

WHY SMALL CAPS - NOW

Seven reasons Emerald believes
small caps could be poised
to outperform

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We believe the recent turmoil in the markets could possibly lead to changes in market leadership moving forward. While the large and mega cap companies have garnered much of the media and investors’ attention since the pandemic hit several years ago, under the surface of the market there have been numerous indicators possibly pointing to small cap outperformance. History has shown this could be a multi-year phenomenon. Emerald does not recommend asset allocations, however, we believe this is definitely not a time to be reducing small cap exposure and could be an opportune time to increase small cap allocations. Finally, if investors have exposure to small caps, we believe it is one area of the market that historically has most benefitted from active management.

1. SMALL CAP PERFORMANCE HAS LAGGED

- We are seeing historic spreads between small cap and large cap performance that have not been seen since the late 1990s.

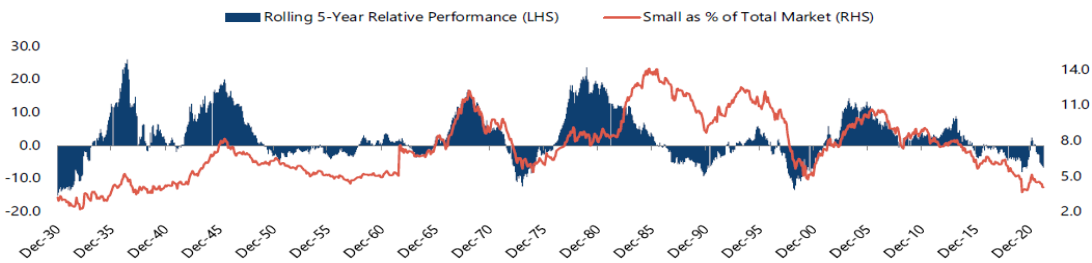
	1-Year	2-Year	3-Year	4-Year	5-Year
Russell 1000 Growth	+15.0%	+36.8%	+23.6%	+20.8%	+20.9%
Russell 2000 Growth	-14.3%	+27.7%	+9.9%	+8.3%	+10.3%

Source: FTSE Russell

2. UNDERPERFORMANCE HAS RESULTED IN SMALL CAPS REPRESENTING A HISTORICALLY SMALL PERCENTAGE OF OVERALL US EQUITY MARKETS

- Underperformance of small caps has led the asset class to become a historically small percentage of the overall US equity markets.
- Small cap stocks currently represent only 4% of the overall US equity market. This stands below the average weight of 7%, close to a 60-year low.
- Statistically and historically, reversion to the mean is a very common phenomenon and normally occurs when investors least expect it. Simple reversion to the mean could indicate a period of small cap outperformance.

Small represents 4% of US equity market, relative performance is awful, time for a shift?



Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP@), The University of Chicago School of Business; Jefferies

5-Year Quintile Performance	Subsequent Performance			Batting Average		
	1-Year	3-Years	5-Years	1-Year	3-Years	5-Years
Q1 (Best)	3.4	0.1	0.8	61.6	49.3	51.1
Q2	2.3	1.2	0.6	49.8	49.3	49.8
Q3	2.1	1.7	2.1	53.1	48.6	52.2
Q4	1.8	3.3	3.1	53.0	53.3	65.5
Q5 (Worst)	7.2	7.6	8.1	65.3	78.5	84.2
Overall	3.4	2.6	2.8	56.6	55.3	59.8

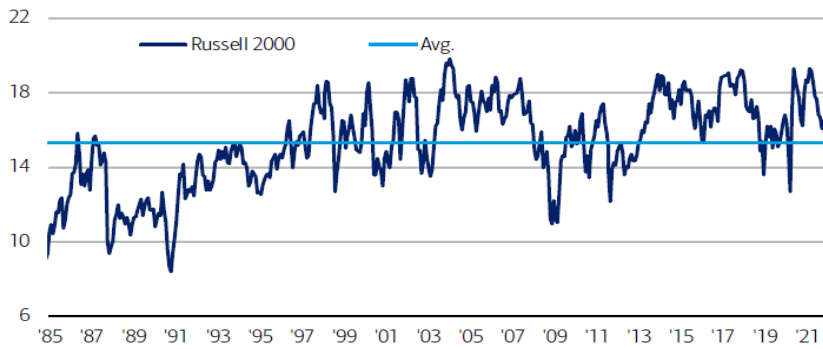
Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP@), The University of Chicago School of Business; Jefferies

3. HISTORICALLY ATTRACTIVE ABSOLUTE VALUATIONS

- Small cap stocks from an absolute valuation standpoint (Price-to-Earnings) look attractive from a historical perspective.
- These valuations are approaching levels last seen during the Great Financial Crisis and the late 1990s.

