Perspective from **Franklin Equity Group**

# Is now the time to consider allocating to US small- and mid-cap growth stocks?

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Historically, small- and mid-cap growth companies in the United States have demonstrated notable outperformance relative to their large-cap peers in periods following bear markets.[1] Understandably, these bear markets tend to reflect periods of broader market concerns, and investors generally favor less economically sensitive stocks in anticipation of recessions. These dynamics appear at play today, as markets grapple with mixed economic data, rising rates and uncertainty over whether the Federal Reserve (Fed) can navigate a soft-landing and avoid recession. Over the pullback period from November 1, 2021, through September 30, 2022, the S&P MidCap 400 Growth and S&P SmallCap 600 Growth Indexes posted declines of –25.18% and –24.28%, respectively.[2] Year-to-date through June 30, 2023, these indexes have only just started to show positive returns (+10.44% and +7.02%, respectively, primarily due to market appreciation in the month of June), while the large cap S&P 500 Growth Index was up over 21% during the same period.[3] In our opinion, overdone selling of small- and mid-cap growth stocks may provide an attractive opportunity for long-term investors today, as otherwise high-quality small- and mid-cap growth stocks are trading at what we believe to be depressed valuations despite demonstrating positive and improving fundamentals.

Small- and mid-cap growth companies can benefit from valuation re-ratings well into recoveries. When the market begins to discount a recovery, capital often returns to small- and mid-cap growth companies, as investors hope to benefit from the sensitivity of their improving earnings streams. Additionally, the cost rationalization that often occurs during times of downward volatility and recessions may produce efficiency gains for small- and mid-cap companies in the ensuing recovery period, as they often right-size their operations during periods of weakness.

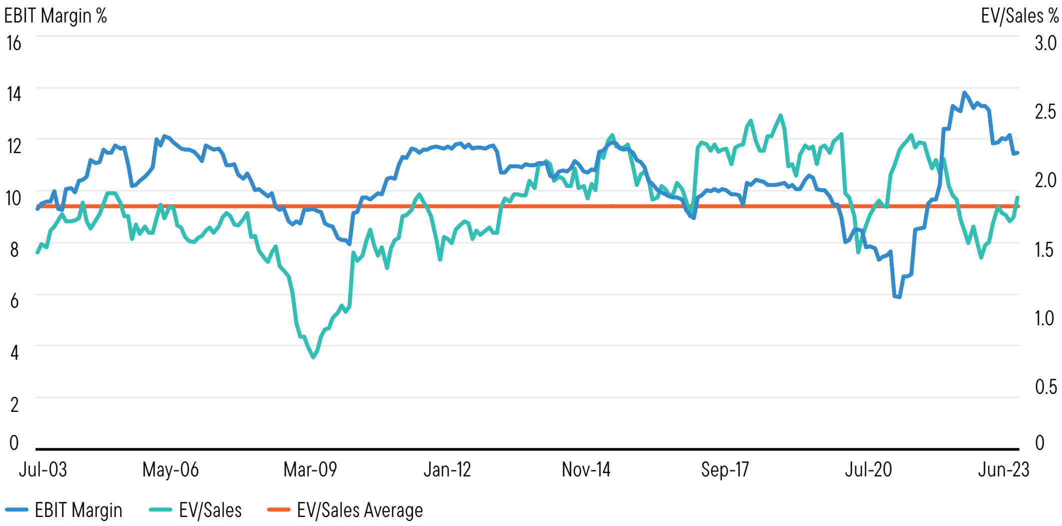
## Declining valuations, improving quality

Small- and mid-cap growth indexes today paint a compelling picture, in our analysis. Valuations (i.e., enterprise value or EV/sales have declined nearly to the lows seen during the global financial crisis (GFC) (Exhibits 1 & 2) and are below where valuations sat for much of the 2003–2012 period, prior to the lower cost of capital environment that followed the Fed's response to the GFC.[4] The recent rise in interest rates has been a key driver in declining valuations, as higher discount rates can dramatically impact the value of cash flows expected far in the future. This is often the case for small- and mid-cap growth companies, which are spending to support the development of their businesses over a multi-year period.

Access to capital plays a critical role as well.Financing rates have increased as the yield curve has shifted higher in recent quarters. These rates (as measured by one-year US Treasuries) were also low in the 2003–2012 period, topping out at 5.27% on June 19, 2006. The one-year US Treasury reached 5.42% on June 30, 2023. In comparison, valuations and fundamentals—using EBIT margin as a profitability measure—are both more attractive today than then, potentially creating an attractive entry point.

