Below is the latest informational commentary from Rothschild Asset Management Inc., the subadvisor to Pacific Funds℠ U.S. Equity Funds.

Value, Growth, or Both? A Framework for Allocating to Small-Cap U.S. Equity

Conventional wisdom suggests that for investors with the appropriate risk tolerances, even a limited allocation to small-capitalization (small-cap) stocks has the potential to diversify risk and increase returns over the long term. On the other hand, the recent sharp divergence between small-cap value and small-cap growth stocks has complicated the allocation decision for investors.

For risk-averse investors preferring a set-it-and-forget-it approach, exposure to small caps through a core option may make sense. But for those investors willing to make tactical tilts, a "goalpost" approach, which refers to an allocation to both value and growth strategies, has the potential to improve investor outcomes.

To help frame the allocation decision, an overview of the asset classes is in order.

Summary

- The decision to invest in small-cap value, core, or growth asset classes is as much about sector exposure as investment philosophy.
- Performance across small-cap value, core, and growth indexes can vary considerably over short and intermediate periods.
- While investing solely in the small-cap core asset class offers one-stop shopping, those who believe in rebalancing or taking tactical views will prefer allocating to both small-cap value and small-cap growth.

The Case for Small-Cap Value

Historically, small-cap value stocks sat at the intersection of two positive long-term trends in asset management. In their groundbreaking research, Eugene Fama and Kenneth French argued that both small-cap stocks and value stocks (regardless of market capitalization size) have historically tended to outperform the broader market. Explanations for this anomaly include the belief that market participants misprice the value of these companies, and conversely are willing to pay up for growth and for blue-chip (large-cap) stocks.

On the surface, deciding whether to invest in growth or value stocks is a philosophical debate; that is, it's a decision whether to invest in fast-growing companies that one believes may be valued fairly, or to instead invest in slower-growing companies that are thought to be trading at a discount. In practice, this decision will greatly influence an investor's sector exposure. This is particularly true in the small-cap universe. For instance, some investors may be surprised to learn that just two sectors out of 11—Financials and Industrials—together account for about 45% of the sector weights in the Russell 2000® Value Index's sector weights (Exhibit 1).

Exhibit 1. Russell 2000 Value Index by Sector Composition

Sector	%
Financials	32.10
Industrials	12.68
Information Technology	10.21
Real Estate	9.98
Consumer Discretionary	9.74
Utilities	6.17
Materials	4.72
Health Care	4.70
Energy	4.45
Consumer Staples	2.74
Cash and Other	1.88
Telecommunication Services	0.61

Source: Russell, as of March 31, 2017.

The Case for Small-Cap Growth

Similarly, roughly 45% of the Russell 2000® Growth Index, which measures the performance of the small-cap growth segment of the U.S. equity universe, is comprised of two sectors, namely, Information Technology and Health Care (Exhibit 2). Advocates for investing in small-cap growth companies argue that investing in small-cap growth stocks offers the potential to harness the power of some of the most dynamic companies in the economy. For various structural reasons, companies in the Health Care and Information Technology sectors are benefiting from long-term growth drivers. In these sectors, innovation is not a pipe dream, but a reality. Today, personalized medicine is revolutionizing healthcare, with biotech research leading to cures for diseases.

Technological innovation is no longer just the stuff of futuristic sci-fi movies, but has manifested itself through the Internet of Things[1], wearables, and unified communications. These advances, along with security, cloud computing, and software-defined networks are all disruptors and drivers of growth.

Exhibit 2. Russell 2000 Growth Index by Sector Composition

Sector	%
Information Technology	24.67
Health Care	21.69
Industrials	15.79
Consumer Discretionary	14.73
Financials	5.63
Materials	5.46
Real Estate	5.39
Consumer Staples	3.02
Energy	1.24
Utilities	0.81
Cash and Other	0.78
Telecommunication Services	0.78

Source: Russell, as of March 31, 2017.