Small cap fwd P/E below the long-term average

Forward P/E: Russell 2000, 1985-3/31/2022

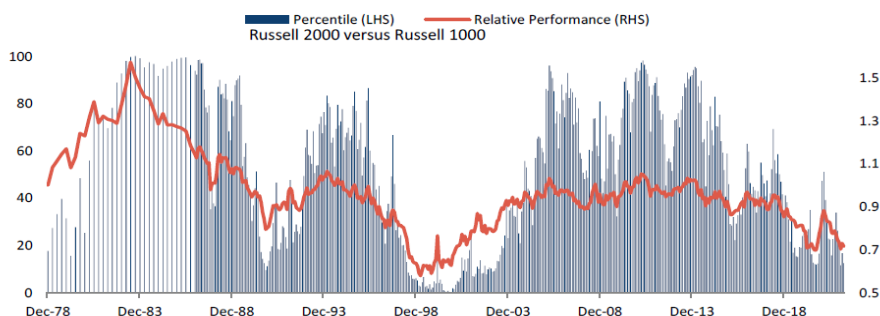


Source: BofA US Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat

4. RELATIVE VALUATIONS OF SMALL CAP TO LARGE CAP

- Not only are absolute valuations for small caps attractive, but relative valuations when comparing small caps to large caps are hitting historically attractive levels.
- From a relative valuation perspective, small caps have not been this attractive versus large caps since the late 1990s.

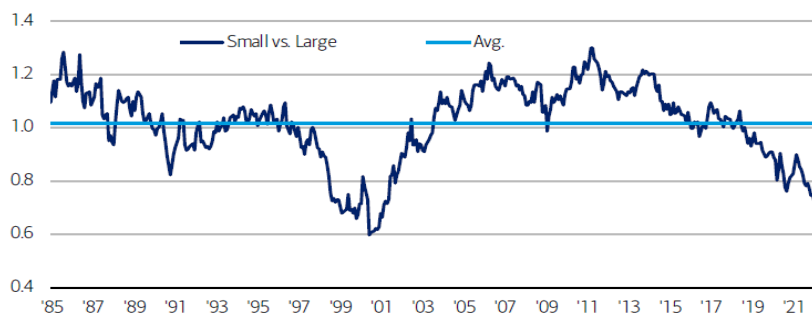
Chart 8 - ...While relative model stands in just the 13th percentile



Source: FactSet, FTSE Russell; Jefferies

Small caps trade at a near-record historical discount vs. large caps

Relative Forward P/E: Russell 2000 vs/ Russell 1000, 1985-3/31/2022



Source: BofA US Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat

Table 5 - Relative valuations for Russell 2000 vs. Russell 1000

Valuation Metric	Russell 2000 vs. Russell 1000		
	Current	LT Avg	% Diff
Trailing P/E (Non Negative)	0.68	1.00	-31.6
Forward P/E	0.96	1.05	-8.4
Price to Book	0.59	0.77	-23.5
Price to Cash Flow*	1.07	1.33	-19.4
Price to Sales	0.78	0.80	-1.4
P/E to Growth	0.81	0.83	-2.8

*Price to cash flow started in 2002.

Note: From March 31, 2016 forward Jefferies estimates.

Source: FactSet; FTSE Russell; Jefferies

5. RELATIVE EARNINGS GROWTH

- Earnings growth rates for small cap stocks are once again higher than mid and large cap stocks.
- Our belief is that earnings growth drives stock prices and this would indicate a possible outperformance of small cap stocks.

