ATIVO CAPITAL

U.S SMALL CAP STOCKS: PRIMED FOR A RECOVERY

Executive Summary:

Ativo Capital, a global equity manager that invests in undervalued, high-quality companies, sees small-cap stocks in the U.S. as a potentially appealing investment opportunity. This perspective arises from historical valuation metrics showing small-cap stocks as very attractive. Furthermore, the combination of lower interest rates and indications of a soft economic landing suggests a promising outlook for small-cap stocks. This note examines the historical context, positive factors, and potential risks, concluding with practical insights for long-term investors.

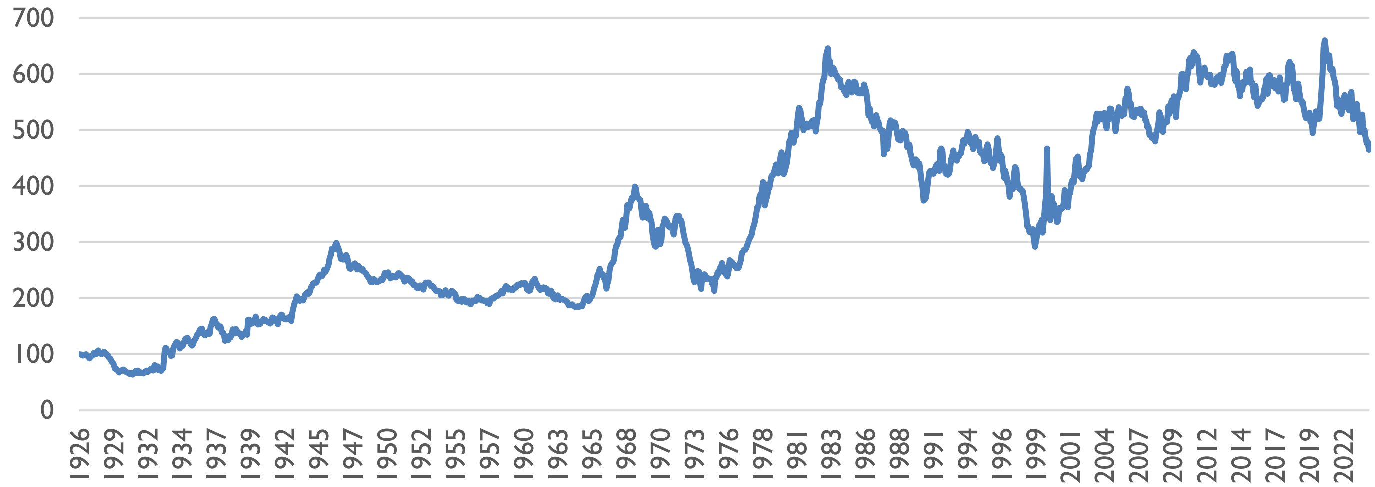
Ativo Capital specializes in global equity management, targeting undervalued companies that excel at creating substantial shareholder value by generating superior cash flows surpassing their cost of capital. Our systematic, factor-based investment approach enables us to comprehensively cover a wide array of small-cap stocks worldwide.

After a softer than anticipated U.S. inflation report on July 11th, which heightened market predictions for Federal Reserve rate cuts this year, small-cap stocks considerably outpaced their large-cap counterparts. The Russell 2000 index surpassed the Russell 1000 index of large and mid-cap stocks by 8.7% in July. This marked the third-largest monthly relative return for the Russell 2000 index since January 1979. (The Russell 2000 outperformed the Russell 1000 by 16.8% in February 2000 and by 9.35% in January 1992). Over recent years, small-cap stocks have generally lagged behind their large-cap peers due to market leadership being driven by Mega-Cap technology firms like the "magnificent seven," especially after the Federal Reserve began raising interest rates. However, the small-cap rally was curtailed when markets dropped sharply at the beginning of August following a weaker than expected jobs report that increased recession concerns. Additionally, the markets were negatively affected by the unwinding of the USD/JPY carry trade after the Bank of Japan raised interest rates, leading to a rapid appreciation of the Japanese Yen against the Dollar. So, what is the outlook for small-cap stocks? Are we regressing to the long-term trend of small-cap underperformance, or are we entering a new phase? We believe the latter scenario is more likely, thus we remain optimistic about the prospects for small-cap stocks in the US. The subsequent sections of this report delve into historical performance data of small-cap stocks, valuations, comparisons of various small-cap benchmarks, and the reasons for our bullish stance.