The Case for Small-Cap Core

There are two approaches to allocating across small cap. One is to utilize a small-cap core strategy which blends value and growth elements. A second one is to take a goalpost approach, which utilizes both small-cap value and small-cap growth options.

Utilizing a small-cap core strategy may offer an immediate benefit. A small-cap core approach has the potential to mute some of the volatile swings if value or growth falls out of favor. Part of this benefit stems from the fact that sector weightings in small-cap core tend to be more diversified than either value or growth strategies. For example, no single sector comprised more than 20% of the Russell 2000® Index (Exhibit 3).

Exhibit 3. Russell 2000 Index by Sector Composition

Sector	%
Information Technology	19.25
Health Care	17.23
Industrials	14.19
Consumer Discretionary	12.95
Financials	12.17
Materials	7.75
Real Estate	5.08
Consumer Staples	3.57
Energy	2.89
Utilities	2.88
Cash and Other	1.35
Telecommunication Services	0.69

Source: Russell, as of March 31, 2017.

Analysis of trailing returns also shows a more muted volatility of relative returns for small-cap core when compared to small-cap growth and small-cap value. When compared across 6 asset classes during the past 10 calendar years, the Russell 2000 Value Index was a top or bottom performer seven times, and the Russell 2000 Growth Index was a top or bottom performer three times; meanwhile, the Russell 2000 Index, a mix of growth and value, never finished at the top or bottom for the entire 10-year period (Exhibit 4).

[1] Internet of Things: The network of physical objects—devices, vehicles, buildings, and other items—embedded with electronics, software, sensors, and network connectivity that enables these objects to collect and exchange data.

Exhibit 4. Annual Returns (1997–2016)

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
S&P 500 Growth 9.13%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 Growth 29.09%	S&P 500 Growth 4.65%	Russell 2000 Value 18.05%	Russell 2000 Growth 43.30%	S&P 500 Growth 14.89%	S&P 500 Growth 5.52%	Russell 2000 Value 31.74%
Russell 2000 Growth 7.05%	Russell 2000 -33.79%	S&P 500 Growth 31.57%	Russell 2000 26.85%	S&P 500 2.11%	S&P 500 Value 17.68%	Russell 2000 38.82%	S&P 500 13.69%	S&P 500 1.38%	Russell 2000 21.31%
S&P 500 5.49%	S&P 500 Growth -34.92%	Russell 2000 27.17%	Russell 2000 Value 24.50%	S&P 500 Value -0.48%	Russell 2000 16.35%	Russell 2000 Value 34.52%	S&P 500 Value 12.36%	Russell 2000 Growth -1.38%	S&P 500 Value 17.40%
S&P 500 Value 1.99%	S&P 500 -37.00%	S&P 500 26.47%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	S&P 500 16.00%	S&P 500 Growth 32.75%	Russell 2000 Growth 5.60%	S&P 500 Value -3.13%	S&P 500 11.96%
Russell 2000 -1.57%	Russell 2000 Growth -38.54%	S&P 500 Value 21.17%	S&P 500 15.06%	Russell 2000 -4.18%	S&P 500 Growth 14.61%	S&P 500 32.39%	Russell 2000 4.89%	Russell 2000 -4.41%	Russell 2000 Growth 11.32%
Russell 2000 Value -9.78%	S&P 500 Value -39.22%	Russell 2000 Value 20.58%	S&P 500 Growth 15.05%	Russell 2000 Value -5.50%	Russell 2000 Growth 14.59%	S&P 500 Value 31.99%	Russell 2000 Value 4.22%	Russell 2000 Value -7.47%	S&P 500 Growth 6.89%

Source: Morningstar, as of 12/31/16

The performance data represents past performance, which does not guarantee future returns.

Tactical Tilts: the Case for Both

On the other hand, a goalpost approach could make sense for investors who prefer to use a more tactical strategy. Arguably, volatility presents as much of an opportunity as a challenge for making allocation decisions. In 2016, small-cap value stocks outpaced small-cap growth stocks by nearly 20%, with the Russell 2000 Value Index up a robust 31.7%, and the Russell 2000 Growth Index up just 11.3%. A contrarian investor might see such dispersion as an opportunity to take profits in their small-cap value strategy, and reallocate in favor of small-cap growth.

