

A Good Time to Add Small Cap Growth Exposure

The Russell 2000 Growth Index peaked on February 9, 2021 at 1,710 and as of Friday's close (March 11, 2022) was down 29% to 1,222. While the index has retreated deep into bear market territory, earnings estimates for many of its constituents have continued to improve. As a result, price to earnings (P/E) multiples using fiscal year two estimated earnings for the companies have dropped to very attractive levels by historical standards.

For several years, we have been tracking the valuations of profitable companies in the Russell 2000 Growth Index by P/E deciles. In other words, we are taking the roughly 700 profitable companies in the index and placing them into ten equally weighted buckets. The first bucket is comprised of approximately 70 of the cheapest stocks by P/E and the tenth bucket is comprised of the 70 most expensive stocks. The eight buckets in between from the second to the ninth are similarly constructed from cheapest to most expensive.

In doing this, we can compare each bucket's current price to earnings to its historical average and readily identify whether that part of the universe looks cheap

or expensive relative to its own history. Table I, below, shows a summary of such data.

The data may appear startling to those who have not seen a similar analysis recently. The cheapest stocks in the universe are trading at significant discounts relative to the history of their respective P/E deciles. On the other end of the spectrum, the tenth decile stocks are very expensive relative to the history of their P/E decile.

During the past 22 years, the first decile stocks have traded at an average P/E on FY2 earnings estimates of 8.2X earnings. The range over this time has been from a low of 4.2X (December 31, 2008) to a high of 10.5X (December 31, 2003). The only time that this bucket has been cheaper than it is now was at the end of 2008.

As can be seen from the table, eight out of the ten buckets are trading at cheaper multiples than their historical average.

It is easy to come up with a list of reasons to be cautious with regard to stocks at this time. We've experienced an unprecedented level of government stimulus

TABLE I: PROFITABLE COMPANIES IN THE RUSSELL 2000 GROWTH INDEX GROUPED BY P/E DECILE⁽¹⁾

Decile	Decile P/E		Discount or Premium
	Today	Historical Average	
1st	4.8	8.2	-42%
2nd	7.5	11.3	-33%
3rd	9.3	13.1	-29%
4th	11.7	14.7	-20%
5th	14.0	16.3	-15%
6th	16.1	18.2	-12%
7th	19.1	20.7	-8%
8th	23.9	24.2	-1%
9th	35.7	30.9	16%
10th	101.8	60.4	69%

Data as of 3/7/2022

⁽¹⁾Please refer to the disclosure entitled "Construction of P/E by Decile" in the Disclosures Section.

Sources: Renaissance Research, FactSet

during the last two years, and that stimulus is all rolling off. Interest rates are at elevated levels compared to the last two years. Inflation is at levels we haven't seen in four decades. Russia's invasion of Ukraine has created massive uncertainty, both geopolitically and economically. Oil is north of \$100 per barrel.

However, it is these uncertainties that have created the current entry point. We do not have a crystal ball that can provide a clear view of how the future will unfold, but historically, investments into small cap growth stocks at these valuation levels has typically proven to be a profitable move.

DISCLOSURES

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CONSTRUCTION OF P/E BY DECILE

Each P/E decile represents the universe of profitable companies in the Russell 2000 Growth Index as of 12/31/1999 broken down into ten buckets of companies with an equal number of companies in each bucket. The companies were placed in their respective buckets based upon their price-to-earnings ratio on estimated earnings-per-share for fiscal year two. The deciles were then recalculated the next year-end and each year thereafter through 12/31/2021 and for the year to date as of 3/7/2022. For each decile, the average P/E was calculated using a trigonometric mean, throwing out 20% of the outliers.

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RUSSELL DATA

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REFERENCED INDEX

(Indices are unmanaged and are not available for direct investment.)

Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.

If you would like to learn more about Renaissance's Small Cap Growth Strategy, please contact Mary Meiners, Director of Client Services (mcm@reninv.com, 513-723-4553), or Paul Radomski, Lead Portfolio Manager for our Small Cap Growth Strategy (par@reninv.com, 513-607-3496).