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Small Cap Investing Whitepaper

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Contents

Welcome to CAMRADATA's Small Cap Investing Whitepaper

As part of the investment ecosystem, small caps make a relatively muted ripple in institutional portfolios. While potentially an allocation that can add returns, they are also some of the more volatile assets investors can hold.

They also have not been the growth driver many have been seeking in recent years. The Numis Smaller Companies Index, which tracks the bottom 10% of the UK main market, lost 17.9% in 2022, ignoring the impact of investment companies or trusts. But smaller companies are the lifeblood of all major – and minor – economies. They are the first (or second) step for companies coming to the capital markets for growth funding and can produce fantastic results for investors.

However, with such a huge swathe and range of companies, all small caps are not created equal.

From different factors driving risk and return to where revenues are derived, the small cap world is rich and varied. It also is beset with concerns about liquidity and size constraints for some larger funds and allocators.

Yet, as investors seek diversified return profiles from their portfolios, do small caps hold at least some of the answer and if so, when is a good time to jump into the shallow end of the capital markets pool?

Meet the Team

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Small Cap Investing Roundtable

The CAMRADATA Small Cap Investing Roundtable took place in London in September 2023

Institutional investors often consider small caps to be a risky part of public markets and a challenging place for those making very large allocations to get exposure. Nevertheless, there are considerable alpha opportunities in this space, which is home to a wide range of innovative and often high-growth companies.

One of the challenges for small-cap strategies over the past decade has been strong competition from large-cap funds, which have produced strong performance buoyed by an investment environment more favourable for larger companies.

"General flows have favoured large-cap stocks for much of the past decade, which have been driven by central banks' loose monetary policy in place since the Global Financial Crisis," says Patrick McDonough, managing director and portfolio manager at PGIM Quantitative Solutions.

Nevertheless, while large caps have performed strongly over this period, investors shouldn't assume that this will continue forever – particularly if the macroeconomic backdrop continues to shift.

"Size is episodic. It is a factor that sometimes works, and sometimes doesn't," says McDonough. "We view size as an opportunistic factor rather than something we want a fixed exposure to. It is not something you want to bet on just because it worked for a decade or so."

Small-cap stocks have been out of favour for several years, leaving many currently trading at low valuations. They may now be considered attractive and offer the opportunity to gain alpha. But, when it comes to stock selection, investing in small caps requires bravery just as much as skill.

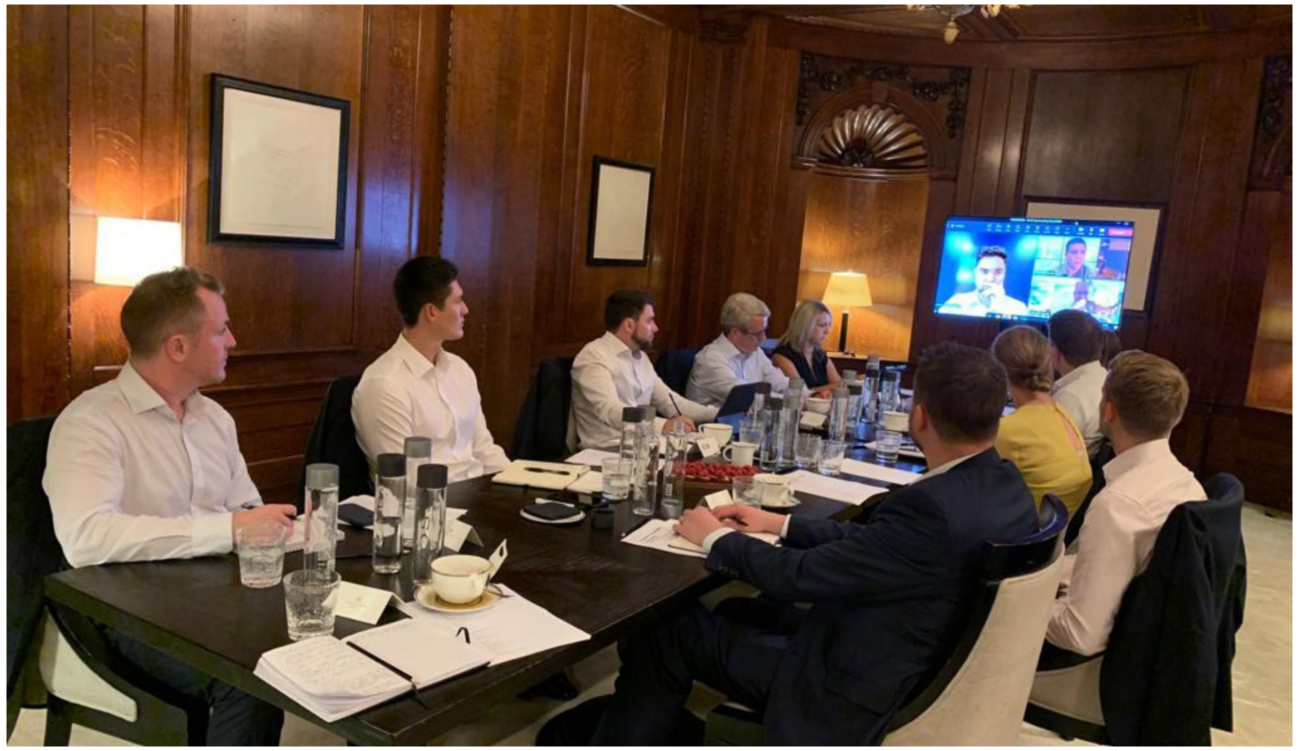
"Fund managers do not get fired for buying yesterday's winners – there is less personal risk," adds McDonough. "Whereas, if you take a contrarian bet against something that has been driving the market for a long time, it can be dangerous "This market has been out of whack for so long that it has been tough for people who base their investment decisions on real fundamentals, real economic views and a real understanding of what drives markets over the long term."

