

BACK TO BACK: A STUDY OF MULTI-YEAR BEAR MARKETS IN MICROCAPS

Russell Microcap Index: 659.39

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THE BEST OF TIMES?

For investors, 2023 was reminiscent of Dickens' famous opening: the best of times, and the worst of times. The US economy demonstrated remarkable resilience amid historic interest rate hikes. To the casual observer, it might seem like a return to normalcy, especially with the rebound of well-known mega-cap tech companies. Yet, beneath the surface of market-cap weighted indices, a stealth bear market looms. Smaller stocks, more reliant on floating debt than larger counterparts, suffered a second consecutive year of price declines.

This prompts the question: How often do small caps endure multi-year bear markets, and what lessons can be drawn from these periods?

A Historical Perspective

Historically, small caps have outperformed large caps over extended periods. Since 1927, the largest 10% of US stocks grew at a 9.24% compound annual growth rate (CAGR), while the smallest 10% grew at an eye watering 16.33% CAGR.

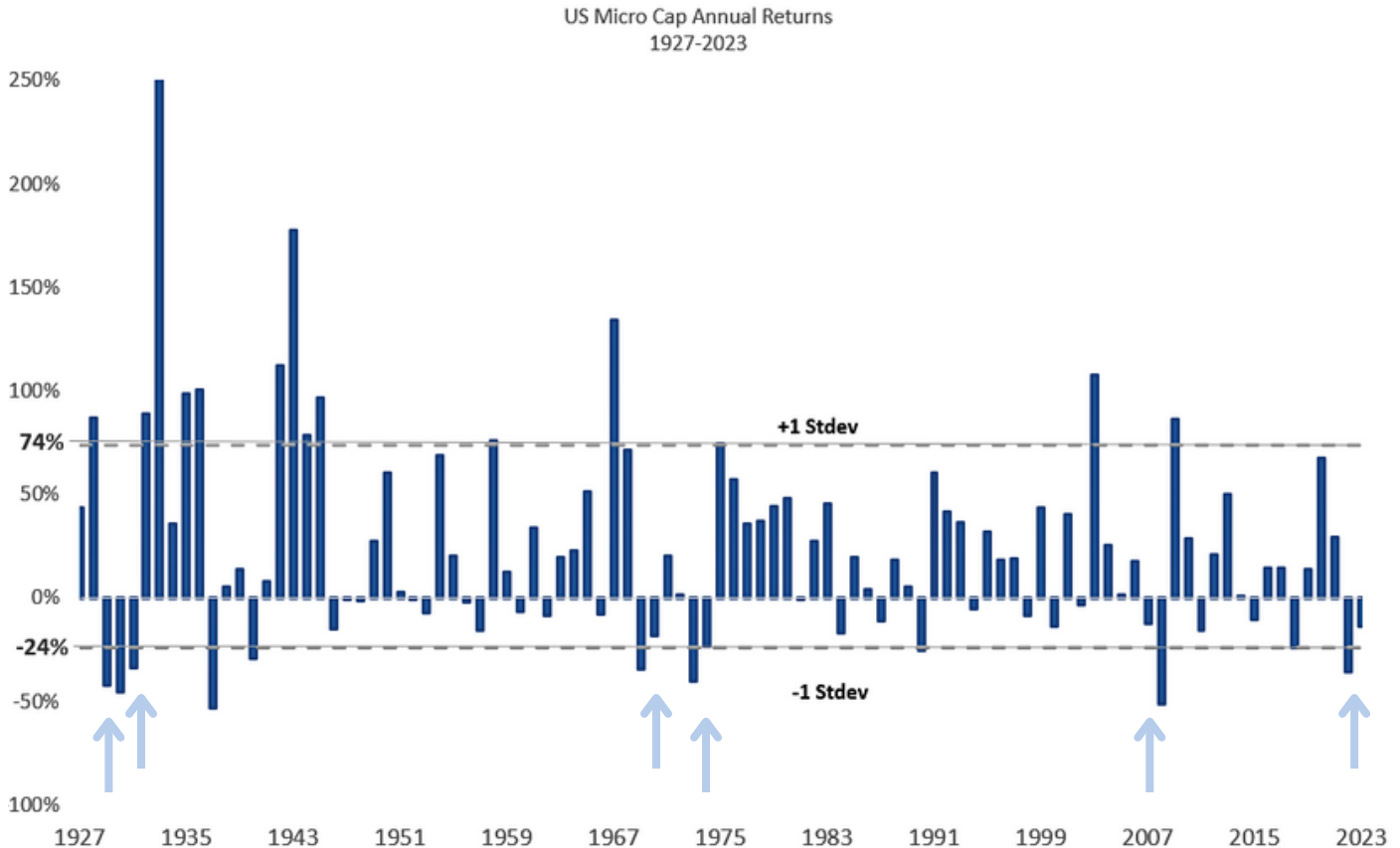
Approximately two-thirds of the years were positive for these smaller stocks. However, consecutive negative years for the smallest stocks were less common. Our research found just 10 instances of back-to-back negative returns. The average investor should expect to encounter several such markets in their lifetime.

Bear markets in small stocks, defined as declines exceeding one standard deviation from the average (over -24.5%), are also rare. In the past 100 years, we identified 11 such occurrences. Yet, multi-year bear markets are extraordinarily uncommon.

Experiencing back-to-back annual declines, with at least one year dropping more than -24.5%, is the investor's equivalent of witnessing Halley's Comet. Since 1927, this has happened only five times, including twice during the Great Depression. If current trends persist, we will be observing our first since 2008.

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Figure 1: Annual Return of US Micro Caps 1927 - 2023



Source: DJWM & Fama & French

Fortune Favors the Bold

There's a saying that in Chinese, the word for 'crisis' also implies good 'opportunity'. For investors willing to deploy capital into these multi-year bear markets, this has certainly been true.

Investors brave enough to invest in small stocks after multi-year bear markets have never lost money over the next two years, and they have averaged an impressive 60.26% *per year* over that same time.

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Figure 2: Microcap Average Annual Return 2 Years following Multi-Year Bear Markets

YEARS	COMPOUND ANNUAL RETURN THE FOLLOWING 2 YEARS
1929-1930	11.96%
1930-1931	158.88%
1969-1970	10.32%
1973-1974	65.40%
2007-2008	54.77%
2022-2023	?
AVERAGE	60.26%
AVERAGE SINCE WWI	43.50%

Source: DJWM & Fama & French

Looking Ahead:

While the future is uncertain and past performance is no guarantee of future results, the history of multi-year bear markets in small caps suggests a compelling opportunity may be at hand. Investors should consider asking Santa

to leave some microcaps in their stocking – or portfolio – for 2024 and beyond. Investors should remember: sometimes the worst of times can be the best of times to invest.

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