Table 3 - 2022 earnings and sales growth by sector

GICS Sector	Small Caps		Mid Caps		Large Caps	
	Earnings	Sales	Earnings	Sales	Earnings	Sales
Comm Serv	66.1	12.1	31.3	12.9	1.2	7.7
Discretionary	13.6	12.9	9.9	10.6	14.6	14.2
Staples	11.9	5.1	22.3	15.9	4.1	4.5
Energy	380.2	25.2	183.7	16.4	80.4	23.8
Financials	-11.1	2.3	-5.5	1.8	-11.6	3.5
Health Care	-4.4	7.0	10.7	8.3	9.2	6.7
Industrials	12.7	9.3	19.4	10.7	29.9	11.4
Info Tech	15.5	7.9	10.6	19.9	10.3	11.2
Materials	46.3	11.7	14.7	8.0	8.7	8.3
Real Estate	31.6	7.9	16.2	9.9	12.4	13.4
Utilities	7.8	-0.2	11.6	3.3	49.6	-4.8
Benchmark	15.6	10.2	11.8	11.0	10.1	9.2
Benchmark less Energy	9.0	8.8	10.0	10.8	7.2	8.0
Growth	22.8	10.1	16.0	11.6	8.6	10.3
Value	14.0	9.5	11.2	10.3	10.0	8.3

Note: As of March 31.

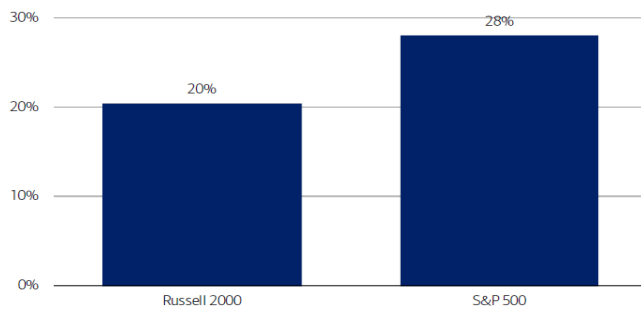
Source: FactSet; Standard & Poor's; Jefferies

6. WE EXPECT SMALL CAP EARNINGS GROWTH TO BE MORE RESILIENT

- While the slowdown in global GDP growth most likely will translate into a slowdown in corporate earnings growth, we believe small cap earnings growth should prove to be more resilient than large cap earnings growth due to the following reasons:
 - Small cap companies on average have more domestic exposure and less foreign exposure than large cap companies, which should make small cap earnings more resilient. Geopolitical issues in Europe (war in Ukraine) and the zero COVID policy in China could make small caps more attractive than their large cap brethren moving forward.
 - In addition, small cap companies on average have more exposure to services than goods. Given the pull forward of goods purchased from the pandemic (furniture, cars, appliances, etc.), this could make them more attractive than large caps as consumer spending shifts to more services (restaurants, entertainment, travel, etc.).

Small caps are more domestic (20% foreign exposure vs. ~30% for large caps)

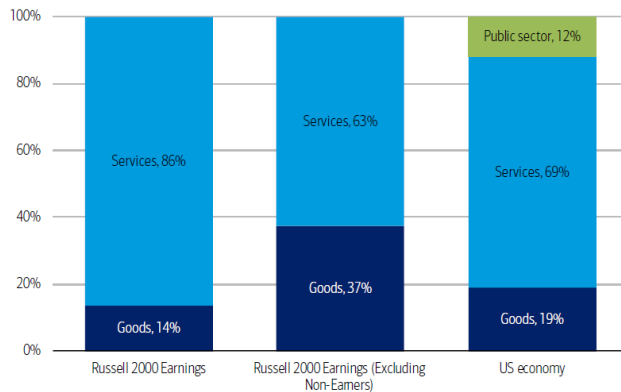
Foreign sales exposure for Russell 2000 vs. S&P 500 (as of 2020)



Source: FactSet; Company Reports, BofA US Equity & US Quant Strategy

Small caps are more geared toward services than goods spending (like US GDP)