### Exhibit 1: S&P SmallCap 600 Growth Index: Valuation (EV/Sales) and Profitability (EBIT Margin)

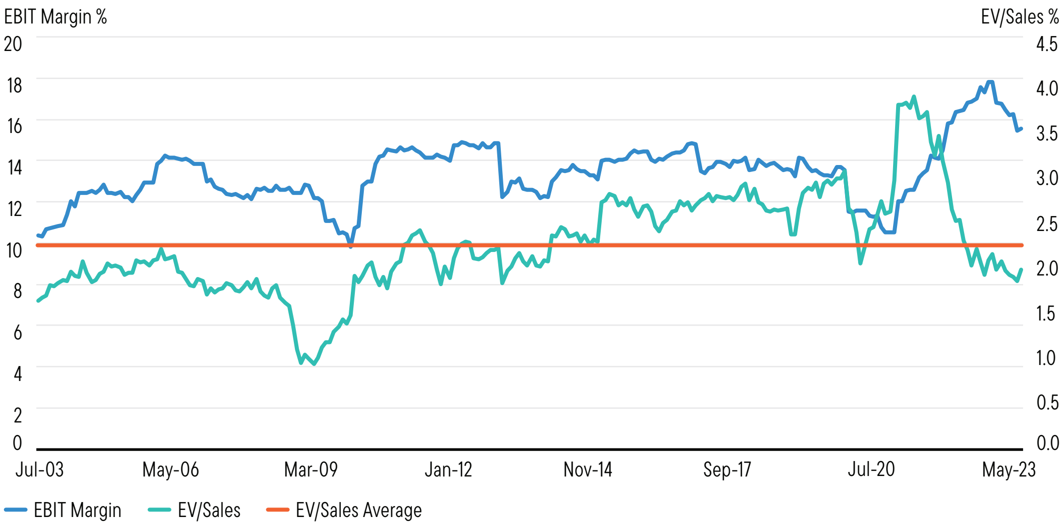
20-Year Period Ended June 30, 2023




Source: FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
**Past performance is not an indicator or a guarantee of future results.**

### Exhibit 2: S&P MidCap 400 Growth Index: Valuation (EV/Sales) and Profitability (EBIT Margin)

20-Year Period Ended June 30, 2023




Source: FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
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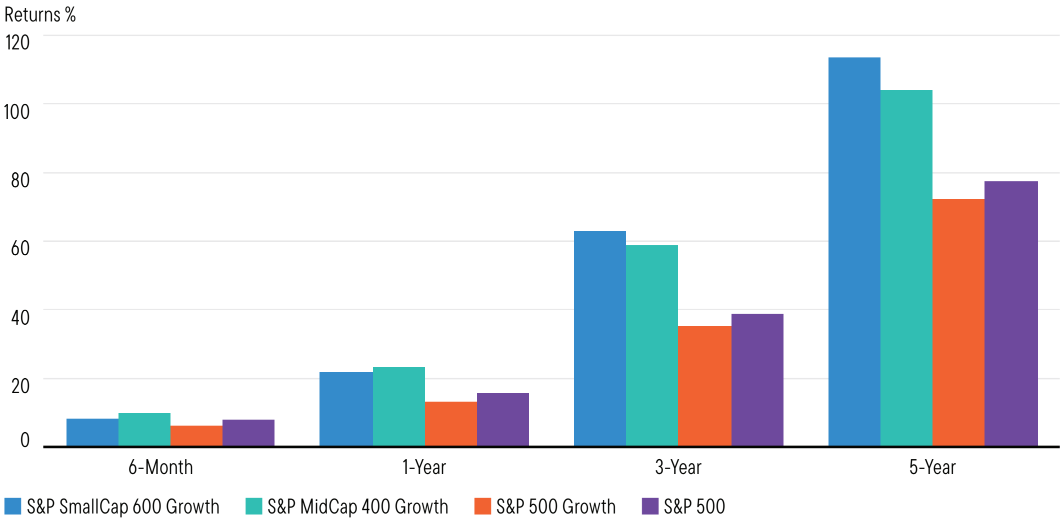
## Historical performance following bear markets

Historically, small- and mid-cap growth equities have demonstrated greater return potential than large-cap stocks overall, and large-cap growth stocks in particular, following bear market periods. Smaller companies are generally less established, earning them a higher relative risk profile in periods of uncertainty. On the other side, however, they can offer attractive leverage through enjoying scale on their smaller operations and higher relative growth, which could lead to market participants revaluing their equities.

