Small Cap Growth Market Update

Now Is A Good Time to Buy Small Cap Growth

Peter Lynch once famously said that longer-term the markets will go up 8% annualized because that's how fast companies grow their earnings on average. Of course, John Bogle had something to say about that. It depends on the price you are paying for your investments.

Three decades-plus later, Peter Lynch seems to continue to be right. For profitable small cap growth companies, the annualized growth rate for the last twenty years has been 9.4% through year-end 2021 (see Chart 1). Of course, we saw quite a spike in growth during 2021, so if we back up a year, the 19-year annualized growth rate through the end of 2020 was 7.6%. It makes a difference, but either way, it looks like Peter Lynch is directionally correct.

Earnings growth for the profitable companies of the Russell 2000 Growth index continue to look robust. Earnings estimates from FactSet are currently projecting a 24% gain during the current year.

Through the first four plus months of 2022, the Russell 2000 Growth Index is down 29.2%. It's now down 38% from its all-time high posted almost 15 months ago on February 9, 2021. From a valuation perspective, we've quickly gone from significantly overvalued to significantly undervalued. At the end of 2020, the profitable companies of the Russell 2000 Growth index were trading at 28.2 times FY2 estimated earnings. Today, that figure is 13.3 times. (See Chart 2).

John Bogle's point was simple. Add money to stocks when broad market P/Es are low and take some profits when P/Es are high. His comments were made heading into the 90s after an incredible run during the 80s. Of course, stocks did go on an amazing run in the late 90s, but Bogle's point was prescient as stocks struggled during the first half of the decade.

John Bogle utilized a simple construct for projected future returns for the market. Take Peter Lynch's 8% earnings growth and then adjust it for

what he thought the change in P/E would be. A more statistically pure way of doing this math is a binomial regression using annual year-end P/Es for the market and subsequent five-year returns.

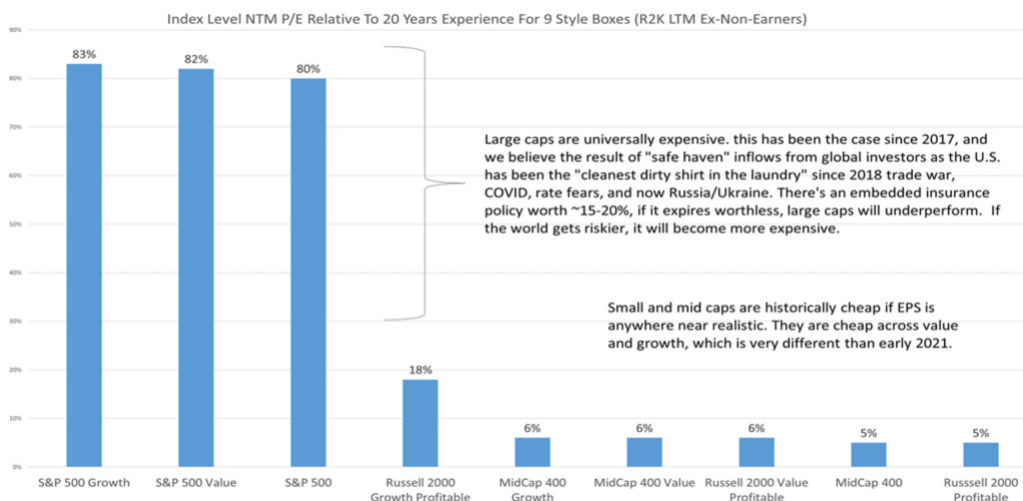
Using such a construct, for the profitable companies of the Russell 2000 Growth index, we get an intercept of 47.9% and a slope of -2.15%. These slopes and intercepts were calculated off of 15 years of P/E data from year-end 2001 through year-end 2016 and five-year returns starting with year-end 2001 and ending with the five-year return starting on 12/31/2016.

So, with the P/E of the profitable companies of the Russell 2000 Growth index sitting at 13.3 times fiscal year two estimated earnings, what does this formula suggest for forward returns? Let's apply the formula:

Five year forward annualized returns = 47.9% + (13.3 X -2.15%) = 19.4%.

Of course, it's ridiculous to think that the future five years forward can be predicted by a binomial regression. We think earnings growth will be slower than average over the next five years. However, there is decades worth of market research that suggests buying stocks after a large sell-off is rewarding. We've had a large sell-off in small cap growth stocks. And this to me, looks like a good entry point. Some simple math supports that thesis. We're not as optimistic as the math suggests, but our outlook from here is definitely constructive. We would not be at all surprised by double-digit annualized returns over the next five years from here.

Raymond James put out this graphic two weeks ago:



The bars represent how expensive or cheap each style box is for the U.S. markets relative to their own history over the last 20 years. A tall bar indicates that segment of the market is expensive, and a short bar indicates that it is cheap.

This is fascinating stuff. Basically, all large cap styles are expensive (value, core, and growth) while all midcap and small cap styles are cheap. Their math suggests that the profitable companies of the Russell 2000 Growth index are currently in the 18th percentile. Their analysis supports our conclusion but also adds some needed broader perspective. Not all asset classes are cheap.

Now is a good time to add to your small cap growth positions. If you do not have an investment in small cap growth, please feel free to contact us. We can help you with that.

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, 513-723-4554), or Paul Radomski, Lead Portfolio Manager for our Small Cap Growth Strategy (par@reninv.com, 513-607-3496).

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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.