Contributors >>>

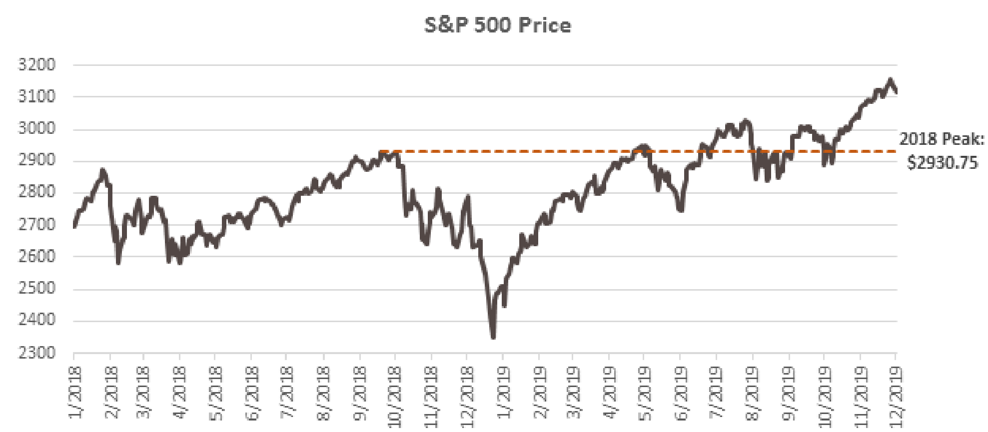
Andrew Mies, CFA®
Chief Investment Officer
Will Horner, CFA®
Investment Management Associate

6 MERIDIAN

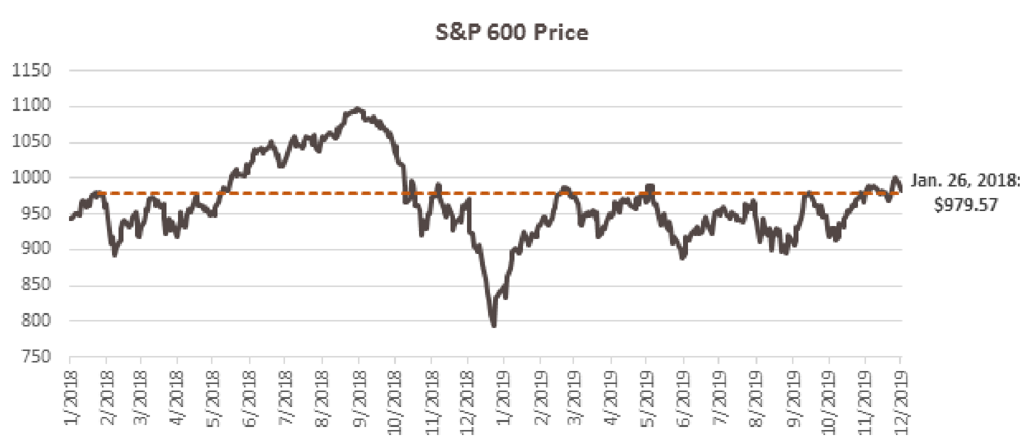
Investment Perspectives – January 2020

A very cheerful 2019 (for large caps)

As we come to year end and the holiday season, investors have plenty to be cheerful about. Both stocks and bonds have had a great year so far. The S&P 500 posted a return of 27.6% through the first 11 months of the year, rebounding spectacularly from a selloff late last year. In April the S&P 500 surpassed its previous all-time high (September 2018) and hasn't looked back since.