The opportunity

An allocation to small-cap stocks could provide several benefits to an institutional investor's portfolio. One major factor is diversification; the size of the universe means there are thousands of companies to choose from when building a portfolio.

> ***"Growth is a significant part of the small-cap universe. These are smaller companies, by definition, but the ones that get it right have a bigger opportunity set ahead of them."***

"It is such a huge opportunity set. Globally, there are probably around 10,000 listed small companies," says Ingmar Schaefer, portfolio manager for small-cap strategies at Van Lanschot Kempen.



"These companies make the news less often than Apple and Nestlé and consequently they are not necessarily known by investors and consumers. In addition, small-caps are typically covered by fewer sell side analysts than large-caps. So, if we as fund managers and analysts do our homework correctly, we can identify hidden gems presenting a mispricing opportunity or those that will generate better returns or growth."

In such markets, a quantitative approach may be better employed to help investors identify those opportunities, says PGIM's McDonough.

"While quantitative investing is much more common in the large-cap space, we believe such an approach is much better utilised for small caps because of the lack of information," he says. "Using quantitative models we have been able to identify companies whose valuations don't reflect their true worth."

As markets have been led over the past decade by mega caps in the technology sector, and those companies with high exposure to the digital economy, there is a danger that investors have become too reliant on a single sector for growth. Therefore, adding an unrelated source of alpha could prevent investors from becoming too concentrated in a small pool of stocks.

"One of the primary drivers for small-cap investing is the diversification of alpha," explains Martha Brindle, director in the public markets team at investment consultancy bfinance. "You can expect higher risk, but you may also get higher returns over the long term.

"Small-cap investing involves choosing stocks from a much wider universe, but what drives returns can be idiosyncratic. It is very different from large-cap investing."

Greater market uncertainty and a more challenging macroeconomic backdrop have contributed to a slowdown in public listings in recent years. While having fewer IPOs has an impact on the number of new opportunities coming to market, the size of the small-cap universe means there are still many opportunities for investors, says Aidan Farrell, managing director at Morgan Stanley Investment Management and head of the Eaton Vance Non-US Small/Mid Cap team.

"The lack of IPOs diminishes some markets, but it does not necessarily diminish the small-cap universe," he explains. "There might be missed opportunities, but these things are outside our control. It ultimately depends on capital markets and the appetite of those thinking about listing their companies. Companies do not necessarily list straight into the small-cap universe."

Farrell adds: "Growth is a significant part of the small-cap universe. These are smaller companies, by definition, but the ones that get it right have a bigger opportunity set ahead of them.

"Your chances of making a 500% return over time in this universe is much greater than it would be investing in large caps. Also, 90% of M&A targets sit within this

> ***"There is huge dispersion among small caps and a huge opportunity set among the thousands of stocks in the benchmark. Even if there are a lot of poor companies, the size of the universe means there is an opportunity to sort out the good, the bad and the ugly. This should be a fertile hunting ground for active managers."***

universe, so several structural tailwinds exist."

While there are many growth stories to be found in developed market small caps, there are also considerable opportunities in emerging markets too, says PGIM's McDonough.