Factor-Based Investment and size effect

The size effect suggests that market capitalization has notable marginal explanatory power concerning security returns. Consequently, smaller companies tend to generate higher returns over time compared to larger firms, as compensation for the increased risk associated with investing in smaller enterprises. The size effect was initially identified by Banz (1981) and gained prominence through the incorporation of the SMB (small minus big) factor in the Fama & French Three-factor model (1992). So, how has the size factor fared over time within the United States?

Fama & French Three Factor Model - Small minus Big (SMB) Factor Performance



Source: Kenneth French – Data Library

As depicted in the above chart, the size factor has exhibited positive performance in the US since 1926. There have been intervals where smaller stocks outperformed larger ones for extended periods, such as from 1931 to 1946 (368%), 1975 to 1983 (203%), and 1999 to 2011 (119%). Conversely, the opposite trend occurred between 1946 to 1964 (-38%), 1983 to 1999 (-54%), and 2011 to 2024 (-27%).

Recent returns for the SMB factor in the US have not been particularly impressive. It's important to recognize the complexities involved in constructing the SMB portfolio, many of which have faced criticism. A key issue is that the SMB factor and its variations, as discussed in financial literature, are not investable portfolios; they simply serve as indicators of the size premium. Practitioners believe there are more effective methods to track the small cap premium by focusing on investability and practical application. Additionally, many stocks in the lower capitalization segment tracked by the size factor are microcaps with poor liquidity, making them difficult to invest in. There is also a concentration of small cap returns observed in January, initially documented by Reinganum (1981). Furthermore, these stocks often have subpar earnings quality. Asness et al. (2018) noted a significant size premium even during weak periods for the SMB factor when accounting for firm quality. However, Simpson MW & Grossmann A (2024) demonstrated that this size premium disappears during monetary tightening periods, even when controlling for firm quality. We monitor the size premium from a factor-based perspective and consider it an important exposure across our client portfolios based on our risk management process.

Benchmarks and valuations

Small-cap benchmarks play a crucial role when assembling small-cap portfolios. Benchmark providers develop and maintain these benchmarks, which active investors use to compare their portfolio performance. The three main benchmark providers are S&P Global, MSCI, and FTSE Russell. Among the most frequently tracked small-cap benchmarks are the Russell 2000, the S&P 600, and the MSCI USA Small-Cap Indices. These providers employ significantly different methodologies for constructing and maintaining their benchmarks, leading to variations in the number of holdings, inclusion criteria, and rebalancing schedules. Here are some key differences:

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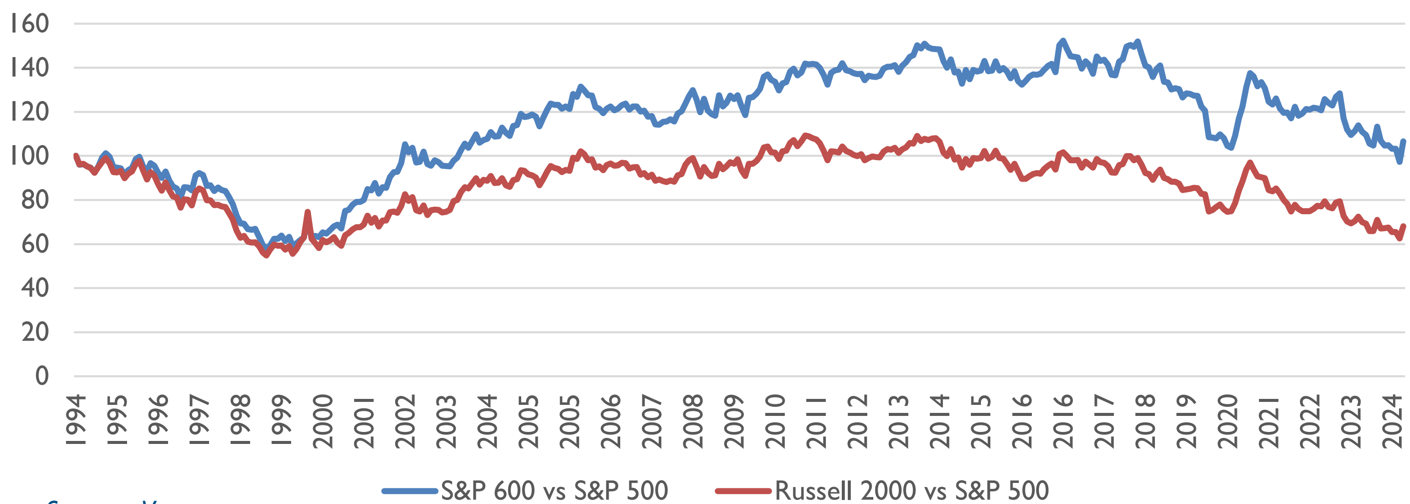
Here are some key differences in benchmark construction methodologies:

1) Russell 2000: Comprising 2,000 small firms within the US equity market, this index uses free float-market capitalization for weighting positions and is rebalanced annually.

2) MSCI USA Small Cap: This index includes 1,726 constituents, also weighted by free float-market capitalization. Minimum liquidity and trading frequency requirements must be met for inclusion. Typically, small-caps represent the bottom 15% of free float-adjusted market coverage. This benchmark is rebalanced quarterly.

3) S&P 600: Encompassing 600 constituents, this index covers companies with market capitalizations ranging from USD $1 billion to $6.7 billion, representing the 93rd to 99th percentiles of the US market. Market ranges are updated based on current market conditions and include screens for liquidity and financial viability. Rebalancing occurs quarterly.

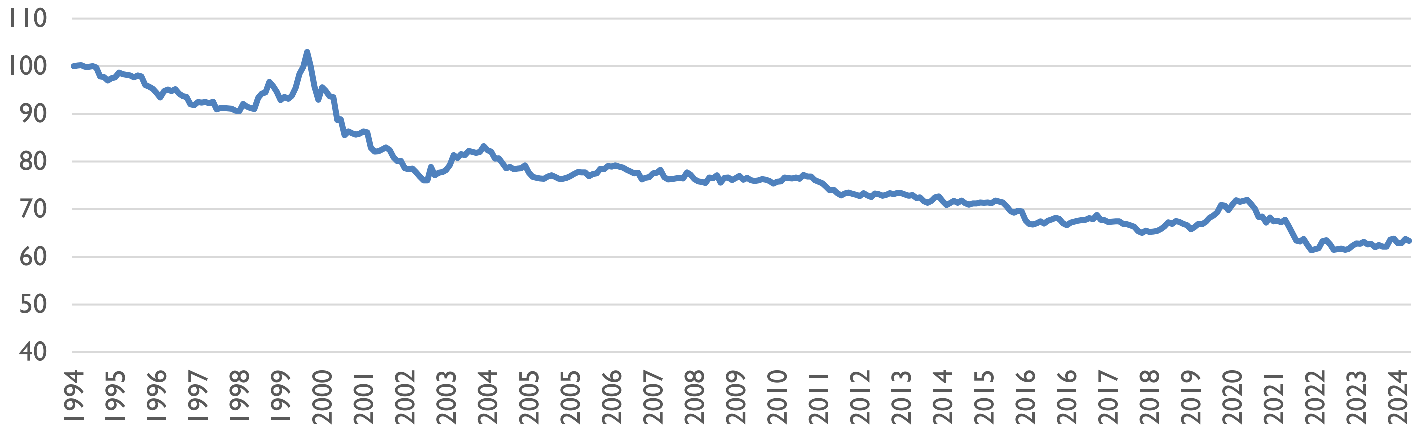
Choosing the right Small Cap benchmark Matters



Source: eVestment

Many firms rely on the Russell 2000 as a performance benchmark for their small-cap portfolios. However, this benchmark is rebalanced just once a year and includes numerous companies with low-quality earnings. In comparison to the S&P 600 and MSCI USA Small Cap, the Russell 2000 is heavily weighted in Biotechnology stocks, which often have negative earnings and binary outcomes that hinge on drug discoveries or approvals. As of July 2024, nearly 44% of the companies in the Russell 2000 posted negative earnings, while this was true for only 20% of the S&P 600 (and merely 6% of the S&P 500). An effective alpha strategy over time would have involved maintaining long positions in the S&P 600 or MSCI USA Small Cap and short positions in the Russell 2000 through ETFs.

