WHY SMALL CAPS - NOW...PART II

Another seven reasons Emerald believes small caps are poised to outperform

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In June of 2022, Emerald authored a whitepaper describing the factors that we believed were laying the groundwork for the reemergence of a small cap outperformance cycle. Market returns over the last five months have lent support to this thesis with the Russell 2000 (+11.1%) outpacing the Russell 1000 (+8.6%) by 250 basis points since June 30, 2022. In this follow-up whitepaper, titled "Part II," we outline an additional seven factors highlighting why the recent outperformance of small capitalization stocks is setting the stage for what we believe could be a multi-year shift in market leadership.

While Emerald does not recommend asset allocation, this 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. EMERGING SIGNS OF A SMALL CAP OUTPERFORMANCE CYCLE

- During Q3 2022, the Russell 2000 succumbed to selling pressure, but notably, despite the surge in treasury yields and historic strength in the U.S. Dollar, small capitalization stocks held their own on a relative basis in the face of the broad-based market turmoil.
- The Russell 2000 (-2.19%) outpaced the Russell 1000 (-4.61%), ending a five-quarter streak of relative underperformance.
- Even more noteworthy was the relative outperformance within the growth component of the Russell 2000. Not only did the Russell 2000 Growth Index (+0.24%) outperform the Russell 2000 Value (-4.61%), the Index also substantially outpaced larger cap peer, the Russell 1000 Growth (-3.60%).
- New market leadership, however, can be born out of bear markets and as we sift through the market carnage and pervasive negative sentiment, the outperformance of small capitalization stocks and growth as a style are noteworthy standouts in this backdrop.
- The third quarter of 2022 was the first quarter in the last five quarters that the Russell 2000 has outperformed the Russell 1000. That was the longest streak of underperformance for the Russell 2000 since the six-quarter run that ended in the first quarter of 1999, according to Furey Research.
- Also noteworthy was the relative outperformance of growth as a style during the third quarter. The relative performance of Growth versus Value has been nearly perfectly correlated to the 10-year real rates since 2018 (approximately 92% until August 2022) according to an October 3, 2022 report from Savita Subramanian of B of A Securities.

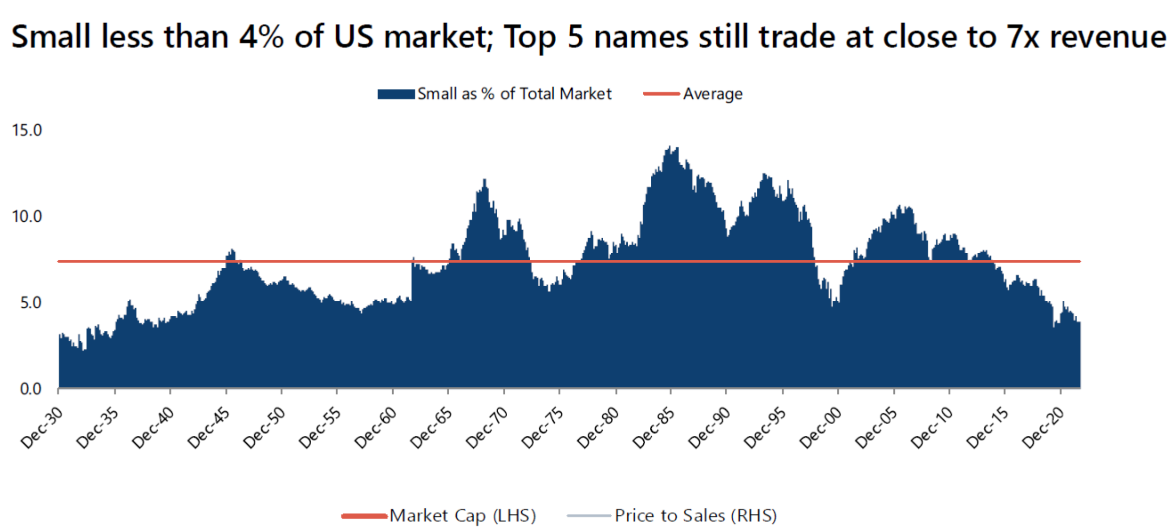
- That nearly four-year relationship decoupled during the third quarter, as growth stocks outperformed across the capitalization spectrum. Given the significant relative outperformance of the value style across the market over the trailing periods, this decoupling in the hardest hit area of the market, given the heightened volatility and market turmoil is similarly noteworthy.

