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Small Caps Whitepaper

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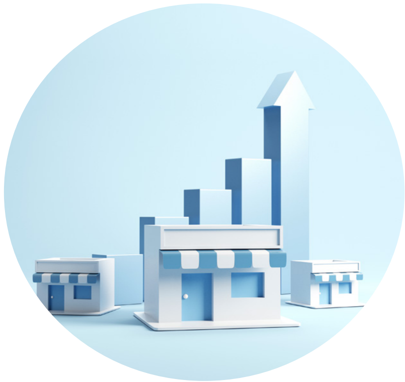


Welcome to CAMRADATA's Small Caps Whitepaper

As investors mull which risk assets best suit the conditions ahead, some are turning away from megacaps to the smaller end of the quoted equity range. Depending on which universe you follow, small caps represent 14% of total global market cap but 71% of the names. This lack of concentration leaves small-cap managers plenty of opportunity to demonstrate their skill in stock selection. The relative lack of sell-side analyst coverage on smaller businesses only encourages further independent thinking on the part of the managers.

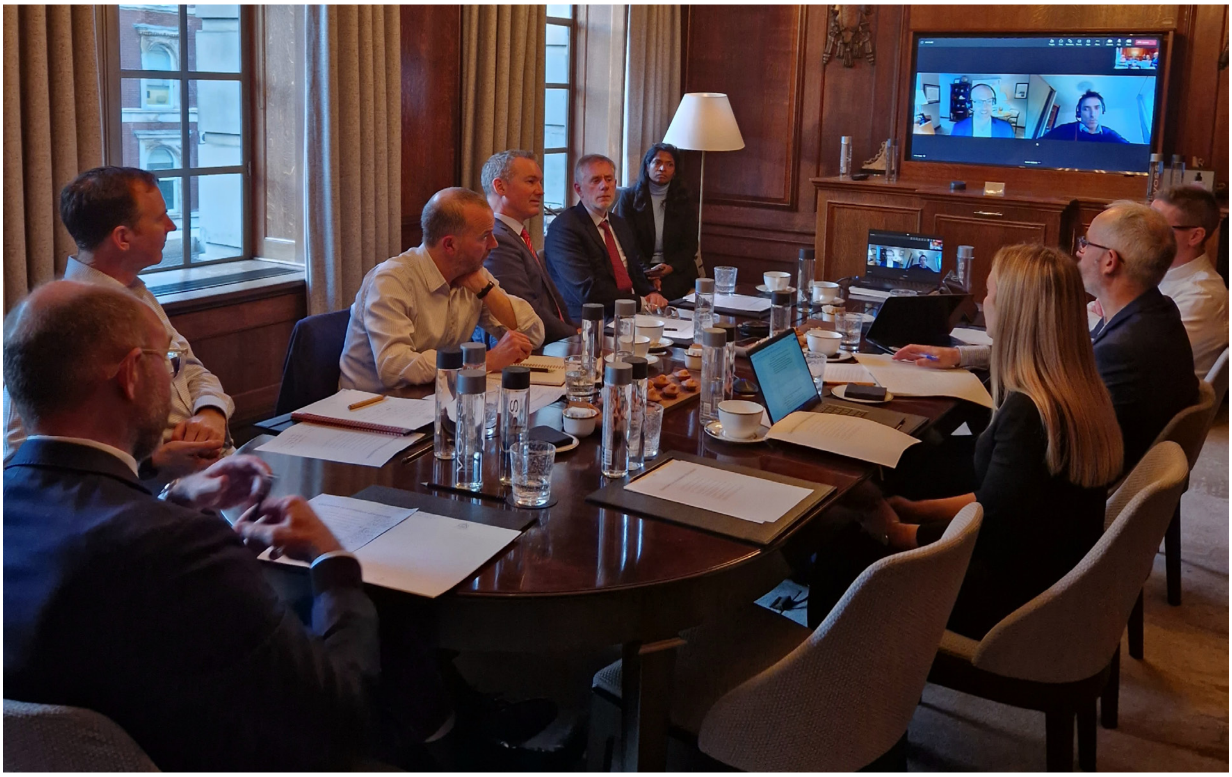
And yet, pension funds and insurers do not show a great appetite to invest in these opportunities. In part that is because equities are a declining proportion of total pension fund assets. Additionally it is because some consultants are prepared to entertain 'all cap' managers and no more. Those two points are related.