## Exhibit 3: Equity Returns Following Bear Markets[5]

January 31, 1990–September 30, 2022



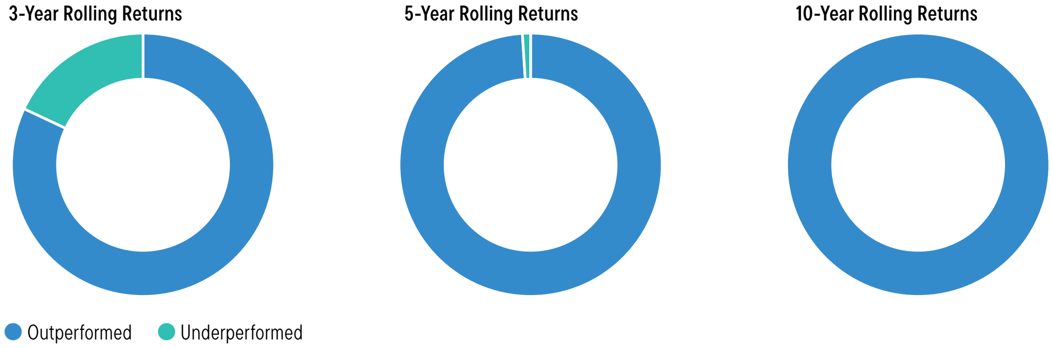

Source: Morningstar. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
**Past performance is not an indicator or a guarantee of future results.**

## Long-term growth outperformance

In addition to outperforming following significant market declines, small- and mid-cap growth stocks have also generated greater returns over longer time horizons with a high degree of consistency relative to their core counterparts. Exhibits 4 and 5 illustrate that the small- and mid-cap growth benchmarks outperformed the small-cap core index the majority of the time over three-year rolling periods, and that consistency of outperformance only increased over longer time periods.

## Exhibit 4: S&P SmallCap 600 Growth Returns vs. S&P SmallCap 600 Returns

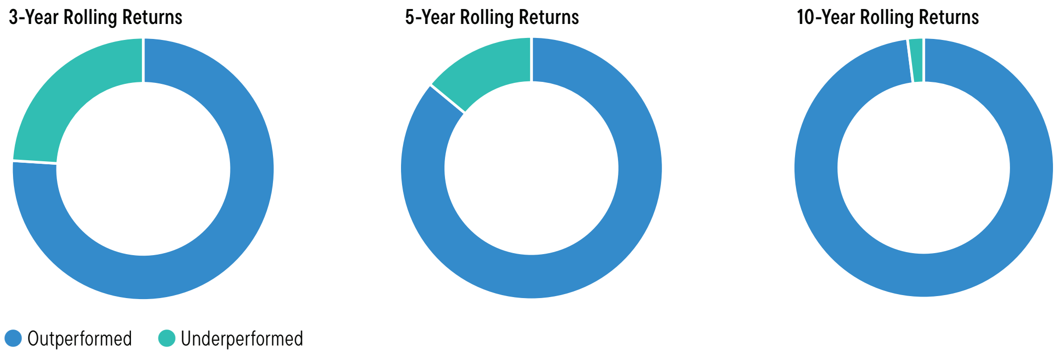
Twenty Years Ended June 30, 2023




Source: Morningstar. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
**Past performance is not an indicator or a guarantee of future results.**

## Exhibit 5: S&P MidCap 400 Growth Returns vs. S&P MidCap 400 Returns

Twenty Years Ended June 30, 2023




Source: Morningstar. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
**Past performance is not an indicator or a guarantee of future results.**

## Definitions

The **S&P MidCap 400 Growth Index** is the growth component of the S&P MidCap 400 Index, which is composed of 400 companies that broadly represent companies with midrange market capitalization between US$3.6 billion and US$13.1 billion. Growth stocks are chosen using three factors: sales growth, the ratio of earnings change to price and momentum.

The **S&P SmallCap 600 Growth Index** is the growth component of the S&P SmallCap 600 Index, which seeks to measure the small-cap segment of the US equity market. Growth stocks are chosen using three factors: sales growth, the ratio of earnings change to price and momentum.

The **S&P 500 Growth Index** is a stock index that represents the fastest-growing companies in the S&P 500. It is currently heavily weighted toward prominent American technology companies.

The **S&P 500 Index** features 500 leading US publicly traded companies, with a primary emphasis on market capitalization. The S&P 500 Index was launched in 1957 by the credit rating agency Standard and Poor's.

**Endnotes**

1. Source: Morningstar.
2. Source: Ibid. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.
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4. Source: FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**
5. Bear markets defined as periods of market declines exceeding –20%.

## WHAT ARE THE RISKS?

**All investments involve risks, including possible loss of principal.**

**Equity securities** are subject to price fluctuation and possible loss of principal.

**Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks.

The **investment style** may become out of favor, which may have a negative impact on performance.

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