Index	September	q3 2022	YTD 2022
Russell 2000	-9.58%	-2.19%	-25.10%
Russell 2000 Growth	-9.00%	0.24%	-29.28%
Russell 2000 Value	-10.19%	-4.61%	-21.12%
Russell 2500	-9.53%	-2.82%	-24.01%
Russell 2500 Growth	-8.61%	-0.12%	-29.54%
Russell 2500 Value	-10.11%	-4.50%	-20.41%
Russell 1000	-9.25%	-4.61%	-24.59%
Russell 1000 Growth	-9.72%	-3.60%	-30.66%
Russell 1000 Value	-8.77%	-5.62%	-17.75%
Russell 3000 Growth	-9.68%	-3.37%	-30.57%
Russell 3000 Value	-8.86%	-5.56%	-17.97%

Source: FTSE Russell

2. A DECADE OF ANNUALIZED RELATIVE UNDERPERFORMANCE HAS RESULTED IN SMALL CAPS REPRESENTING A HISTORICALLY SMALL PERCENTAGE OF OVERALL U.S. EQUITY MARKETS

- The Russell 2000 has lagged the Russell 1000 by more than 600 basis points over the trailing one-year, more than 500 basis points annualized for the trailing 5-year period, and approximately 300 basis points for the trailing 10-year period ended September 30, 2022.
- As a result of this underperformance, small capitalization stocks today represent less than 4% of the U.S. equity market, a level not witnessed since the 1930's, outside of the brief March 2020 COVID-related market sell-off, according to a recent report from Steve DeSanctis of Jefferies. Underperformance of small caps has led the asset class to become a historically small percentage of the overall U.S. equity markets. 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. A simple reversion to the mean would result in a period of small cap outperformance.

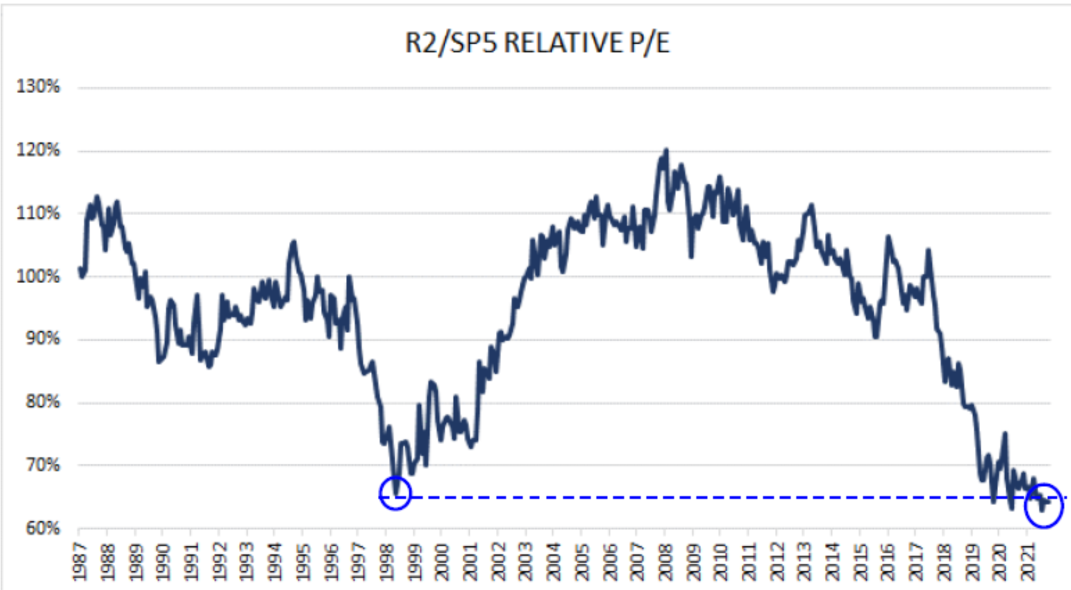


Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP@), The University of Chicago School of Business; Jefferies