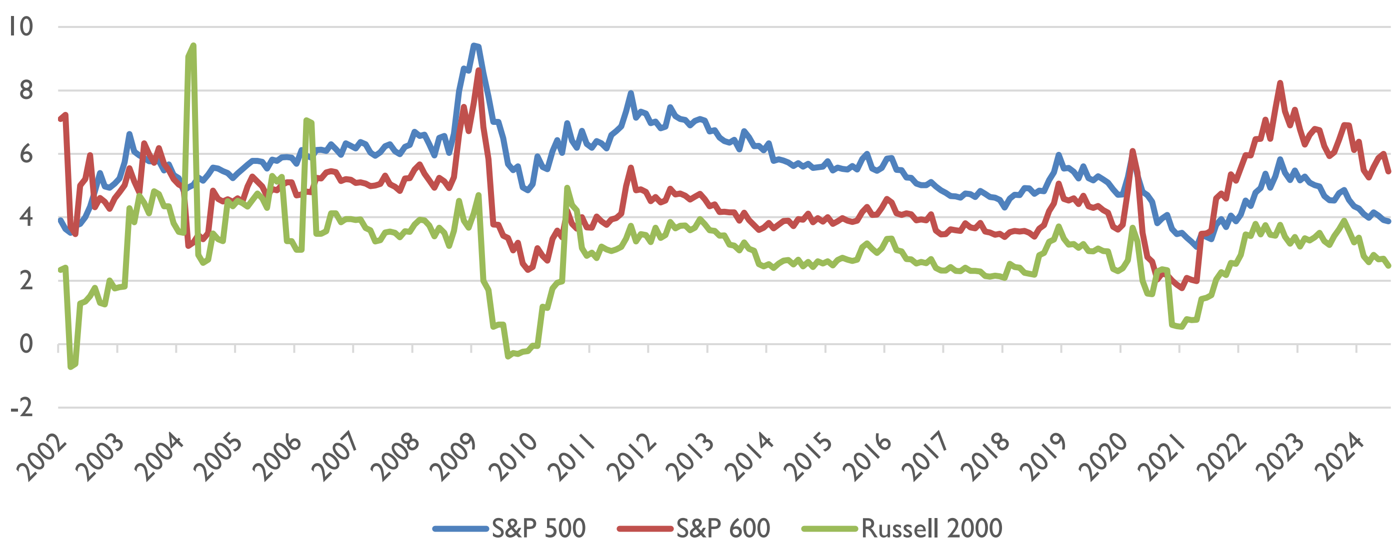
Russell 2000 vs S&P 600



Source: eVestment, PGM

At Ativo, we favor the MSCI USA Small Cap index as the policy benchmark for our small-cap strategy. This preference is because it undergoes quarterly rebalancing and contains fewer low-quality stocks compared to the Russell 2000. Although the S&P methodology employs a financial variability filter to include only firms with recent positive earnings, we prefer to apply our own investment process to screen for profitability and quality. Our proprietary methodology involves measuring and forecasting a company's discounted cash flow return on investment (DCFROI). Companies that achieve returns surpassing their cost of capital generate shareholder value. Additionally, we target companies exhibiting positive operating momentum, price momentum, and lower price volatility. This approach enables us to invest in quality, undervalued firms that are profitable, possess robust balance sheets, and exhibit sustainable growth. Quality small-caps appear attractive in the US market relative to large-caps.

Quality Small Caps are the most attractive
U.S equity indices, earnings yield minus 2y UST yield %



Source: PGM (Core Logic Case Shiller data via Bloomberg)

