Small (Cap) but Mighty

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Despite a number of economic and political headwinds in 2013, US stocks have powered ahead, and not just the large-cap names that equity investors tend to gravitate toward during times of uncertainty. Small-cap stocks have also been looking pretty mighty overall this year. Michael McCarthy, portfolio manager for Franklin Small Cap Growth Fund, believes there are still reasons to be bullish in 2014, although careful stock selection could be even more important after 2013's small-cap run.

The US equity markets in 2013 have been strong, fueled in large part by accommodative monetary policy and a generally improving economic backdrop. Compared to this time last year, today, we seem to have a much different investor frame of mind and a greater willingness to embrace risk assets across the spectrum of market capitalization. In late 2012, investor fear was running pretty high. At that time, investors were very concerned about looming automatic tax increases and spending cuts dubbed the "fiscal cliff," and the impact they would have on the economy in 2013. Investors became very fearful about companies with economic sensitivity in their business model, which generally encompasses the small-cap stock universe.

Definitions of "small cap" can vary, but Franklin Small Cap Growth Fund invests at least 80% of its net assets in the equity securities of companies with market capitalizations not exceeding $1.5 billion or the highest market capitalization in the Russell 2000 Index (a small-cap benchmark), whichever is greater, at the time of purchase. For long-term investors like us, we believe late 2012 actually was a good environment in which to find bargains. We often find opportunities when the rest of the market is fearful about short-term issues, and we remained (and still remain) very focused on the long-term outlook for our investments. We found a lot of opportunities at the end of last year in areas including industrials and technology, which provided attractive returns for us in 2013. Because we are bottom-up investors, stock selection dictates our performance in most periods. As we look at our results so far this year, we think our team of analysts – with their outstanding research – deserves a lot of credit for its careful process.

Investment Selection Process

We seek to invest in rapidly growing small-capitalization companies, targeting companies we believe have pricing power, cost advantages, sustainable competitive advantages or innovative products or services. One company we feel exemplifies our investment approach and process is Shutterfly[1], an e-commerce retailer of photo-related products. We believe it's a high-quality company with a competitive advantage not just tied to brand loyalty, which is very high, but also through its cost structure, which provides it an opportunity to compete successfully against a number of competitors that have tried to gain market share. Another aspect of its business that really fits well with our strategy is the growth opportunity. We believe Shutterfly has good potential not only to grow within its market segment, but for its segment overall to grow as well.

Shutterfly is also an example of how we look for companies we believe have potential, but may be out of favor with other investors. In early 2012, Shutterfly reported a very disappointing fourth quarter to the investment community, and its stock was under pressure. As we analyzed its situation, it became clear to us that the issues that plagued the company appeared short-term in nature. As we looked across its competitive landscape and understood its competitive advantage better, we came to the conclusion that the heavy discounting that Shutterfly's competitors used to disrupt its business in that quarter wasn't likely sustainable, and earnings growth subsequently reaccelerated.

2014 Backdrop Generally Favorable, but Valuations Need Support

Looking ahead into 2014, it's a bit difficult to provide an outlook given the unknowns out there, but the backdrop for equities generally looks favorable to us. Our team believes small-cap stocks should remain attractive in the coming year, and the macro environment could provide more opportunities for companies to further grow their earnings and cash flow.

One particular area we will be watching in 2014 is mergers and acquisitions (M&A). Many large companies which are looking to grow have, we believe, really under-invested in recent years. So, one way they could achieve that growth is through acquisitions. We believe small caps may be uniquely positioned to benefit from a more robust M&A environment in the coming year.

The main market risk we see ahead involves the two key drivers of performance in 2013: economic growth and Federal Reserve monetary policy. A change in those two tailwinds that is perceived as negative could have an adverse effect on the stock market in 2014. In the current market, small-cap valuations have clearly moved higher, and we need to see continued growth to support the higher valuations. We think the 2014 market is likely to be one in which fundamental factors become more important, where earnings growth becomes more important and where cash flow growth becomes more important.

Overall, we believe in our process and the long-term case for small-cap stocks. Small-cap companies can provide investors good opportunities for growth and exposure to what we believe are some of the most dynamic companies in the domestic economy.
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What Are the Risks?

All investments involve risks, including possible loss of principal. Smaller, mid-sized and relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Historically, these securities have experienced more price volatility than larger company stocks, especially over the short-term. Growth stock prices reflect projections of future earnings or revenues, and can, therefore, fall dramatically if the company fails to meet those projections. To the extent the fund focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a fund that invests in a wider variety of countries, regions, industries, sectors or investments. From time to time, the trading market for a particular security or type of security in which the Fund invests may become less liquid or even illiquid. These and other risks are detailed in the prospectus.

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1. As of 10/30/13, Shutterfly, Inc. common stock represented 1.75% of net assets of Franklin Small Cap Growth Fund. Holdings subject to change without notice.