"Emerging markets in small cap is completely overlooked," he explains. "These assets can be great geographic diversifiers for investors and give them exposure to interesting companies in countries that are growing much faster than developed markets."

There are exciting growth opportunities in countries such as India, China and Brazil where expanding middle classes and growing wealth are driving growth, says McDonough.

"What is also interesting is that small caps tend to do well when there is relatively low volatility and there is growth in the economy," he adds. "And if you look at emerging markets, these conditions are much more prevalent than in developed countries."

For some larger investors, one of the challenges of investing in small-caps has been striking the right balance in their portfolios, making an allocation that is neither too big to pose liquidity issues nor too small that it is unlikely to have a meaningful impact on performance.

"Capacity is always a major concern for us," says Kamal Warraich, head of equity fund research at Canaccord Genuity Wealth Management. "We have seen so many fund managers ruin their strategy by not soft closing early enough, and then suddenly their alpha deteriorates."

He adds: "For us, liquidity goes hand in hand with capacity. How quickly you can get your money back is crucial. You want to ensure that you would not damage the strategy if, for whatever reason, you have to sell."

Costs can be another potential stumbling block for institutional investors, says Warraich, as small-cap funds tend to be more expensive than plain vanilla, large-cap funds. This is due to the greater resources needed to cover a much larger universe of stocks, compounded by the lack of third-party analyst coverage.

The focus on costs has intensified in recent years, with cheap index-tracking passive products becoming ever more widely used by institutional investors. While passive strategies are also popular in the small-cap space, evidence suggests that skilled active fund managers can add value.

"In our studies on mutual funds across all categories globally, we have found that small-cap strategies tends to be an area where active management adds value relative to a passive exposure; this benefit shines through in funds which have a regional focus rather than a global remit," says Rob Starkey, portfolio manager at Schroders. "So, if I were a betting person and I'm going to roll the dice, I would feel safer backing an active small cap team, particularly if there is an attractive fee point for a skilled team."

"If small caps is not a space you can be active in, then I don't know where is," adds Ramon Tol, senior fund manager for equities at Blue Sky Group. "There is huge dispersion among small caps and a huge opportunity set among the thousands of stocks in the benchmark. Even if there are a lot of poor companies, the size of the universe means there is an opportunity to sort out the good, the bad and the ugly. This should be a fertile hunting ground for active managers."

Another issue that has emerged more recently for small-cap managers is the introduction of regulatory initiatives that are focused on proving value for money. In the UK, value for money disclosures are required around performance and cost," says bfinance's Brindle. "The intention was really good, to protect the end-investor, but there have been some unintended consequences because a one- or three-year time horizon, say, is arguably too short for small-cap strategies.

"The focus on relative returns and the ability to differentiate from the benchmark over a short time period is a bit unfair. If you are an institutional investor, you should be willing to look out over a much longer horizon."

Stewardship for small caps

As investors increasingly incorporate ESG into their portfolios, an opportunity is emerging for fund managers to exercise greater stewardship of smaller companies. However, stewardship of smaller companies can be more challenging than with large caps because of their size, the number of them, and the amount of time engagement takes.

"You can often have better engagement and more impact on smaller companies than you can with large caps," says Sonia Bluzmanis, senior funds management executive at Australian superannuation fund REST. "But how do you make that scalable? There is a resourcing issue – even if you outsource to a provider, how can they cover all these stocks and engage effectively."

Often, many smaller companies will not have the resources that larger companies have to respond to shareholders' queries, says Morgan Stanley's Farrell. "It is getting better, however, we have had examples in the US where smaller companies have come to us for guidance on improving their sustainability credentials and materials. Nevertheless, they don't have the manpower of an Apple or a Nestle to produce a 100-plus page report," he says.

There is now a greater expectation among investors that fund managers are tackling ESG issues and monitoring them for any changes, practices that Farrell says is becoming more prevalent in the industry.

"It is the right direction of travel, and analysis is now being done with a fine-toothed comb. But does that mean you get more flows?" he asks. "I don't think so. It is more of a requirement by investors. And if you are not doing it correctly, that can be an impediment rather than a benefit."

One of the challenges for ESG investing in small caps is the lack of quality data available to fund managers and investors, says Blue Sky Group's Ramon Tol. While the reliability of ESG data and lack of standardisation are industrywide issues, they are an even greater challenge in the small-cap space. "We prefer one neutral, independent provider of ESG data," says Tol.

