CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q2 2024

The Big Keep Getting Bigger

The biggest companies, and especially those more growth-oriented stocks, massively outperformed during the second quarter, leaving smaller cap companies in their dust. The economy remained resilient, with the Atlanta Fed's GDPNow forecasting 3.0% for 2Q 2024 real GDP. Consensus expectations for a recession have receded, and consumer sentiment remains at reasonable levels. What was most striking to us during the quarter was instead the huge dispersion in the market. Small cap stocks were actually down during the quarter, exposing the reality that the small cap universe is quite different from the large cap universe. For one, small cap benchmarks do not have the massive concentration in a few names that we see in the large cap space. The top 10 companies in the Russell 2000 represent 3.4% of the Index. Even adjusting for the additional number of names, concentration among the top 10 is still a fraction of the Russell 1000's 34%. The entire return of the S&P 500 this quarter was driven by four companies, and it's easy to see why as AI enthusiasm continues at a feverish pitch, propelling those stocks to all-time highs. In large cap, the growth/value spread was over 1,000 basis points. In small caps, which naturally excludes those mega cap tech companies, the growth/value spread became almost negligible.

How Much Is Too Much?

At what point does the spread between large and small caps get too large? Currently, relative performance of the Russell 2000 vs the S&P 500 Index measured over the last decade sits at its lowest level ever. LTM P/B multiples for the Russell 2000 relative to the S&P 500 (clearly a crude measure of value but illustrative), are sitting at almost 25-year lows. In any case, we continue to do what we have always done which is look for mispriced small cap stocks. Sometimes these opportunities are in great businesses where we are careful not to overpay, and for more average businesses, we demand an extreme level of discount and the right timing. In large part, we are finding opportunities somewhere more in the middle of that range with the sweet spot being strong businesses trading at more modest discounts. That has proved rewarding thus far.

What Could Drive The Market Higher?

Historically election years are positive for the market, and a big driver of this is higher government spending. Looking at the year-over-year change in government spending since 1959, the fourth year of a presidential cycle has seen a big spending boost, coming in roughly 4% ahead of the first three years' average government spending growth. Additionally, expectations for the Fed to cut rates have been increasing again over the last few months. After the number of Fed policy cuts over the next twelve months bottomed out in April at 1.8, the futures market now implies 3.5, which could be supportive of higher equity prices if it happens in a controlled manner.

Caution During Good Times Is Prudent

There remain existing and emerging risks to be aware of. For example, we are watching the divergence between the high-end consumer, who broadly remains flush with home and market prices at record levels, and the lower-end consumer, who is pressured by continued inflation (remember that disinflation still involves rising prices). Lower-income households have significantly higher inflation expectations, which today hover close to 7%. This is likely driven by what they experience and where they shop, and since rising prices for food, housing, and utilities are particularly impactful, inflation feels even more severe. Consumption is the largest component of GDP in the United States, so we continue to follow up to see if these trends remain consistent or start to move upmarket.

Avoiding Complacency

This natural give and take in the market is why we consider ourselves relative value managers, as finding mispriced stocks requires more than a calculation. We continue to manage our portfolio and positions in the same steady way, and recognize that smaller capitalization stocks still remain at historically inexpensive levels versus large cap. We look for mispriced opportunities, good companies, and reasonable balance sheets. We remain laser-focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship but, at the same time, participate in strong markets. As we noted last quarter but wish to reiterate, we are continually examining our portfolio and our convictions to ensure that we hold stocks trading at discounts to our conservative assessments of their worth, and we remain excited about our stocks over a multi-year time horizon.

Sincerely,

The Cornerstone Investment Team

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.