Conversely, investors with a structural view might argue that certain factors leading to the recent relative outperformance of small-cap value are likely to persist. So, if it is believed that interest rates will continue to head higher and deregulation will continue, the Financials sector may have room to run, thus warranting an additional allocation to small-cap value. Similarly, if it is believed that the Trump administration will be able to pass a large infrastructure buildout, and that business investment will continue to pick up steam, then the rally in the Materials and Industrials sectors could continue, fueling small-cap value stocks higher.

For investors with an informed view, being tactical doesn't necessarily require a crystal ball. In fact, a simple rebalancing strategy can potentially increase returns while reducing risk by trimming the higher-performing asset class. Taking this approach in the small-cap space allows investors working with their advisors to leverage "reversion to the mean," which is the tendency for extreme dispersions in returns to revert and even out over the long haul. For example, after an extended period of underperformance for small-cap growth stocks when compared to small-cap value stocks through the financial crisis, many were not shocked to see small-cap growth stocks outperform their value counterparts by nearly 4.6% per year through 2015 (Exhibit 5). Capturing even half of this inflection could make a meaningful difference in investor outcomes, particularly since sharp reversals between small-cap growth and small-cap value are not uncommon.

Exhibit 5. Reversion to the Mean: Relative Performance of Small-Cap Indexes

Index Name	2016	2015	2014	2013	2012	2011	2010	2009	**Return** (Annualized) (2009-2015)
Russell 2000 Value	31.7%	-7.5%	4.2%	34.5%	18.1%	-5.5%	24.5%	20.6%	**11.7%**
Russell 2000	21.3%	-4.4%	4.9%	38.8%	16.3%	-4.2%	26.9%	27.2%	**14.0%**
Russell 2000 Growth	11.3%	-1.4%	5.6%	43.3%	14.6%	-2.9%	29.1%	34.5%	**16.3%**

Index Name	2008	2007	2006	2005	2004	2003	2002	2001	2000	**Return** (Annualized) (2000-2008)
Russell 2000 Value	-28.9%	-9.8%	23.5%	4.7%	22.2%	46.0%	-11.4%	14.0%	22.8%	**7.0%**
Russell 2000	-33.8%	-1.6%	18.4%	4.6%	18.3%	47.3%	-20.5%	2.5%	-3.0%	**1.2%**
Russell 2000 Growth	-38.5%	7.0%	13.3%	4.2%	14.3%	48.5%	-30.3%	-9.2%	-22.4%	**-4.7%**

Source: Russell, as of March 31, 2017.

Conclusion

Particularly for those with longer time horizons, small-cap stocks can play a valuable role in investors' portfolios. Smaller capitalization companies are often nimble and more dynamic, and offer the opportunity for larger, more mature companies to harness higher growth rates through acquisition. Lower liquidity and fewer Wall Street analysts covering small-cap stocks also create inefficiencies that over time have produced opportunities for active management to add value.

Investors looking to refine their small-cap allocation should consider many factors, including risk tolerances as well as their exposures to value and growth strategies across mid- and large-cap investments. For those preferring a set-it-and-forget-it approach, an allocation to small-cap may make sense. But for those investors looking to take a hands-on approach, separate allocations to small-cap value and small-cap growth may better enable tactical decision making.

Definitions

The **Russell 2000 Growth Index** measures the performance of equity securities of small-capitalization growth companies. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000 Index** is a small-cap stock-market index of the bottom 2,000 stocks in the Russell 3000® Index.

The **Russell 2000 Value Index** measures the performance of equity securities of small-capitalization value companies. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500 Growth Index** measures the performance of equity securities of large-capitalization growth companies in the S&P 500 Index.

The **S&P 500 Index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market

The **S&P 500 Value Index** measures the performance of equity securities of large-capitalization value companies in the S&P 500 Index.

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