The outlook

While an allocation to small caps can help diversify a portfolio and valuations continue to look attractive, there have been false dawns before that led some investors to miss out on returns.

"With such extreme swings in momentum, I feel we need to take a step back and take stock of the middle ground," says Canaccord Genuity's Warraich. "It is a challenging landscape in which to make long-term predictions. We need to go back to the bottom-up approach of looking for the companies that are going to survive, and I think that will be favourable for small caps."

"Market timing remains extremely difficult. The concentration of capital toward large caps and the valuation discrepancies between large and small caps are extreme," adds Blue Sky Group's Tol. "I am a big believer in mean reversion, and if I had to put all my chips on the table, I would put most of them on small caps rather than large caps."

Idiosyncratic opportunities also continue to emerge in the small-cap space, says bfinance's Brindle, with new growth areas appearing all the time.

"Global small caps and emerging markets, in particular, are continuing to expand," she explains. "Another area is impact investing, which is relatively new for small caps. Many of the transformational technologies that will help us get to net-zero emissions are being developed by companies in the small-cap space."

Nevertheless, it may be some time before investors become comfortable making significant allocations to small-cap strategies.

"It doesn't have to be a matter of mega caps or small caps, you can have both to balance the portfolio," says REST's Bluzmanis. "There is a strong argument to at least allocate a small amount to small-caps opportunistically, but having a long-term strategic allocation is something we struggle with given the unreliability of the small-cap factor and fees for alpha proposition."

Roundtable Participants

Aidan Farrell
Managing Director

Personal Profile

Aidan is a managing director of Morgan Stanley. He is Co-Head of the Eaton Vance Non-U.S. Small/Mid Cap team. He is responsible for managing global and international small-cap equity portfolios, leading a team of analysts. He joined Eaton Vance in 2015.

Morgan Stanley acquired Eaton Vance in March 2021. Aidan began his career in the investment management industry in 1996. Before joining Eaton Vance, he was managing director and a lead portfolio manager for Goldman Sachs Asset Management (GSAM).

Prior to June 2008, he served as a director of European equities for Investment Insight (formerly the asset management arm of Halifax Bank of Scotland). Aidan earned a B.A. in economics from the University College Dublin and a postgraduate diploma in business studies from the University College Dublin Michael Smurfit Graduate Business School. Aidan is an associate of the CFA Society of the UK.

Company Profile

Morgan Stanley Investment Management (the Firm) brings innovative, highly relevant solutions to investors across the globe. Our unwavering commitment to investment excellence, diversity of perspective, and differentiated values help us to deliver innovative solutions and a suite of value-added services to our clients.

Established in 1975, the Firm has provided client-centric investment and risk-management solutions to a wide range of investors and institutions for more than 40 years. Our investment teams strive to provide strong investment performance, excellent client service and a comprehensive suite of investment management solutions to a diverse client base, including governments, institutions, corporations and individuals worldwide.

In March 2021, Morgan Stanley completed the acquisition of Eaton Vance, including its market-leading affiliates Calvert Research and Management and Parametric Portfolio Associates LLC, allowing the Firm to bring even more value to clients through an expanded array of diverse and complementary investment offerings across public and private markets.

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INVESTMENT MANAGEMENT

Patrick McDonough
Managing Director

Personal Profile

Patrick McDonough is a Managing Director and Portfolio Manager for PGIM Quantitative Solutions working within the Quantitative Equity team.

He is responsible for investment strategy as well as portfolio management, research and analysis for Quantitative Equity portfolios. Prior to joining PGIM Quantitative Solutions, Patrick was a Global Portfolio Strategist at State Street Global Advisors, with a focus on quantitative strategies.

Previously, Patrick worked at Goldman Sachs, first as a Researcher on the Quantitative Investment Strategies team and then as Co-Head of Systematic Strategies at GSAM AIMS, providing solutions for OCIO and high net worth clients.

Patrick was also a Quantitative Portfolio Manager and Researcher for the Multi-Asset Solutions team at AllianceBernstein. He earned a BA in history at the College of the Holy Cross and an MS in quantitative management from the New York University Stern School of Business.

Company Profile

PGIM Quantitative Solutions is the quantitative, multi-asset and liquid alternatives specialist of PGIM. For more than 45 years, PGIM Quant Solutions has helped investors around the world solve their unique needs by leveraging the power of technology and data as well as advanced academic research.

PGIM Quant Solutions manages portfolios across equities, multi-asset and liquid alternatives and also offers defined contribution solutions.

