

Here's why investors are betting big on small stocks



Adam Shell, USA TODAY

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(Photo: Richard Drew, AP)

Small stocks are logging big gains largely because tiny companies generate most of their sales and profits domestically, where Donald Trump's economic agenda is seen benefiting the most.

Trump's call for lower taxes, fewer regulations on businesses and government-financed infrastructure projects are viewed as a boon for smaller companies.

"Almost all of Trump's platform ideas will be better for small companies than large ones," says Randy Warren, chief investment officer at Warren Financial Service.

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Since Election Day and through Monday's close, small-company stocks in the Russell 2000 index have surged 10.6%, far better than the 2.7% gain for the large-company Standard & Poor's 500 stock index. The Russell 2000 has been up 12 straight days.

"What's really driving returns (of small stocks) is Trump's focus on the domestic economy," says Gregory Manley, a small-cap portfolio manager for Brandywine Global. Manley has seen big gains in some holdings since Election Day, as investors price in better growth, more inflation and resulting pricing power, and higher interest rates. TriState Capital Holdings (TSC), a small bank that benefits from an uptick in rates, is up nearly 13% since Trump's win. Hyster-Yale Materials Handling (HY), which makes forklifts, is up 18%.

"The market is looking through the sluggishness and saying what if?" Manley says. If Trump's agenda is pushed through, the "earnings power (of small firms) could be tremendous."

The hope is the Russell 2000 will grow into its rich valuation of nearly 26 times earnings (if you strip out firms that are losing money), according to FTSE Russell's website. The large-company Russell 1000 index is trading closer to 21 times earnings, Manley says.



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Investors are betting that Trump's policies will put more money in workers' pockets to fuel more spending at Main Street businesses and boost the economy; fewer regulations will result in lower costs for small firms to comply with rules; and billions of dollars in infrastructure spending will provide fresh demand for smaller businesses.

Large-company stocks in the Standard & Poor's 500 stock index generate nearly half (46%) of their sales overseas, S&P Dow Jones Indices says. The average market value of S&P 500 companies is \$37.4 billion. In contrast, companies in the Russell 2000 stock index — where the average market value is around \$2 billion — get roughly 80% of their sales in the U.S..

The U.S.-centric focus of small companies also means they will suffer less from Trump's potentially more restrictive free-trade policies that could hurt global commerce. Smaller companies, which are net importers, will also be hurt less than U.S. multinationals by the rising dollar, which makes the prices of U.S. products sold abroad more expensive. The greenback has strengthened sharply against foreign currencies since the election, as

investors start to price in higher U.S. interest rates.

Another factor driving small-cap stocks: the biggest sector weighting (19%) in the Russell 2000 is financials, which benefits most from higher rates, adds Martin Jarzebowski, a small-cap fund manager at Federated Investors.



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At the moment, “this is a hope trade,” says Jarzebowski. “There’s still no tangible policy on the table. Six months down the road, you will need to see tangible policy changes” that jibe with Wall Street’s current bet.

Can the rally last? It depends on whether the bullish thesis comes to fruition, says Scott Chronert, managing director of small and mid-cap strategy at Citigroup.

“Investors have to recognize (this rally) is an abrupt repositioning,” Chronert says. “Now the burden falls on more specifics, timeframes and details to see if (the hoped-for growth) works into the company-specific business fundamentals.”

SMALL STOCKS GET BULK OF SALES FROM AMERICA

Since small stocks get most of their sales domestically, they’re likely to benefit more from Trump’s U.S.-focused policies. Percentage of domestic and foreign

● % U.S. sales ● % foreign sales

S&P 500 large-company index



Russell 2000 small-company index¹



¹—estimate

SOURCE S&P Dow Jones Indices; USA TODAY research
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