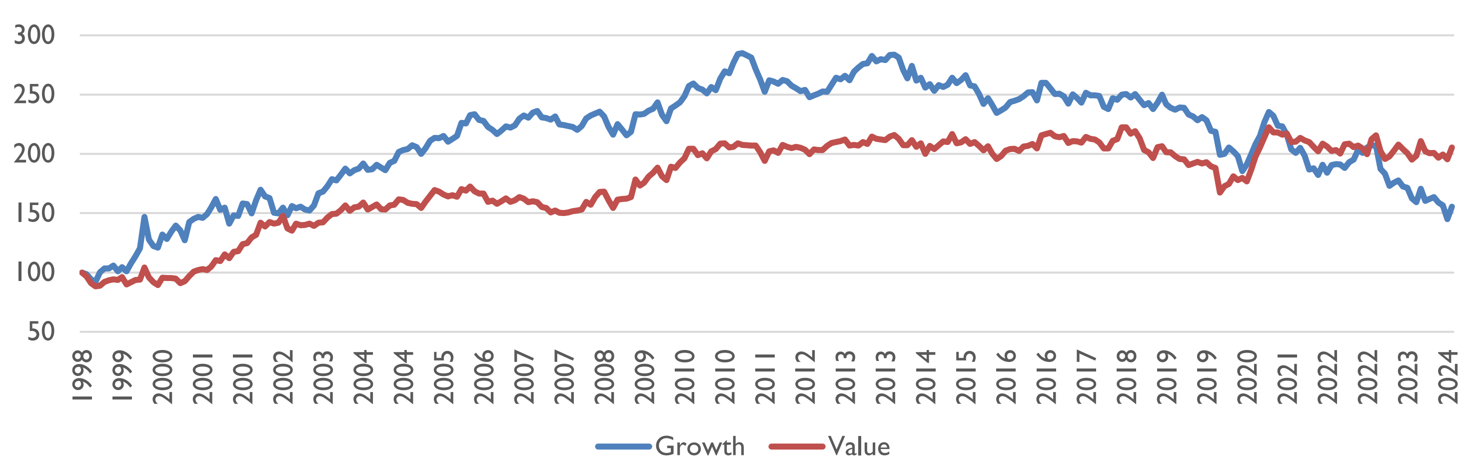
Our investment models presently show a favorable outlook for small-cap stocks in the US. The chart below illustrates that starting in 2000, small-cap stocks were undervalued compared to large-cap stocks and progressively became overvalued by 2011. Since then, this overvaluation has been corrected.

OVERVALUATION OF SMALL CAPS HAS BEEN CORRECTED
S&P 600 P/E RATIO OVER S&P 500 P/E RATIO

Source: Factset, PGM

Additionally, the weak performance of small-cap stocks in recent years varies when comparing growth to value stocks. Small-cap value stocks have remained relatively stable. In contrast, the underperformance is primarily seen in small-cap growth stocks, which aligns with the trend of large-cap outperformance dominated by technology stocks, typically considered growth stocks.

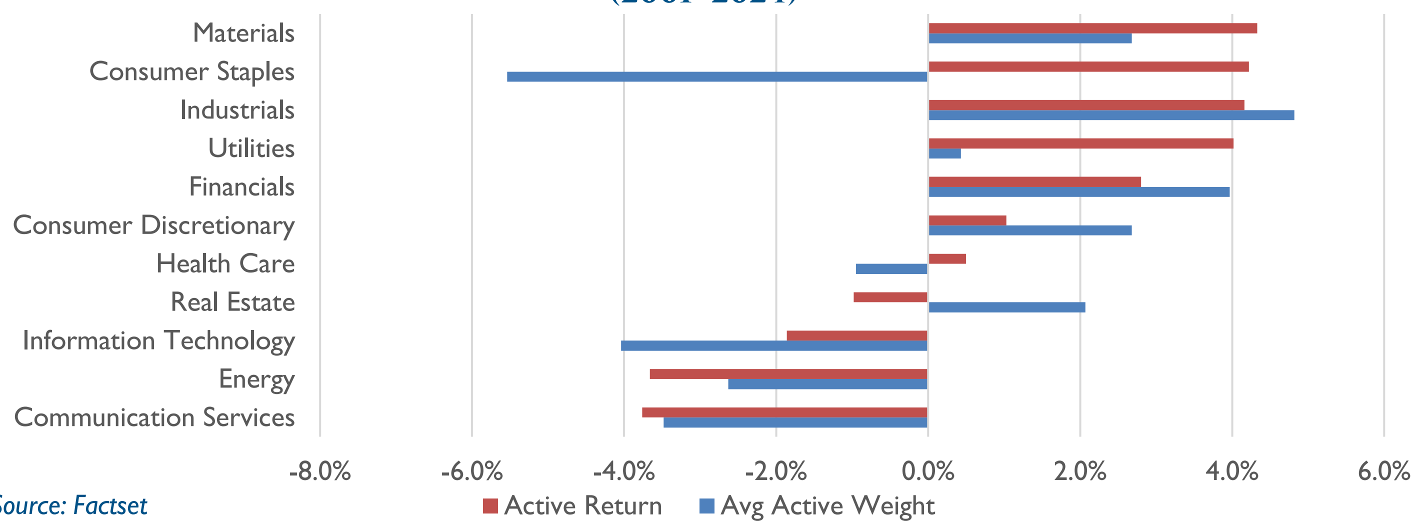
STYLE BENCHMARK PERFORMANCE - MSCI USA SMALL VS (LARGE+MID)



Source: MSCI

Likewise, an analysis of sector performance between small-cap and large-cap benchmarks shows that small-cap stocks have generally outperformed in most sectors, with the exceptions being Information Technology, Communication Services, and Energy.

