go down as well as up and investors may not get back the full amount they invested.

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