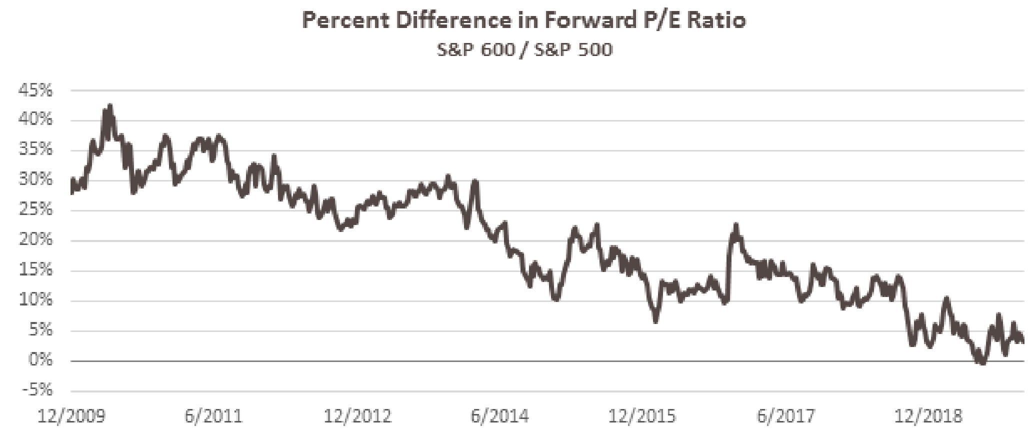


You might assume that small cap companies shared in these good spirits. They did not. The S&P 600, an index of small cap stocks, has lagged the large cap S&P 500 by more than 8% in 2019. While that still results in a strong 19% return, that return is coming from a much steeper drawdown – -28% peak-to-trough for the S&P 600 – at the end of 2018. The index closed the first trading day of December at 981.57, only 2 points (0.38%) higher than its closing price from January 26, 2018. That means roughly no gain over a 22-month period for investors in small cap stocks.

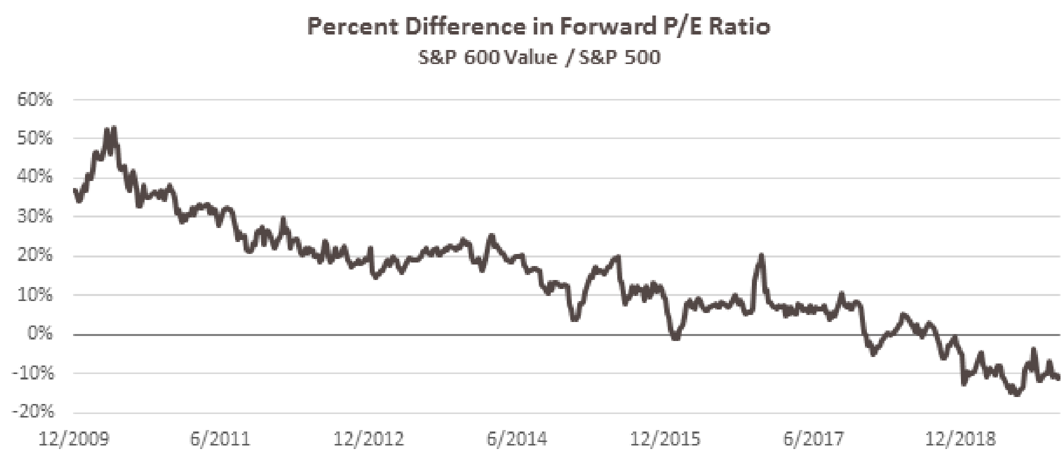


Sources: Bloomberg

While price movement alone is not enough to tell a compelling investment story, we believe the current valuation gap between large and small could offer a reason to give small caps another look. Over the past ten years, small caps have tended to trade at a valuation premium over large caps. This could reflect higher growth expectations for small companies on average, or simply greater relative demand from investors for small cap names. However, the valuation gap has closed over the past ten years and has gotten particularly narrow in the last 15 months. The S&P 600 currently trades at a forward P/E of 18.6, less than a 3% premium to the 18.1 multiple for the S&P 500.



An even more significant shift has taken place in the value portion of the index. The S&P 600 value index has historically traded at a 14% premium to the S&P 500 on a price to forward earnings basis. It is currently at a *discount* of over 10%, with a forward P/E of 16.1.



Sources: Bloomberg

Small cap stocks are a risky investment. Smaller companies generally have a higher level of business risk than their larger peers, and their stock prices tend to reflect this through higher volatility. The downside risks in the event of an economic downturn or other such crisis would probably be felt more sharply in small caps than large caps. However, it appears that the current relative value could provide an opportunity.

While the analysis to this point provides a very generalized view of the space, we believe it is possible to drill down into even more relatively attractive subsets if the appropriate strategy is employed. For example, 6 Meridian's small cap strategy attempts to hold securities that are trading cheaply or with lower volatility relative to the index after applying a screen to eliminate the worst quality names. The resulting portfolio looks discounted on valuation multiples and provides a higher dividend yield but has realized lower volatility than small cap indexes more broadly.

Portfolio	Forward Price/Earnings	Forward Price/Sales	Dividend Yield	Realized Volatility (2Y Trailing)
S&P 500	18.1x	2.2x	1.8%	14.9%
S&P 600	18.6x	0.9x	1.6%	17.0%
S&P 600 Value	15.9x	0.6x	1.9%	17.2%
6M Small Cap	13.1x	0.5x	2.9%	14.8%

Source: Bloomberg Data as of 12/16/2019

Most assets have enjoyed a stellar 2019 so far. In the resulting environment where very few portions of the market look undervalued, we wonder if it is time for cheaper small caps to share in the joy as well. Please consult your financial advisor for further information.

6 Meridian
8301 E. 21st St. N.
Ste. 150, Wichita, KS 67206
P: 316.776.4601

www.6meridian.com