Small cap managers with outstanding track records can rail against this trend. But therein lies another twist in the tale. Outstanding managers in this area can reach capacity constraints far more quickly than their large-cap peers. Asset owners and their consultants are then forced to look for the next great small-cap offering. The managers may be tempted to go into new styles, regions or hold winners that grow into mid-caps; all in order to gather more assets.

For those asset owners unfazed by these conditions, is there a case for combinations of managers? In the world of hedge funds, bundling up exotic beta strategies in one offering is treated as normal because those beta are considered diversifying per se and in toto. When it comes to small caps, such manager combinations are rare. Given that there are plenty of regional and style specialists, perhaps this is the start of a discussion.

Small Caps Roundtable

The CAMRADATA Small Caps Roundtable took place in London on 6th December 2022.



"Where a client has a strategic allocation of more than 70% to risk assets and a truly long-term outlook, there I see appetite."

The last decade saw a gradual concentration of stock markets as 'mega caps' such as Apple, Alphabet and Amazon absorbed more of investors' capital. That trend has finally abated but it is not clear where the money will flow instead. The CAMRADATA small caps roundtable of December 2022 began by gauging whether smaller quoted companies will receive greater interest from long-term asset owners.

Ian Gamon, investment partner at LCP, said that for medium-sized UK pension funds – with total assets of £100-500m – allocation to small caps has been a downward trend for the last 10-15 years. He explained that this was part of a greater shift out of public equities altogether.

Even for the largest such schemes, if the public equity exposure is in the region of £100m, then that means just £10m in small caps, as a rough approximation of their proportion of securities markets. Gamon could not see many trustee boards wanting to deal with the governance burden involved.

Where LCP does see more potential clients is within the growing Defined Contribution pension segment and perpetual investors such as endowments and charities. "Where a client has a strategic allocation of more than 70% to risk assets and a truly long-term outlook," said Gamon, "there I see appetite."

For Aon, senior equity manager researcher and selector, James Jackson said that clients' appetite for small cap was influenced by their location. In the U.S., Aon clients were happy to dissect small caps by region and style. Elsewhere, he said a handful of asset owners had a dedicated small cap exposure but that was all.

Jackson explained that Aon clients often divided the world along the lines of Developed and Emerging Markets, so adding the extra governance of a division by size (i.e. large caps versus small caps) was seen as a burden. He said that one way to gain small cap exposure without overcomplicating portfolios was to use managers with wide opportunity sets and benchmarkable against an ACWI IMI benchmark.

Jackson emphasized that Aon's equity research team per se likes small caps. "We don't advise clients against considering them," he clarified. He distinguished between MSCI ACWI IMI and the MSCI ACWI benchmark, which ignores the stratum of small caps, accounting for 10-14% of the global universe. "For investors using ACWI, small caps are off the radar," said Jackson. "But they perform at different times to large caps, proving diversification."

Is there a small cap premium? Jackson wasn't convinced. The wider opportunity set including small caps, however, offers more inefficiencies for active management to exploit – hence the preference for all-cap, 'go-anywhere' equity mandates.

For bfinance, equity manager researcher, Martha Brindle said over the last ten years the firm had conducted on average two small cap searches a year. The typical mandate size has been US$50-100m, with the largest over US$150m and the smallest at US$10m. She agreed with the other consultants that the client has to be large enough. "The biggest trend has been a shift from regional to broader global small cap," she said. Over the last five years roughly 40% of mandates have been global small cap versus 10% in the previous five years. Brindle's last observation was that asset owners were not merely picking managers investing in their home region or country.

The managers at the CAMRADATA roundtable then responded. Mark Niznik, co-manager of the Artemis UK small cap strategy, claimed that the median manager has beaten the small cap index in the UK by 1% annualized after fees over the last 20 years. By contrast, large-cap managers' median performance over the same period was slightly behind the index. Niznik said it gets easier to beat the index as you move down the scale. That was his argument for small cap active management.