As of Jun. 30, 2023, PGIM Quant Solutions managed $96.7 billion in client assets. For more information, please visit pgimquantitativesolutions.com.

PGIM QUANTITATIVE SOLUTIONS

Roundtable Participants

Ingmar Schaefer

Portfolio Manager | Small-cap Strategies

Personal Profile

Small-cap investing has been in Van Lanschot Kempen Investment Management's DNA since the launch of the company's first (Dutch) Small-cap strategy in 1990. Since then, the Small-cap offering has been expanded such that Ingmar now has the privilege to look after investments in the Kempen Oranje Participaties, Kempen Orange and Kempen Sustainable European Small-cap Strategies.

As engaged, long-term investors, Ingmar and the team concentrate on the business fundamentals of each portfolio company and are convinced that the sound philosophy underlying the structured investment processes provide a solid foundation for future active returns for their clients.

Previously, Ingmar has worked as fund manager in European Small-cap equities at APG Asset Management and Delta Lloyd Asset Management where he started his professional fund management career in 2006.

Company Profile

We are active managers who bring free thinking, resolve and originality to investment decisions. This helps us to reach hard-to-access asset classes that are often missed by our competitors.

As leading fiduciary managers, we look after large pension portfolios for our Netherlands and UK clients – taking great care to facilitate good outcomes for everyone invested in our schemes. What's more, all clients benefit from our fiduciary expertise and investment infrastructure.

VAN LANSCHOT KEMPEN

Martha Brindle

Director, Public Markets – Equity

Personal Profile

Martha joined bfinance in January 2021 as a Director in the Public Markets team, specialising in equity manager research. She has over ten years' experience in the fund management industry, most recently as an investment analyst responsible for equity manager monitoring at Stamford Associates, a UK-based investment consultancy.

Martha is a CFA Charterholder, holds the CFA ESG certification, and holds a BSc in Economics from the University of Nottingham.

bfinance

Ramon Tol

Senior Fund Manager Equities

Personal Profile

Ramon holds a Masters Degree in Economics with a specialisation in international financial economics and Investment theory. He joined Blue Sky Group (which manages the pension assets of KLM) in February 2000 as quantitative analyst in the Performance & Risk department.

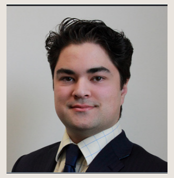
Ramon was responsible for setting up and implementing the manager monitoring and selection process at Blue Sky Group. Currently, he works as a senior fund manager within equities. One of his major tasks is the selection and monitoring of external equity managers. He is also involved in equity transitions.

Ramon speaks quite frequently on international conferences regarding manager selection, monitoring and transition management and has published regularly in (academic) journals and economic magazines on the performance of 130-30 strategies and on Managed Volatility strategies. Also, he published several articles on transition management.

Recently, he published a paper with Goyal and Wahal on the hiring & firing policy of institutional investors (including the patience they have with underperforming managers).

Blue Sky Group

Roundtable Participants



Kamal Warraich

Head of Equity Fund Research

Personal Profile

Kamal is the Head of Equity Fund Research at CGWM UK and is responsible for open and closed ended UK equity fund selection.

Kamal heads up the CGWM UK equity fund investment process and chairs the fund selection committee, which sets the firm's equity fund strategy, meets fund managers and makes adjustments to the buy list.

In addition to fund analysis, he also contributes to macroeconomic research. A member of the Chief Investment Office, Kamal sits on the ESG committee in addition to the fund selection and investment trust committees.

Sonia Bluzmanis

Senior Funds Management Executive

Personal Profile

Sonia is a senior funds management executive with over 16 years' experience in investment research and portfolio management, currently based in London (UK). Sonia joined REST from BT Investment Group in May 2021 and took on the role Head of Global Equities, with responsibility for managing REST's 20Bil+ global equities asset class, the fund's largest asset class by funds under management. In 2022 Sonia was promoted to Head of External Equities to lead the equity research program out of the London office.

Established in 1988, REST is among the largest superannuation fund in Australia by membership, with approximately 1.9 million members and over AU$70 billion in assets under management.

Prior to REST Sonia was a Senior Portfolio Manager, Equities at BT for 5.5 years, with responsibility for over $20Bil in Equities, and a Senior Investment Manager at Colonial First State for 8.5 years where she managed several asset class portfolios, predominantly across Equities.

Sonia holds a Bachelor of Commerce and a Bachelor of Arts (Asian Studies), with majors in Finance, Economics and Chinese (Mandarin) and holds the Certified Investment Management Analyst (CIMA) designation.