3. THE RELATIVE VALUATION OF SMALL CAPS TO LARGE CAPS IS HISTORICALLY ATTRACTIVE

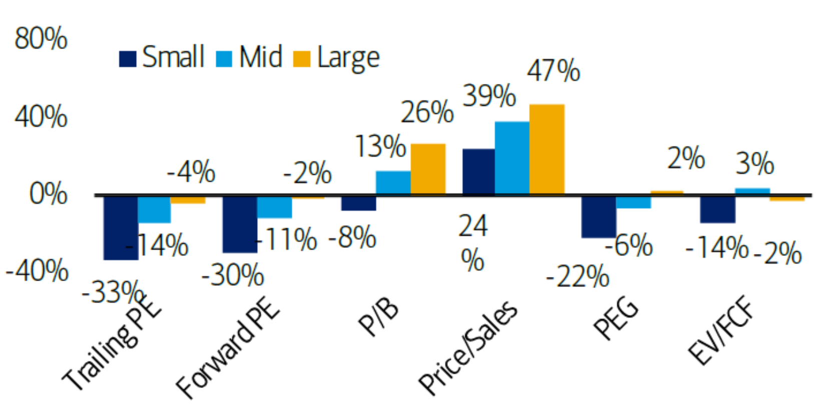
- From a valuation perspective (Price-to-Earnings), relative to the S&P 500, according to Furey Research, there has been no other time in history that the Russell 2000 has been as attractive relative to large-caps.
- Further, according to an October 7, 2022 report from Jill Carey Hall, Equity and Quant Strategist at B of A Securities, the large capitalization stocks on an absolute basis remain the most expensive size segment, relative to long-term historical averages (since 1985).

Fig 90. **Relative to large-caps, small-caps have never been more attractive than of late**



Source: Furey Research Partners and FactSet. Data as of 9/30/22. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only.

Chart 6: Small caps least expensive vs. history on most metrics
Russell 2000, Russell Midcap and Russell 1000: Valuation premium (discount) vs. history across metrics (1/31/1985-9/30/2022)