Niznik added that for UK managers, capacity constraints are an issue. "We need critical mass of £200-300m in total. That is enough money to get a response from company boards and get them to take our concerns seriously. It does get incrementally more difficult to run more money."

Craig Thrasher, co-manager of global and international small caps at Kayne Anderson Rudnick (KAR), said that capacity constraints of small cap strategies merited a fee premium. "Starting out of the gates, KAR has a 50-stock US$3-5bn versus US$100bn for a large cap manager. So costs are higher but if you believe you can add alpha and you can demonstrate that, then the costs are justified."

Mike Rode, senior client portfolio manager for ACI's US Value Small Cap strategy agreed that small cap managers deserve a high fee as a function of supply and demand. "Only a limited number of managers can outperform. We aim to deliver sustainable alpha and have generated 500bps net of fees over 3-5 years with a repeatable process."

Outlining some of the conditions which support superior active management, Rode reckoned there are on average just six analysts per stock with a market cap under US$5bn in the U.S. This sector attracts more retail trading, which should be good for institutional-quality active management. Of all ACI's composites in active management, small caps (as represented by a Growth/Value blend) have the strongest 10-year track record. Rode added that the combination of these two strategies has produced a best-in-class Information Ratio.

Brindle supported the argument of a fee premium predicated on greater alpha potential. "Investors generally accept up to one-third of alpha paid away in fees," she said. "So value for money in small caps seems really appealing even with that premium."

Brindle suggested typical fee proposals on a US$50m small cap mandate have a roughly 20% premium on large-cap mandates, i.e. 50-60bps large cap global equity versus 60-80bps for small cap. She said: "I think that is reasonable if managers deliver."

Gamon added that 'low' is always good. "You have to recognise that you are investing in an asset class where there is an information gap," he said "for which I would be prepared to pay more. Capacity constraints are also an issue - but you have to get the remuneration balance right."

Gamon had seen some managers applying performance fees and thought this can be combined with a low annual management charge as a helpful compromise to reward managers who deliver outperformance. Jackson thought otherwise. "If a client is investing in an equity splice where we think the manager will extract significant levels of alpha, a flat fee probably makes more sense," he said. "In other equity splices we would be more open to different fee structures."

Niznik argued for performance fees because he was confident that the mutual benefits compound up. "UK small caps as a sector have outperformed by 4% per annum since 1955," he said. "That is 2-3% after fees. Such an enormous outperformance makes the compound effect massive."

Rode noted that no European client of ACI had asked for performance fees. He then expanded on managing the consequences of capacity constraints. "It's a double-edged sword," he said, "staying style-pure versus letting winners run up to mid cap. But we have learned that we play a role in a diversified portfolio. We are committed to staying style-pure. We don't want overlap with mid-cap managers."

Rode said that handling closing has to be sensitive. "Not closing is a reputational risk. We do stay open, however, with strategic partners, i.e. a soft close." Pragmatically, this policy permits ACI to warehouse capacity while strategic partners conduct due diligence and make capital available, which can take up to a year.

Rode then explained the ACI U.S. Small Cap Growth portfolio. It holds 130 stocks, of which 30 are in biopharma, one of the most exciting areas in the healthcare sector. "Over time biopharma outperforms. Big Pharma has to replenish its pipeline but doesn't want to do the development," he said. "We have had three take-outs by Pfizer alone from ACI's portfolio."

On style, Rode supposed that all managers philosophically are High Quality, seeking exceptional franchises. "But Growth opportunities are higher in the U.S. than in Europe and Japan," he noted.

As a global manager, Thrasher agreed that alpha was the lifeblood of any manager, and KAR's policy was to hold a rich portfolio with lower assets under management. "We err on the side of closing." Since inception, his global strategy has achieved 698 basis points annualised gross versus MSCI ACWI Small Cap .

On biopharma, Thrasher noted that the most unprofitable companies were found in the biotech sector. "Biopharma is especially hard to value because there are no earnings," he said.

