Small Stocks and the Market Correction

August 2015

In light of the recent volatility in equity markets, we wanted to take a moment and focus for our clients and investors on the impact of the market correction for small stocks. Of course news headlines are dominated by news of the "Dow" which is only a limited subset of the large cap equity markets. Stocks in the Dow Jones Industrial Average have more exposure to global growth. Most institutional market participants take a much broader view of the market and our focus on inefficient markets trains our attention onto the impact of the pullback and the prospects for smaller stocks.

Taking a look at the drop in equity prices through Tuesday August, 25, 2015, we can see that the market has reached correction (greater than -10%) levels, but not quite bear market territory (greater than -20%). In Exhibit 1, you can see that small cap stocks are actually now down more from their peak, declining -14.79% while large cap stocks are down -12.34%. The greatest decline comes from emerging markets as the Russell Emerging Markets Index is down -19.35% from its peak. Less liquid small cap emerging market stocks are down a slightly more modest -18.94% from their peak. While the epicenter of market concerns is in emerging markets, we felt it was important to put these declines in historical context for US investors and more specifically for US small cap investors.

Exhibit 1. Percentage Decline from Index Peaks (Through 8/25/15)

DJIA	-14.07%
Russell 1000	-12.34%
Russell 2000	-14.79%
Russell Microcap	-16.22%
Russell Emerging Markets	-19.35%
Russell Emerging Markets Small Cap	-18.94%

Source: Acuitas Investments, Russell Indexes, Factset

It is important not to read too much into the small vs. large spread during the current correction. We believe the relative decline in small cap stocks is partially a function of the liquid vehicles available to trade as small cap stocks should have less leverage to the crisis. One note is that the volume for the Russell 2000 Index ETF (TK: IWM) has essentially doubled in recent days versus the previous few months. We have noted previously how investors use this ETF during a crisis as a liquid risk-on, or risk-off trade, skewing returns over the short-term. We addressed the longer term impact on active management in our white paper “Active Opportunity - Big is Small, Microcap is Huge” (available on http://www.acuitasinvestments.com/insights/)

Small cap stocks have long had the reputation for being riskier investments. This is a result of their perceived lack of stability given their smaller cap size, more limited revenue base and earlier stage higher growth profile. These stocks are also less liquid and have less leverage to global growth. In fact, small cap stocks have less than half the foreign sales exposure of large cap stocks. As we have shown in Exhibit 2, small cap stocks generate 16% of their revenue from sources outside the U.S. while Microcap companies generate only 12% of their revenues from foreign sources.

Exhibit 2. Percentage of Sales from Foreign Exposure

	Average Foreign Sales Exposure
Russell 1000	34.4%
Russell 2000	16.7%
Russell Microcap	12.4%

Source: Acuitas Investments, Russell Indexes, Factset

Market corrections have not been an uncommon occurrence over the past 36 years and investors have been rewarded for patience. In exhibit 3, we have summarized the history of pullbacks and corrections over the past 36 years, since the advent of the Russell 2000 Index. Our goal was to put our current situation in context. Large cap stocks have had 14 corrections of more than -10% since 1979. That is an average of one every two and a half years. From the time the market was down -10%, those large cap stocks took an average of 362 trading days (around 1.5 years) to recover. The larger corrections of greater than -10% took place more often in small cap space, but stocks recovered more quickly. We have seen 20 incidents of stocks dropping more than -10% since 1979 and on average, it took 302 trading days or roughly 1.2 years for the index to return to its previous high. The most surefire way to lose money was to sell after the correction and return to the market 6 months or a year later, when most all of the market has recovered. While market pundits tend to advise their listeners to sell and avoid further carnage. Historically, patience has been rewarded as it is unlikely that investors return to the market quickly enough to match the returns of the more patient investor.

Exhibit 3. Market Corrections (Large and Small)

	10% Corrections	
	Occurrences Since Jan 1, 1979	Average Trading Days to Recover
Russell 1000	14	362
Russell 2000	20	302

Source: Acuitas Investments, Russell Indexes, Number of occurrences includes current correction, average trading days to recover does not include the current correction.