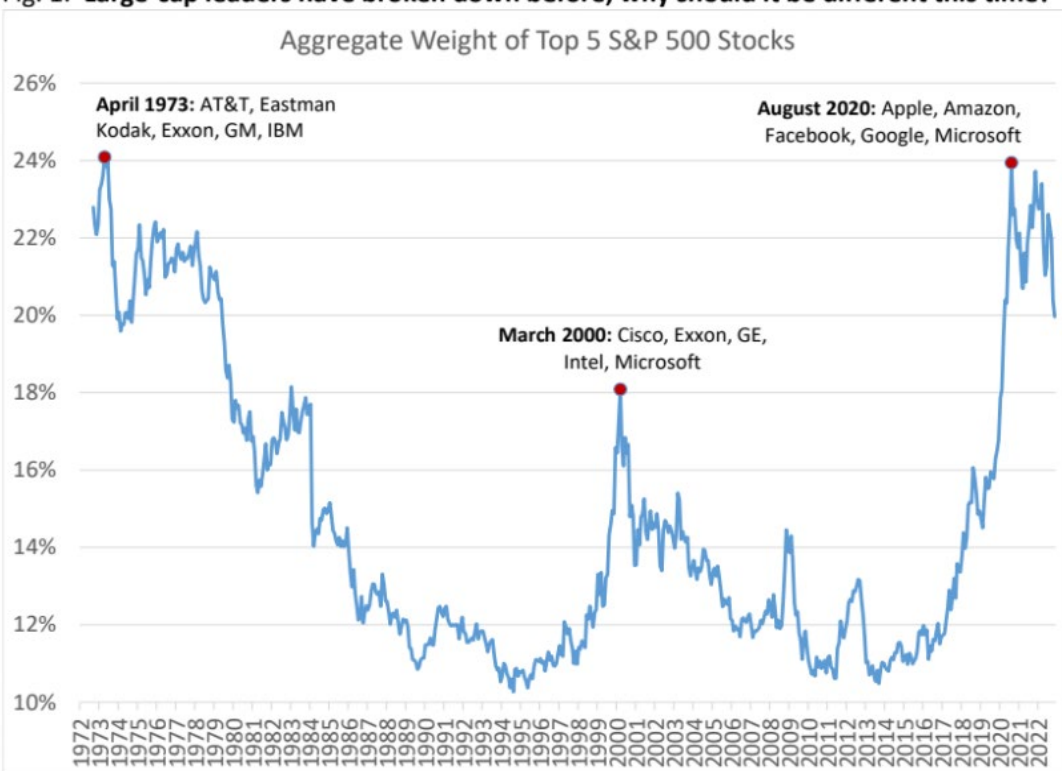


Source: BofA US Equity & Quant Strategy, FactSet

4. THE RECENT BREAKDOWN OF LARGE CAP LEADERSHIP REMINISCENT OF THE NIFTY FIFTY

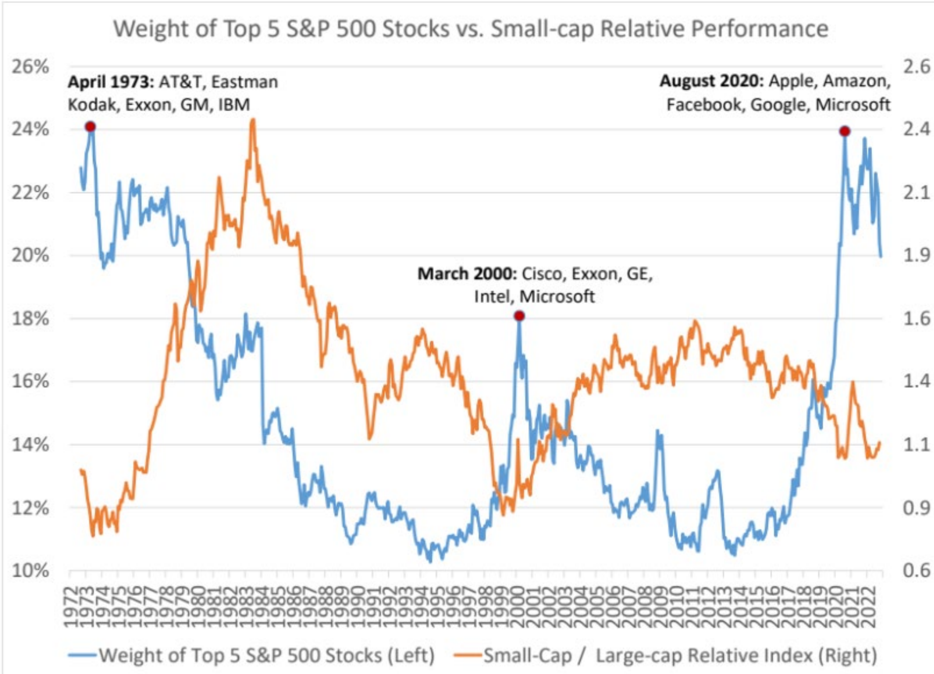
- Historically when market concentration in the top five large cap names peaks, as was the case in April 1973 and March of 2000, it has marked the beginning of a new cycle of small capitalization outperformance, according to a November 3, 2022 research report from Furey Research Partners.
- In each case, according to the same report, following the peaks of 1973 and 2000, small caps demonstrated annualized relative outperformance to large caps over the forward 1, 2, 3, 5, 7 and 10 year time periods.

Fig. 1. **Large-cap leaders have broken down before; why should it be different this time?**



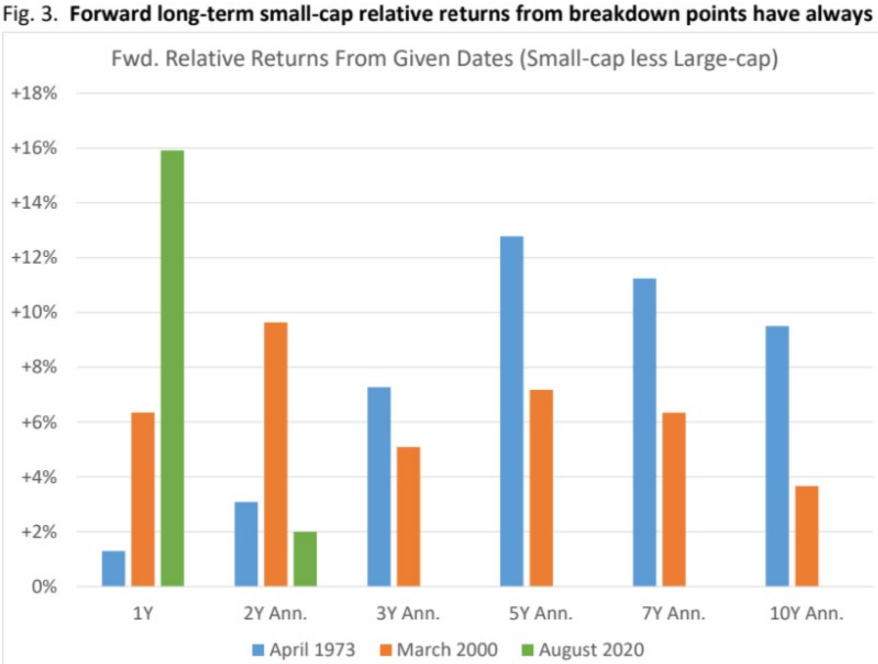
Source: FRP, FactSet; as of 11/1/22

Fig. 2. **Small-cap cycles have started at these breakdown points**



Source: FRP, FactSet; as of 11/1/22

Fig. 3. **Forward long-term small-cap relative returns from breakdown points have always been positive**