Managers' set-up

The CAMRADATA panel then turned to manager personnel and location. Brindle said that the manager's team is crucial, as were "boots on the ground".

Gamon also questioned the set-up of managers claiming to be able to profit from informational inefficiencies surrounding smaller companies. "I want to know whether you have got a team in that region. Do you have local language expertise? My other challenge for the global managers is whether you add value by moving between regions."

That challenge extends to whether global managers ought to include Emerging Markets in their ambit. Having laid down the gauntlet, however, Gamon admitted that many clients would take the simpler approach of hiring one global manager and leaving the allocation decisions to that manager. He said that many UK pension schemes do not have the scale or sophistication to allocate on a regional basis.

Jackson said that opting for regional managers presented a higher onus of getting the allocations between them right. "A UK small cap strategy will likely give you exposure to domestic UK plc and may resultantly be more influenced by macro factors impacting the UK economy. An All Cap mandate is, however, more likely to have more companies with global revenue streams, and thus arguably less influenced by single country factors."

> ***"In our equity search experience, you don't tend to see combinations of global small cap managers of different styles - unlike in All Cap or Large Cap."***

Brindle added that many allocators don't see the benefit of style combinations. "In our equity search experience, you don't tend to see combinations of global small cap managers of different styles - unlike in All Cap or Large Cap."

Thrasher then expanded the KAR global small cap strategy: "We are currently 40% U.S./60% ex-U.S." He picked out U.K. property search platform, Rightmove, as the best business he had ever seen. He highlighted the company's competitiveness, revenue protection and lack of capital intensity. "There is varying sentiment to real estate in the U.K. because of factors such as Brexit and rising interest rates. But no matter what the conditions, estate agencies don't have much choice - they can't cancel their subscription to Rightmove. If we set aside Covid as a unique moment, Rightmove has been incredibly consistent but the stock has been acting as if there is some calamitous event around the corner."

Here the CAMRADATA panel agreed that small caps might deliver higher returns over time than larger stocks, but that outperformance comes with higher volatility. Rode noted, however, that not only was the difference in volatility between large and small caps in the last couple of years diminishing, but small caps are at their cheapest in 20 years relative to large caps whereas the top five 'mega caps' in the U.S. are trading at an average six times' revenue.

Regarding the entry-point for new buyers, he said that "historically, small caps outperform coming out of recession, starting about halfway through. Higher inflation is better for small caps; it is when inflation is rampant that it hurts. The best environment for small caps has been high, but falling, inflation."

Niznik said he was very bullish at the moment for three reasons. "First, there have been five times since 1960 when the trailing 7-year return has been so low," he said. "The average return for the following year in those five cases was 55%. So you are buying at bargain-basement levels.

"Second, every institution from the Bank of England down, has commented that we are going into a recession. It is therefore the most telegraphed recession in history. Since 1960 there have been eight recessions. In five out of those eight, small caps underperformed in the year recession began. From January to the end of November 2022, U.K. small caps are down 20%. That is more than in any of the five previous periods of underperformance in a recession. So it's in the price."

Niznik's third reason concerned mergers and acquisition (M&A). "The Artemis strategy had six takeovers last year, at an average premium greater than 50%. Most were trade buyers from abroad, in cash, taking advantage of weak sterling."

Niznik added that smaller British companies are crying out for more staff: job vacancies are at a 40-year high. Another factor was that UK pension schemes are selling domestic small-caps on their path to buying out liabilities.

The acquisition boost

The managers were then asked how M&A activity affected their strategies. Niznik replied that while takeovers have been a driver of outperformance, he felt they were not usually helpful because it meant letting go of great companies that then had to be replaced. "But most of the time it doesn't matter because there are 1,000 more in the universe, many of which are very attractively valued at the moment – so why be grumpy?"

Thrasher agreed that M&A provided a short-term boost to performance but did not want to rely on it as a source of outperformance. He described parting with holdings as part of an acquisition as "bittersweet".

