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The Fed's Rate Race Has Squeezed Small Caps, but They're Still in the Running

For small cap growth stocks, the last leg of the interest rate journey may be the hardest—but we still see room for optimism (and opportunity).

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It's no secret that the Federal Reserve (Fed) has had a sizable impact on both personal and corporate balance sheets since it began its aggressive campaign to tame inflation in March 2022.

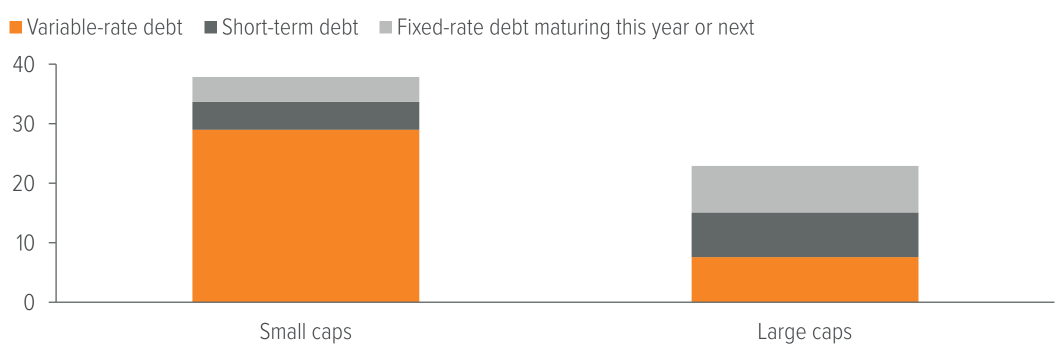
Now, after 11 interest rate hikes, the federal funds rate is in a range of 5.25–5.50%. In the current "higher for longer" rate scenario, **the last mile of this race may be the most challenging** as the Fed attempts to bring inflation in line with its 2% target.

Why?

The Fed's rate-hike path has caused unintended consequences in the U.S. banking system, as seen during the first quarter of 2023 when rising rates devalued regional bank assets. **Quantitative tightening has not only restricted small companies' *access* to capital, but it has also significantly increased the *cost*.** That's because, compared with their larger peers:

- **Small companies tend to seek capital from regional banks.** These banks have instituted stricter lending guidelines—resulting in higher rates for borrowers that are perceived as riskier.
- **Small companies take on a higher proportion of variable-rate debt.** Roughly 30% of the debt small companies assume is in the form of variable-rate loans, compared with only 8% for large companies. These loans have shorter average maturities than fixed-rate debt, and refinancing when rates are rising can stress a small company's balance sheet and may affect its cash flow, net profit margin and growth prospects.

Share of rate-sensitive debt used by small and large cap stocks (excluding financials)



As of 11/1/23. Source: Empirical Research Partners analysis. Small caps represented by S&P 600 Index. Large caps represented by S&P 500 Index.

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These conditions are likely to persist until the Fed starts to cut rates, which we believe will happen in the second half of 2024. **The good news is that fundamental equity research performed by experienced portfolio analysts can help identify companies with strong cash flow characteristics** when growth is challenging.

How we manage small cap assets when interest rates are rising

First, we scrutinize the debt levels of each company in the portfolio to understand the structure and duration of that debt and the company's ability to service it.

We also look to invest in companies that have strong revenue and cash flow generation, the ability to self-fund their operations and opportunities for expansion. **These qualities are especially beneficial when loan costs—which can put a dent in a company's bottom line—are rising.**

[1] Jefferies. As of 11/7/23.

Why should I continue to invest in small cap growth?

Despite the underperformance that small cap growth experienced relative to large cap growth in 2023, we remain optimistic. Fed Chairman Powell's remarks in December hinting at potential rate cuts in 2024 sent small cap stocks running to close out the year. And, **if rates do fall in 2024—as the market expects—the potential for reducing the cost of capital should bode well for small caps**.

Additionally, **much of the impact of higher borrowing costs has already been baked into small cap stock prices and forward earnings revisions.** Earnings growth estimates for small cap growth companies for 2024 average 9.3% (compared with 14.2% for large cap growth companies).[1] We believe this difference should not discourage investors from allocating to small cap growth stocks—especially considering **today's decades-low valuation levels** relative to their large cap growth peers.

Risks of investing

The principal risks are generally those attributable to investing in stocks and related derivative instruments. Holdings are subject to market, issuer and other risks, and their values may fluctuate. **Market risk** is the risk that securities or other instruments may decline in value due to factors affecting the securities markets or particular industries. **Issuer risk** is the risk that the value of a security or instrument may decline for reasons specific to the issuer, such as changes in its financial condition. More particularly, the strategy invests in smaller companies which may be more susceptible to price swings than larger companies because they have fewer resources and more limited products, and many are dependent on a few key managers.

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