Russell 2000 vs. US economy: goods vs. services exposure estimate



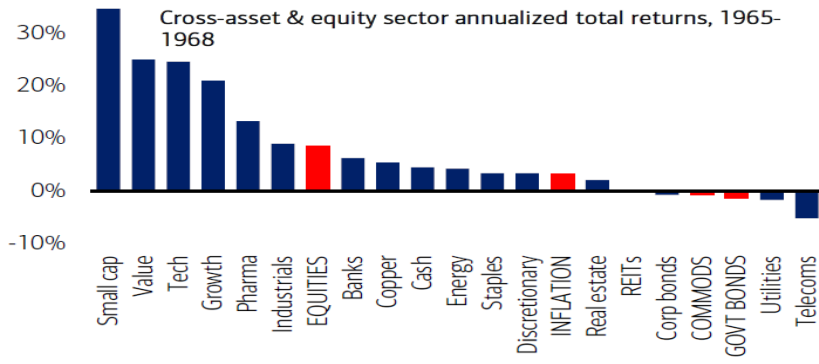
Source: Haver Analytics, FactSet, BofA US Equity & US Quant Strategy.
Based on industry breakout of 2019 earnings for Russell 2000 and gross value added by industry in 2019 for US economy.

7. HISTORICAL SMALL CAP PERFORMANCE DURING PERIODS OF INFLATION AND STAGFLATION

- Historically small cap performance has led large caps in periods of inflation and stagflation.

Historical analog of late-'60s: small caps were best performers

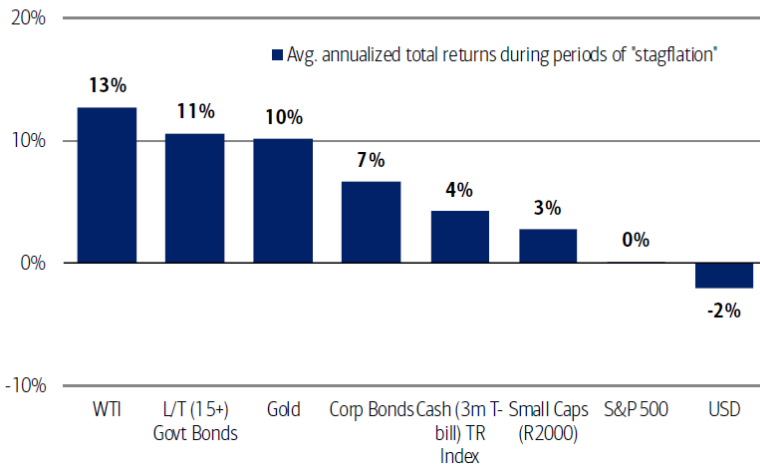
Asset class total returns 1965-68



Source: BofA Global Investment Strategy, Bloomberg, Ibbotson, Global Financial Data, Homer and Sylla "A History of Interest Rates", (2005). As published in: The Thundering Word 11 March 2021.

Hedge against stagflation risk

Small caps outperformed large caps, on avg. during stagflationary environments (periods of slowing growth/rising inflation since 1972)



Source: Haver Analytics, Bloomberg, BofA US Equity & US Quant Strategy

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Mr. Garner is Director of Research and a member of the Small Cap Portfolio Management team. Mr. Garner's research efforts are focused on small and mid-sized firms in the Business Services, Capital Goods, Consumer, Financial Services, and Technology sectors. He has appeared on Bloomberg Television and CNBC. He also has been quoted in *Fortune*, *Bloomberg Business News*, *USA Today*, *Dow Jones News Service*, *Standard & Poor's*, *MarketWatch*, *Investor's Business Daily*, *Wall Street Journal*, and other media. Mr. Garner serves as a Director for the Millersville University Foundation and Chairman of the Investment Committee and previously served as the President of the Board of Directors for the Foundation. Prior to joining Emerald in 1994, Mr. Garner was the Program Manager of the PA Economic Development Financing Authority (PEDFA) and an Economic Development Analyst with the PA Department of Commerce's Office of Technology Development. Mr. Garner received an MBA from the Katz Graduate School of Business, University of Pittsburgh, and graduated magna cum laude with a BA in Economics from Millersville University.



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Ms. Sears is Senior Vice President and a senior member of the Small Cap Portfolio Management team, working directly with the research team, interacting with team members across economic sectors and helping guide the day-to-day portfolio management decision-making process. Ms. Sears is also responsible for portfolio risk monitoring, portfolio attribution analysis, as well as Emerald's portfolio management-related client communications. From a research perspective, Ms. Sears maintains research coverage of the Retail, Apparel, Restaurant, Consumer Goods and Consumer Technology companies. She has been quoted in *Fortune*, *Money*, the *Dow Jones News Service* and various regional newspapers. Ms. Sears received a BS in Business Administration from Millersville University and an MBA from Villanova University.

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