STATERA
ASSET MANAGEMENT

Commentary: June 2021

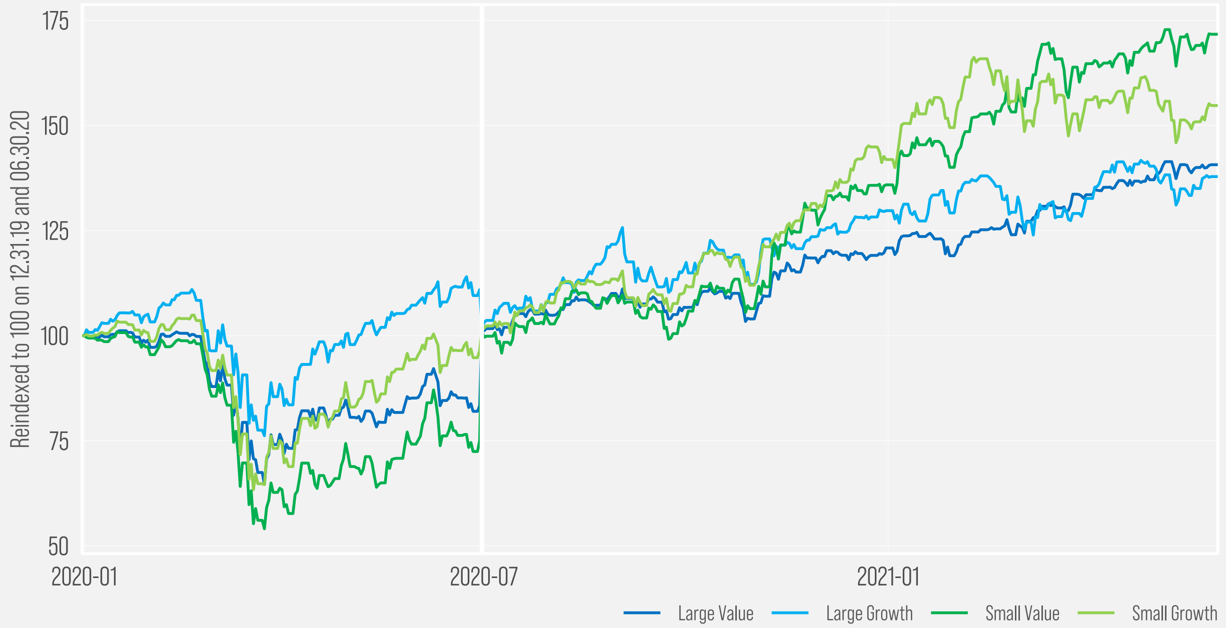
FACTORS WITH LEGS

The relative performance of our favored equity characteristics have set a few records over the past year, with small-cap and value-oriented stocks having found renewed favor among investors. Perhaps that should not come as a surprise, given the lengthy period of underperformance that both factors had and still have been experiencing. Despite the nearer-term relative gains, we think both slices of the stock universe have legs to run. Not least among the reasons is the fact that longer-term gaps in performance and valuation relative to their large-cap and growthier peers remain. History, too, provides evidence that we might not want to guess a going-forward slackening in comparative gains just yet.

What a Difference

Reprising a chart we offered in February, in Figure 1 we show the performance of two of our favored factors—Size and Value—from the beginning of 2020. So that relative performance was more obvious and to separate what we see as distinct periods, we reset each index to a value of 100 on 12.31.2019 and again on 06.30.2020. Speaking of obviousness, both the Size and the Value factors have turned on quite strongly over the past 11 months. Size and Value both kept pace through year-end 2020, with each surging ahead in 2021. Smaller-cap stocks, in particular, have seen a tremendous run this year.

Figure 1: Recent Performance of Small, vs. Large and Value, vs. Growth



From 12.31.2019 to 05.31.2021. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Further to Run?

That strong relative performance might lead some to wonder if the source of heat for all that extra steam might be cooling off. True, near-term relative performance has been stellar for small-caps and for Value stocks, but we think there remains reasonable support for continued outperformance of both factors. First, the basic intuition that drives our preferences for smaller and less-expensive stocks remain unchallenged, in our view: smaller companies maintain characteristics—such as, obviously, their smaller size, relative financial stability and flexibility, etc.—that reflect heightened risk of owning their stocks, which tend to be more volatile. It's thus reasonable that investors should expect a premium for holding those stocks over time. And with regard to Value, other things being equal, a lower price relative to fundamentals (e.g., assets, revenue and earnings) suggests investors are assigning a higher "discount rate", or measure of relative future risk for that stock, which in turn may be indicative of higher expected going-forward returns.

Put other ways, small-cap stocks may have greater ability to grow, but they are riskier, so owning a whole bunch of them tends to offset those individual risks and provide incremental return over the market. With Value, we can be seen as buying stocks that are on sale, but of similar, perhaps even of better fundamental worth that their peers.

Second, both groups remain underwater over still reasonably long periods of time. Even so, history shows that the factors tend to outperform over a range of periods and across a wide swath of investible markets. The fact that periods of underperformance come naturally justifies the "risk" of the risk premium the factors are thought to provide.

Finally, we looked at historical periods of relative outperformance of small-cap and Value stocks and the returns they saw after relative surges in performance. Interestingly, one-year periods of outperformance for small-cap stocks saw, on average, another year of outperformance. Same is true for Value stocks.

We don't wish to press to hard on that final thought, though, as the range of outcomes remained wide, including periods both of continued outperformance and underperformance. Even so, we think that the basic intuition for favoring small-cap and value-oriented stocks, coupled with generally positive realized historical outcomes for those preferences continue to support our designs for models that overweight the Size and Value and other potentially performance-complementary factors.

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