Rode made the point that more takeovers were likely, given the US$3trillion in cash held by large caps and the US$2trillion dry powder stored in private capital vehicles. "Where does Private Equity fish for opportunities?" asked Rode. "Very often it's the small cap universe with a focus on higher quality businesses that generate strong free cash flow. Our small cap growth portfolio is more than just tech and healthcare; our process allows us to identify opportunities for accelerating fundamentals in all sectors. We don't require a high absolute growth rate for potential holdings, we would rather see growth increase from 5% to 15% as opposed to a static 20% growth rate."

"Small caps are oftentimes the disruptors," claimed Gamon. "They will solve the Sustainable Development Goals. That's a big part of the diversification point."

Brindle said there were some interesting parallels between Private Equity and small caps, although bfinance has not seen clients making 1:1 switches. Instead, allocation to small caps has come top down within equities, carving out a higher-returns-generating mandate.

Responding to whether management access was beneficial to managers generating alpha in small caps, Jackson described access as an extra layer of the mosaic; and "additional touchpoints" as probably additive.

Thrasher said that KAR has voted on numerous occasions against management, including against greed in remuneration. "Meeting executives is one part of the analysis," he said, "and there is better access to management in companies this size."

But he also warned that part of being a CEO is salesmanship: "a good sales pitch can be powerful: investment managers have to be wary of being swayed by that."

In response to consultants' desire to see 'boots on the ground', Thrasher said KAR didn't feel this was an imperative. "These companies are exceptional leaders. You can get information on the company's history and its industry by other means. The most important part is the analysis. You can get snowed by talking to company managers."

Niznik said that face-to-face dialogue was much better quality than online meetings. "I love my job because I get to meet people who have built successful businesses and created jobs." He added that his interviews extended beyond the C-suite to factories and on-the-ground meetings below executive level.

Rode said that regarding ESG, the 'G' is more important. He noted the temptation by some executives to grow the company for the sake of growth, often diminishing free cashflow. He said ACI would challenge that strategy where appropriate.

Brindle said capacity was about preserving integrity. "The industry faces a bit of a conflict: we want to push the best managers to give access to investors but the risk is that asset manager performance may be impaired without capacity discipline. We have to keep turning over the manager universe to find new, up-and-coming small cap managers."

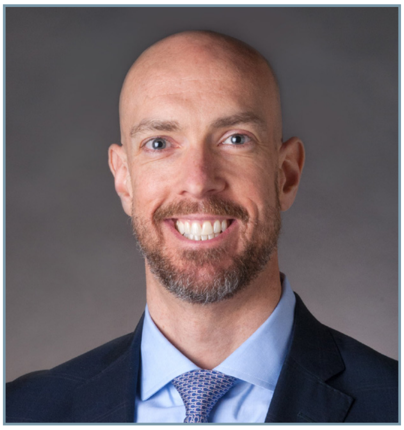
On constraints, Niznik said it was part of the sizing process. "What will this stock weight be projected out five years when I sell? Does it cause you to drift?" He noted that most managers are not running permanent capital vehicles, so they have to consider what happens should a bunch of clients want their money back at the same time.

Rode said that there are SEC guidelines about how much of a strategy can be deemed illiquid. For all the reasons discussed, ACI has looked at a micro-cap strategy but decided it would not be scalable.

The CAMRADATA panel finished with a comparison of small caps with Emerging Markets (EM). Gamon wanted to know the panel's views on which had the higher alpha.

"The fundamentals for active management in both EM and Small Caps should be positive," said Jackson. "There is low sell-side coverage and lower institutional investment in some places, notably onshore China." But he noted that one big thorn for active EM managers has been index concentration, which is not the case for small caps.

Roundtable Participants



Mike Rode

VP & Senior Client Portfolio Manager, US Small Cap Growth

Personal Profile

Mike Rode is vice president and senior client portfolio manager for American Century Investments, a premier investment manager headquartered in Kansas City, Missouri. He is based in the company's Kansas City, Missouri office.

Mike is a member of the Global Value Equity group and is responsible for communicating global value equity strategies and real estate investment strategies and results to the firm's clients and consultants. Prior to joining American Century Investments in 2018, Mike was managing director, Institutional Equity Sales, at SunTrust Robinson Humphrey.

Previously, Mike was managing director, Institutional Equity Sales, at Needham & Company LLC. Mike has worked in the investment industry since 2003.