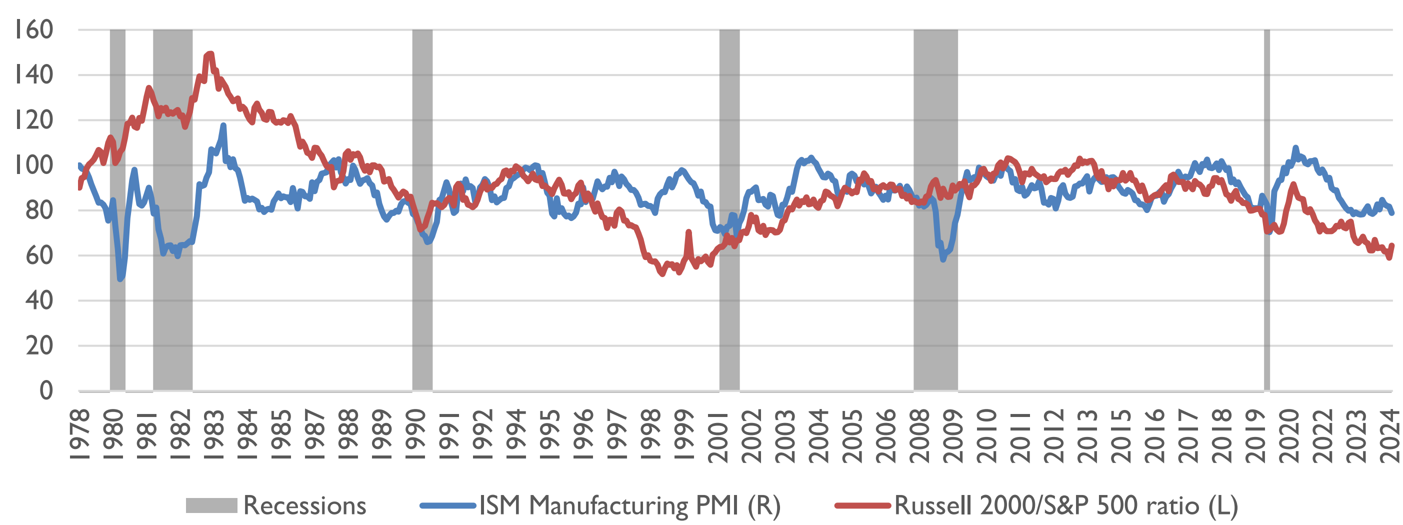
MSCI USA Small Cap vs MSCI USA - Active Sector Weights & Returns (2001- 2024)



Source: Factset

Small-Cap stocks typically face higher capital costs and carry greater amounts of floating rate debt. For instance, about 35% of the debt for Russell 2000 companies is floating rate, compared to just 8% for S&P 500 companies. As the Federal Reserve and other central banks (except Japan) move toward a lower interest rate environment, smaller firms are likely to benefit from reduced debt servicing costs. The economy appears to be on track for a soft landing, with an expected rebound once interest rates begin to decline.

Small-caps : It's all about the economy
Price ratio of Russell 2000/S&P 500 vs ISM U.S Manufacturing PMI Index



Source: eVestment, Factset, PGM

Conclusion:

Given the compelling data and extensive research, the outlook for small-caps and the associated size premium remains promising. In this evolving market landscape, quality is not just important but essential when investing in small-cap stocks—a principle that is central to our strategy at Ativo Capital. With small-cap valuations currently at attractive levels and a shift towards monetary easing on the horizon, the potential for growth in this space is substantial. However, success in small-cap investing requires more than just timing; it demands the right approach. Ativo Capital's systematic, style-neutral investment methodology is specifically designed to navigate the complexities of this asset class. By focusing on a wide spectrum of highly profitable, undervalued companies across various sectors, our strategy is uniquely positioned to identify potential sources of alpha. For investors looking to capitalize on the opportunities within the small-cap market, Ativo Capital offers a disciplined and proven approach that aligns with both short-term opportunities and long-term growth.

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MSCI Index Methodology:

https://www.msci.com/index-methodology

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