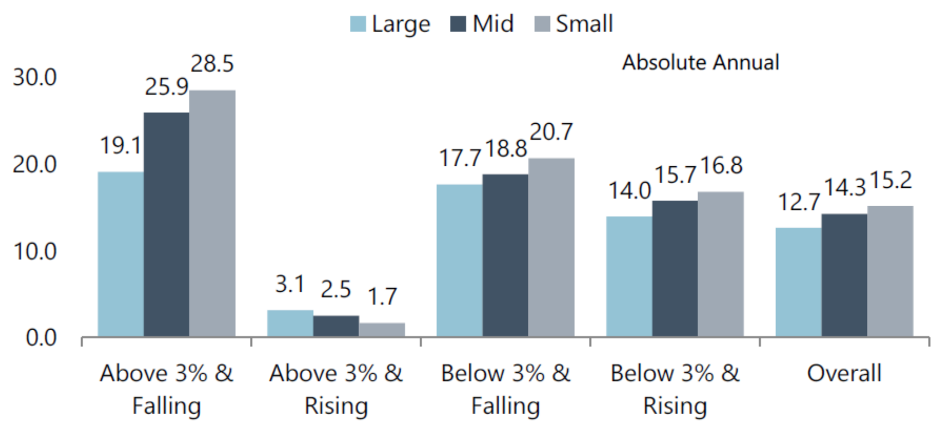


Source: FRP, FactSet; as of 11/1/22

5. INFLATION ABOVE 3% AND FALLING HISTORICALLY A POSITIVE FOR SMALL CAP RELATIVE OUTPERFORMANCE

- Inflationary pressures in the U.S. and abroad have been running at unprecedented levels relative to recent history and the Federal Reserve's target of 2%, eliciting an aggressive tightening of monetary policy by the Federal Reserve. The combination of these factors has weighed heavily on the returns of risk assets and small capitalization stocks.
- With inflation above 3% and decelerating from the peak rate of change, that headwind is on the verge of becoming a tailwind. According to research from Steve DeSanctis, Equity Strategist at Jefferies, historically small capitalization stocks have outperformed mid and large capitalization peers, in environments, where inflation has been above 3% and is falling.

Chart 5 - Next year could be the best inflation environment for small caps, another driver of better relative



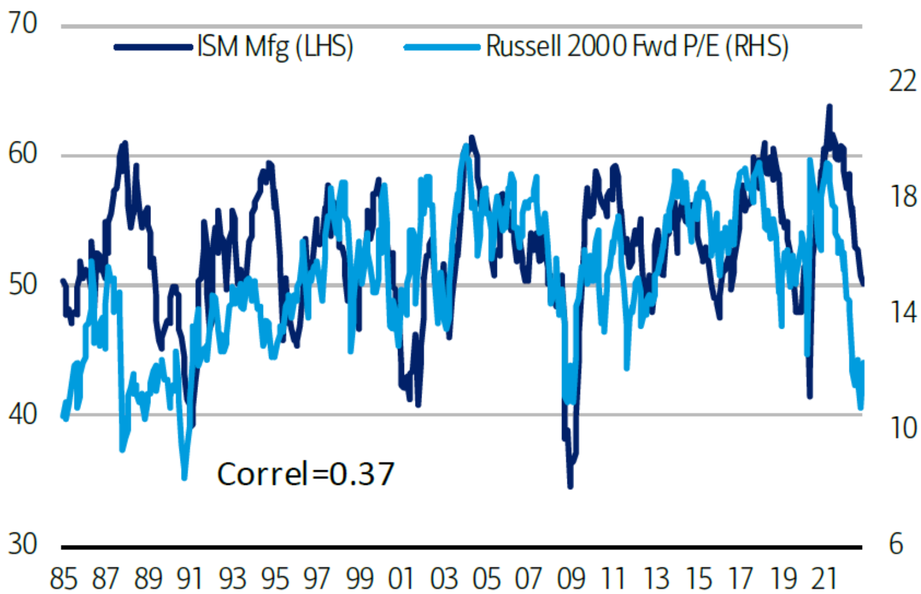
Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