We couldn't help but dive a little deeper into the small cap corrections since 1979. As we noted, there have been 20 corections during this period in small cap. The average decline from peak to trough was -24.2%. The most significant small cap market declines events were surrounding the 2000 Internet bubble bursting (-46.1%) and the 2008 credit crisis (-59.9%). One interesting note is that from the bottom of the trough it took, on average 273 days or around 8 months for the market to recover. Even the most dramatic, post-2008 environment saw the market reaching its prior high within two years. These pullbacks are generally not the kind of events that wipe out savings for decades as the press might lead you to believe. Half of the corrections were smaller than a -16% drop and for those events it took an average of three and a half months from the market trough to recover.

Exhibit 4. Small Cap Market Corrections since 1/1/79

	Peak Date	10% Correction Date	Trough Date	Peak to Trough	Recovery Date	Time to Recover from 10% Correction Date: Trading Days	Time to Recover from 10% Correction Date: Calendar Days	Time to Recover from Trough Date: Trading Days	Time to Recover from Trough Date: Calendar Days
1	10/05/79	10/10/79	10/23/79	-15.4%	12/28/79	55	79	46	66
2	02/08/80	03/06/80	03/27/80	-26.7%	07/16/80	91	132	76	111
3	11/28/80	12/11/80	12/11/80	-10.0%	03/18/81	66	97	66	97
4	06/15/81	08/24/81	08/12/82	-29.2%	11/03/82	303	436	58	83
5	06/24/83	10/18/83	07/25/84	-26.0%	12/11/85	543	785	349	504
6	07/03/86	07/30/86	09/16/86	-15.0%	02/03/87	130	188	97	140
7	08/21/87	10/16/87	10/28/87	-39.1%	08/02/89	453	656	445	644
8	10/09/89	01/22/90	10/31/90	-34.0%	09/27/91	426	613	229	331
9	02/12/92	06/17/92	07/08/92	-12.6%	11/25/92	113	161	99	140
10	03/18/94	04/20/94	12/09/94	-13.2%	05/12/95	269	387	106	154
11	05/24/96	07/11/96	07/24/96	-15.6%	01/08/97	125	181	116	168
12	10/13/97	01/09/98	01/12/98	-11.6%	03/10/98	40	60	39	57
13	04/21/98	06/12/98	10/08/98	-36.9%	12/28/99	394	564	312	446
14	03/09/00	03/29/00	10/09/02	-46.1%	11/09/04	1165	1686	525	762
15	12/28/04	04/15/05	04/28/05	-12.2%	07/07/05	57	83	48	70
16	05/05/06	06/09/06	07/21/06	-14.1%	11/13/06	109	157	80	115
17	07/13/07	08/03/07	03/09/09	-59.9%	04/26/11	939	1362	538	778
18	04/29/11	06/13/11	10/03/11	-29.6%	12/31/12	392	567	314	455
19	03/04/14	10/01/14	10/13/14	-13.2%	12/24/14	59	84	51	72
20	06/23/15	08/21/15							
				-24.2%		302	436	189	273

Source: Acuitas Investments, Russell Indexes, Number of occurrences includes current correction, average trading days to recover does not include the current correction.

Investors may still have the scars from 2008, but for those who stayed fully invested the recovery came quickly. It is hard to believe that more than five years have passed since the market fully recovered from that decline which originated domestically. In 2008, low rates and irresponsible mortgage lending inflated the credit and housing boom. Now the epicenter is much more distant, but still impactful. Despite the recent dramatic fall in Chinese share prices, the Shanghai Composite is still up 42.5% on a year over year basis (as of August 25, 2015). One reason China's slowing growth and steep drop in equity prices has caused concern to ripple through global markets is because the country remains 15% of global GDP and approximately half of global growth. That said, we expect small cap stocks to recover more quickly from the recent decline as investors recognize the events will have less impact on earnings for the smallest companies.

In summary, we don't see cause for alarm, as these market corrections are nothing new and we have witnessed these kinds of dislocations before. While we may not be at the bottom, the worst dislocations have historically come in the wake of domestic speculative bubbles and not market declines related to the emerging market pullback we currently face. We believe that small cap investors should gain comfort knowing that these events are not uncommon and recoveries tend to be reasonably quick. Most importantly, we continue to believe in the case for active management as the smart money will take advantage of these market dislocations, particularly in the smallest stocks.