SHOULD YOU THINK SMALL?

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Given 2017’s impressive returns on the equity market, one might have expected that SmallCap stocks—typically high-risk, high-return investments—would have risen at least as much as their LargeCap counterparts. But that was not the case. SmallCap stocks, as represented in the Russell 2000 Index, returned only 14.6% in 2017, well shy of the 21.64% performance of the S&P 500.

Momentum certainly remained with the larger companies as we entered 2018. The S&P 500 returned 5.62% in January of this year, only to suffer a natural correction and give back 3.89% and 2.69% in February and March, respectively.

In light of trade war concerns and increased U.S. dollar volatility, more investors sought out smaller domestic public companies that seem to provide a shield against world economic fluctuations and the corresponding headline news of LargeCap multi-nationals. Multi-nationals, found in the Dow Jones Industrial Average, have suffered the most in this environment while smaller cap, more domestically focused SmallCaps faired the best.

- The S&P 500® was up 3.03% in August, bringing the YTD return to 8.52%.
- The Dow Jones Industrial Average® gained 2.16% for the month and was up 5.04% YTD.
- The S&P MidCap 400® was up 3.03% for the month and up 7.58% YTD.
- The S&P SmallCap 600® was up 4.72% in August and up 17.31% YTD.

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FactSet data reported that investors in exchange-traded funds (ETFs) have recently turned away from LargeCaps, pulling some $20 billion out of LargeCap ETFs in June alone. SmallCap ETFs appeared to be a major beneficiary of these outflows as we examine monthly equity flow and allocation data.

Below we examine some of the forces spurring investors to consider SmallCaps.

Protections from Trade Wars

The current administration's tariffs on aluminum and steel have caused investors to spurn LargeCap companies that have hefty international exposure, where an impending trade war with China or other countries will affect profits and revenue more significantly. On the other hand, American SmallCap stocks tend to generate revenue through domestic markets, so they are more impervious to world trade policy conflicts.

The Rising Dollar

The continuing rise of the U.S. dollar is adversely affecting domestic equities, but many smaller U.S. companies are again more insulated from the impacts of a rising dollar because most of their sales come from domestic markets. Larger firms, on the other hand, tend to have significant international operations, which a rising U.S. dollar can negatively affect.

Companies in the S&P SmallCap 600 derive 78.8% of their revenue from U.S. consumers, compared with 73.3% in the S&P MidCap 400 and 60.9% in the S&P 500. Historically, SmallCap stocks have weathered geopolitical turmoil and currency fluctuations more effectively than LargeCap equities.

A Less Taxing Environment

SmallCap firms usually pay higher effective taxes and have greater compliance obligations, so tax reform and deregulation would likely be an asset to them. Furthermore, earnings that were formerly generated abroad by LargeCap companies were held in foreign nations as a tax shelter.

This year, off-shore balances will be subject to a one-time tax of 15.5%. That cash can be used in various ways, mostly likely acquisitions, dividend increases and stock buy backs. Small companies will be most attractive for acquisition, so this tsunami of cash returning to American shores may especially bolster SmallCap equity pricing.

Many analysts agree that U.S. SmallCap and MidCap public companies are better positioned for a boost from the corporate tax cuts than are most LargeCap firms in the S&P 500. Russell 2000 firms have paid at least $9.2 billion less in taxes in the second quarter of 2018 than in the last quarter of 2017, Reuters reported. SmallCap firms have shown a propensity to reinvest those savings over stock buybacks, in contrast to LargeCap firms.

Growth Abounds

U.S. economic growth got off to a slow start in 2017 with Q1 GDP at just 1.8%. The final 3 quarters of 2017 then grew to more appropriate levels with Q2 at 3%, Q3 at 2.8% and Q4 at 2.3%