6. SMALL CAPITALIZATION MULTIPLES APPEAR TO HAVE ALREADY PRICED IN A MEANINGFUL DECELERATION IN ECONOMIC GROWTH

- Despite the substantial multiple compression already reflected in current valuations, the debate on where corporate earnings will base rages on.
- In that regard, the recent analysis of the correlation of the Russell 2000 forward P/E to the Institute of Supply Management Manufacturing Purchasing Managers Index (ISM) referenced in the same report from Jill Carey Hall provides some perspective.
- Since 1985, the Russell 2000 forward P/E has had a 0.37 correlation with the ISM, and today's multiple at approximately 12x is pricing in an ISM of approximately 29, which is consistent with the record-low readings posted in the 1974 and 1980 recessions.
- For reference, according to the same report, the average U.S. manufacturing PMI has troughed around 39 during the last four recessions. If this correlation holds, small capitalization stocks appear to be already factoring in a deeper than average recession.

Exhibit 8: Small cap P/E correlated with ISM

Russell 2000 Fw P/E vs. ISM Mfg (1985-10/31/22)



Source: FactSet, Haver, BofA US Equity & Quant Strategy

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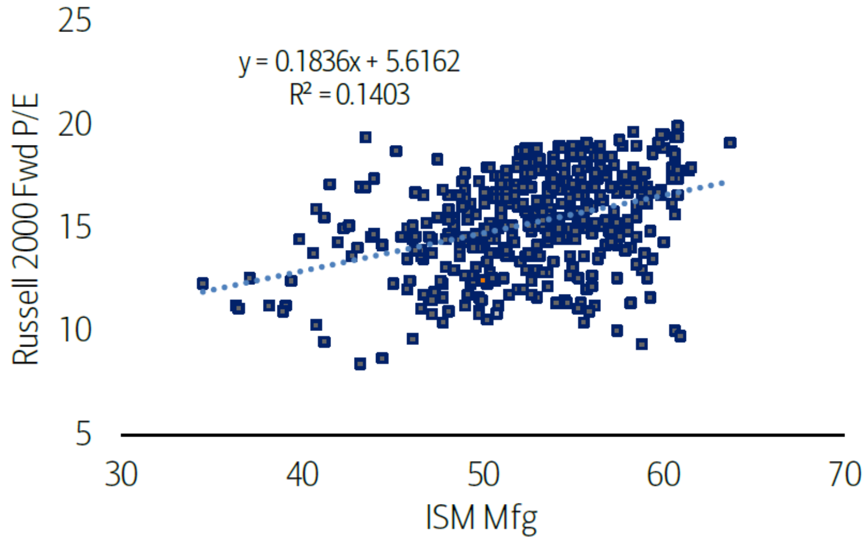
Exhibit 9: Russell 2000 forward P/E of 12x implies an ISM of ~29

Russell 2000 forward P/E vs. ISM Mfg. (1985-10/31/22); orange dot indicates current P/E