Robert Starkey, CFA

Portfolio Manager

Personal Profile

Robert joined Schroders in May 2021 and co-manages the Schroder Investment Solutions range. He started managing multi-asset model portfolios and funds in 2013 and has experience in both the South African and UK markets.

Robert is a CFA Charter holder, holds the CIPM designation, and has passed the CFP and CAIA examinations. He holds degrees in Economics Financial Planning, and Investment Management.

Moderator

Elizabeth Pfeuti

Chief Client Officer

Personal Profile

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

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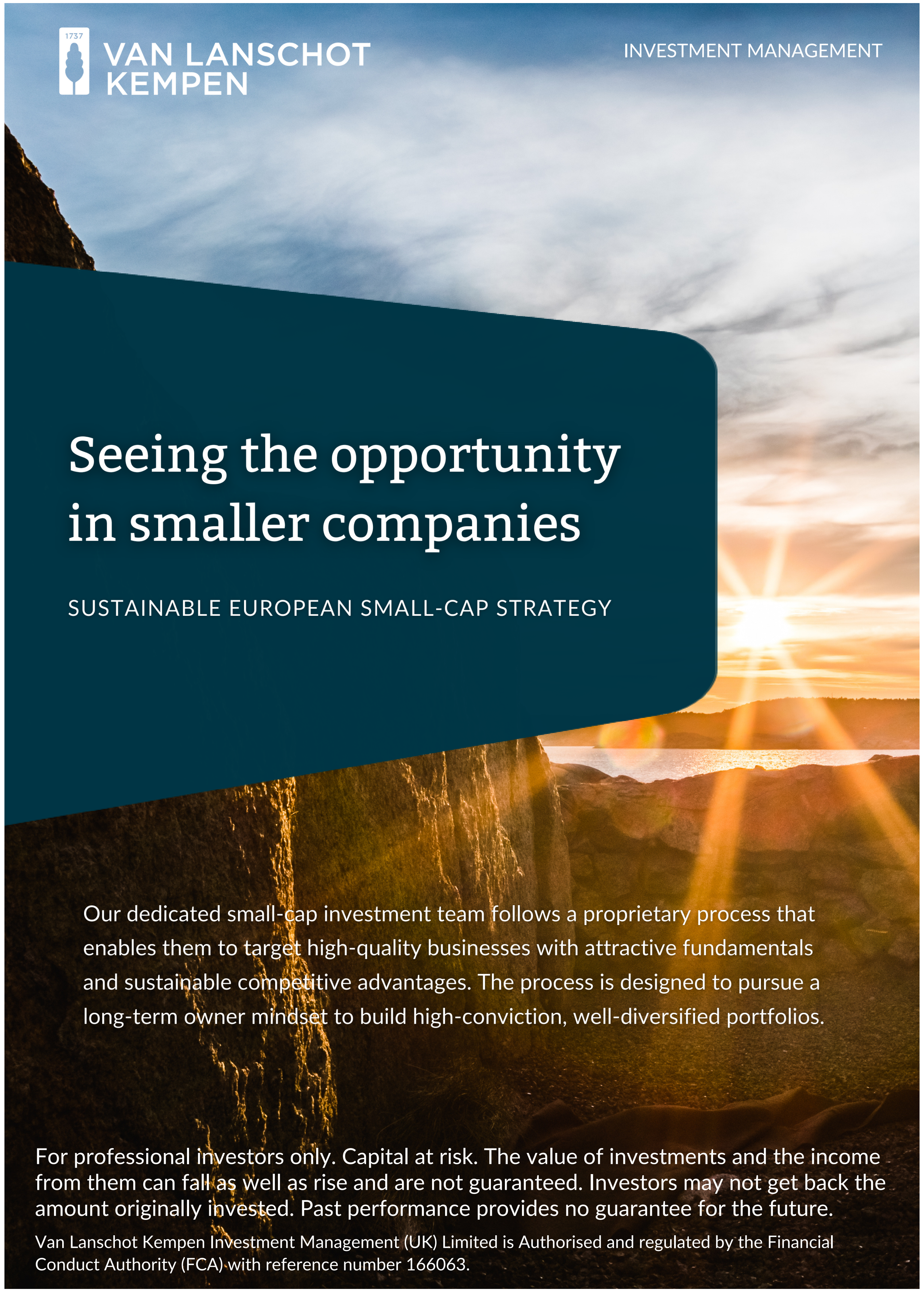

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