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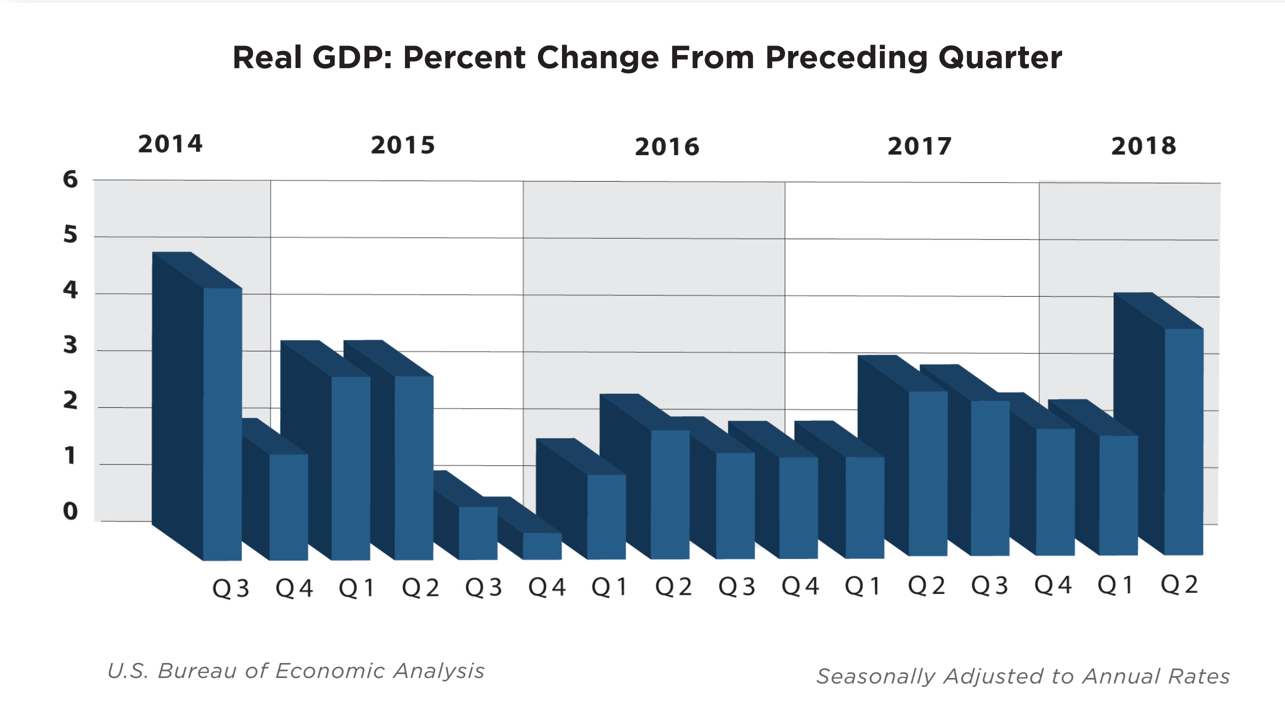
THINK SMALL CONTINUED



We anticipate domestic and global GDP will remain healthy through 2018 and corporate profits will be broad-based. SmallCap firms, catering to a domestic audience, have growth opportunities from both household and government spending (the latter may include an impending infrastructure bill), in addition to easy-credit conditions and business capital expenditure environment.

SmallCap equities may also be advantageous over LargeCap equities in respect to currency effects. A more hawkish Federal Reserve, rising bond yields, and above-trend rates of economic growth may push the dollar higher, relative to our trade partners. A higher-value dollar cheapens producer inputs, which decreases costs for domestic companies that import parts or raw materials. However, a higher-value dollar also increases prices on U.S. products in global markets. On both counts, LargeCap companies, with significant production and earnings generation outside of the U.S., are at a comparative disadvantage to SmallCap companies which do not have the same global reach and dependency.

CONCLUSION

SmallCap stocks should be a measured component of a strategic asset allocation strategy in most market and economic cycles. However, they can have additional volatility over LargeCap equities.

WT Wealth Management's proprietary research has shown that there are distinct periods when owning SmallCap companies are better than at other times. Traditionally, the best time to hold and increase SmallCap stock allocations has been early in the economic recovery cycle. One reason for this is SmallCap companies can react and adapt more quickly to improved economics and traditionally outperform LargeCap companies

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CONCLUSION CONTINUED

which are like battleships and can require more "ramp up time" as the economy exits a recession and enters an economic recovery/expansion phase. Smaller companies can be more like speedboats; agile and quick to respond.

However, our present economic environment is anything but traditional. We are deep into one of the longest, slowest economic expansions in modern times. Since the "great bottom" in the S&P 500 on March 2, 2009, where it stood at 638.38, we have steadily climbed to 2,901.52, a 264% return. Come early next year, we expect the current expansion to celebrate a 10-year anniversary.

Then why look at SmallCaps now when we appear to be so late in the economic cycle? When you couple low interest rates, a strong economy, generational corporate tax cuts, unprecedented deregulation and a trade war, it is definitely worth evaluating SmallCap allocations in the current environment, which appears favorable to such companies. This is clearly a tactical allocation call and could be short or long lived.

We understand that every investor is special and unique. Please consult your financial advisor to determine if an allocation to SmallCaps is appropriate for your portfolio, considering your overall investment objectives, time horizon and tolerance for account fluctuations.

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