Note: orange dot indicates current PE

Source: FactSet, Haver, BofA US Equity & Quant Strategy

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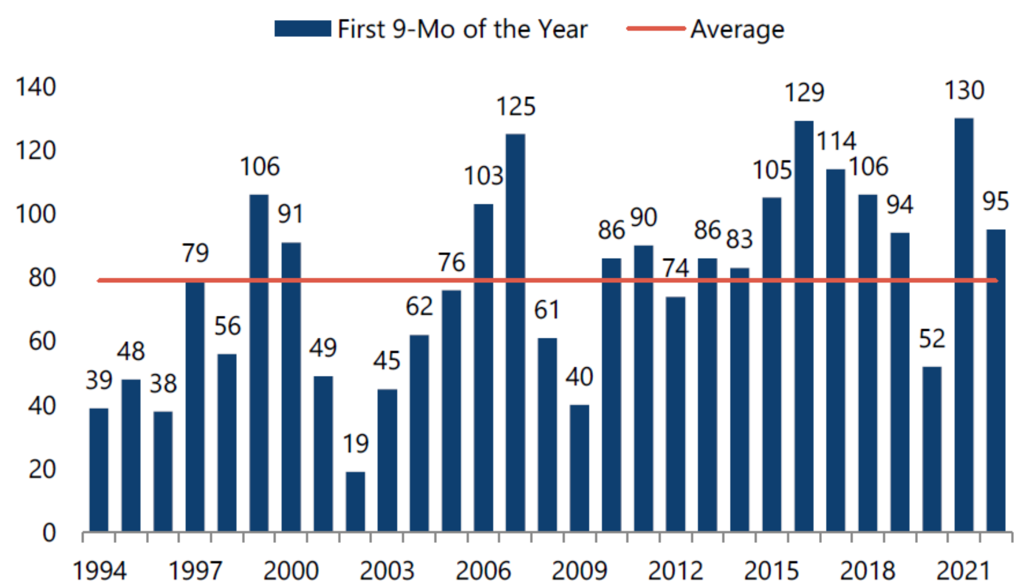
7. M&A ACTIVITY AND MID-TERM ELECTION CYCLE ARE BOTH HISTORICALLY SUPPORTIVE OF SMALL CAPITALIZATION RELATIVE OUTPERFORMANCE

- Ok, so we crammed two points into number seven to stick with the theme of "another seven reasons," but there was too much good stuff to talk about this time around.
- M&A activity has picked up in the last two years. Historically, according to a recent report from Steve DeSanctis of Jefferies, an acceleration in merger and acquisition activity, has disproportionately benefitted small capitalization performance.
- Finally, in the short run, the election cycle also points to another reason to be optimistic on small cap performance moving forward. According to a July 5th report from Jim Furey of Furey Research Partners, average small capitalization returns following a mid-term election since 1960 have averaged approximately 25%.

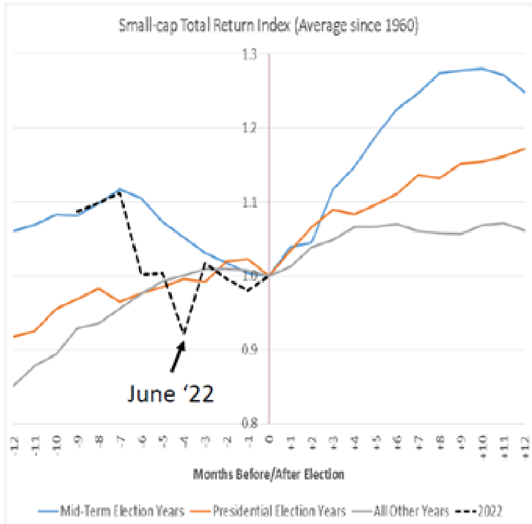
Chart 9 - M&A has picked up and when it accelerates, small outperforms



Source: FactSet; Bloomberg; FTSE Russell; Jefferies

A June Market Bottom Would be Consistent with Mid-term Cycles

The June bottom represented an oversold mid-term year bottom



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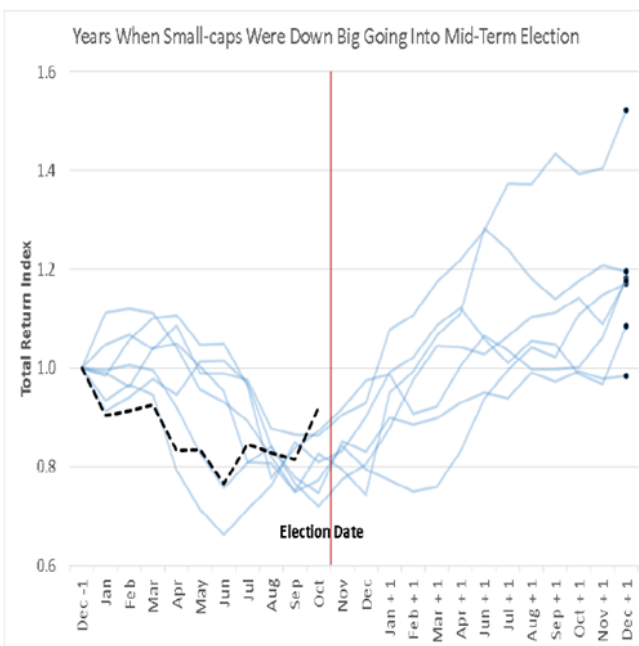
Drilling Down into Down Mid-Term Election Cycle Bottoms

Forward returns reliably positive, in part because gains recapture prior losses



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