Mike holds a bachelor's degree in finance with a minor in English from Marist College. He is a CFA® charterholder and a member of the CFA Institute.

American Century

Company Profile

American Century Investments is a leading global asset manager focused on delivering investment results and building long-term client relationships while supporting research that can improve human health and save lives.

Founded in 1958, American Century Investments' 1,400 employees serve financial professionals, institutions, corporations and individual investors from offices in New York; London; Frankfurt; Hong Kong; Sydney; Mountain View, Calif.; and Kansas City, Mo. Delivering investment results to clients enables American Century Investments to distribute over 40 percent of its dividends to the Stowers Institute for Medical Research, a 500-person, non-profit basic biomedical research organization. The Institute owns more than 40 percent of American Century Investments and has received dividend payments of $1.8 billion since 2000.

Mark Niznik

Fund Manager

Artemis

Personal Profile

Mark has managed Artemis' 'UK smaller companies' strategy since joining the firm in 2007, which he does alongside fellow manager William Tamworth.

His investment career began in 1985 with Legal & General, which was followed by a stint as a private client fund manager at Greig Middleton & Co. In 1992, he joined Perpetual covering the UK part of its Global Smaller Companies Fund; the UK Smaller Companies Core Fund and the Invesco Perpetual UK Smaller Companies Investment Trust.

Then Mark moved to Standard Life Investments as a small/mid-cap fund manager, running its UK Opportunity Fund from launch in November 2002 and its in-house small-cap pension funds.

Company Profile

Artemis is a leading UK-based fund manager, offering a range of funds which invest in the UK, Europe, US and around the world. As a dedicated, active investment house, we specialise in investment management for both retail and institutional investors.

Roundtable Participants

Craig Thrasher, CFA

Portfolio Manager & Senior Research Analyst

Personal Profile

Craig Thrasher, CFA is a Portfolio Manager & Senior Research Analyst with primary research responsibilities for the International Small Cap, International Small-Mid Cap, and Emerging Markets Small Cap Portfolios. Before joining Kayne Anderson Rudnick in 2008, Mr. Thrasher worked at Kirr, Marbach & Company as an Equity Analyst and at Wedbush Morgan Securities in correspondent credit.

He has approximately 18 years of equity research experience. Mr. Thrasher earned a B.S. in Business and Public Administration, concentration in Finance, from the University of Arizona, and an M.B.A. from the University of Chicago, Graduate School of Business.

Mr. Thrasher is a Chartered Financial Analyst charterholder.

KAR

Kayne Anderson Rudnick
Investment Management

KAR Investment Management

Company Profile

Founded in 1984, Kayne Anderson Rudnick is an investment firm focusing exclusively on building concentrated portfolios of high-quality businesses across all asset classes and geographies.

With over $45 billion in assets under management, the firm services a diverse client base including corporations, endowments, foundations, public entities, taft-hartley clients, and mutual funds. The firm is headquartered in Los Angeles and is a wholly owned subsidiary of Virtus Investment Partners, Inc. (NASDAQ: VRTS).

James Jackson, CFA

Investment Manager Research

James joined Aon in 2011 and is an Associate Partner. James is located in Switzerland and is responsible for the research and recommendation of equity funds. James is a senior member of the global equity research team, primarily covering global, emerging market, and regional equity strategies.

James has been responsible for providing thought leadership and shaping the direction of the research for several years, including advising clients globally on equity portfolio positioning, delivering manager selection exercises and liaising with regional teams on portfolio construction.

Prior to joining Aon, James worked for PricewaterhouseCoopers in its Investment funds practice. James is a CFA charter holder.

Martha Brindle

Director, Public Markets – Equity

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.

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Moderator

Ian Gamon

Investment Partner

Lead research partner on global equity at LCP and member of LCP's Responsible Investment team. In my day-to-day work, I advise trustees of charities and pension schemes on investment strategy and their implementation.

With over 20 years of experience as an investment consultant and actuary advising trustees of charities and pension schemes, I specialise in developing investment strategies which reflect the trustees' cashflow requirements, investment objectives and responsible investment policies.

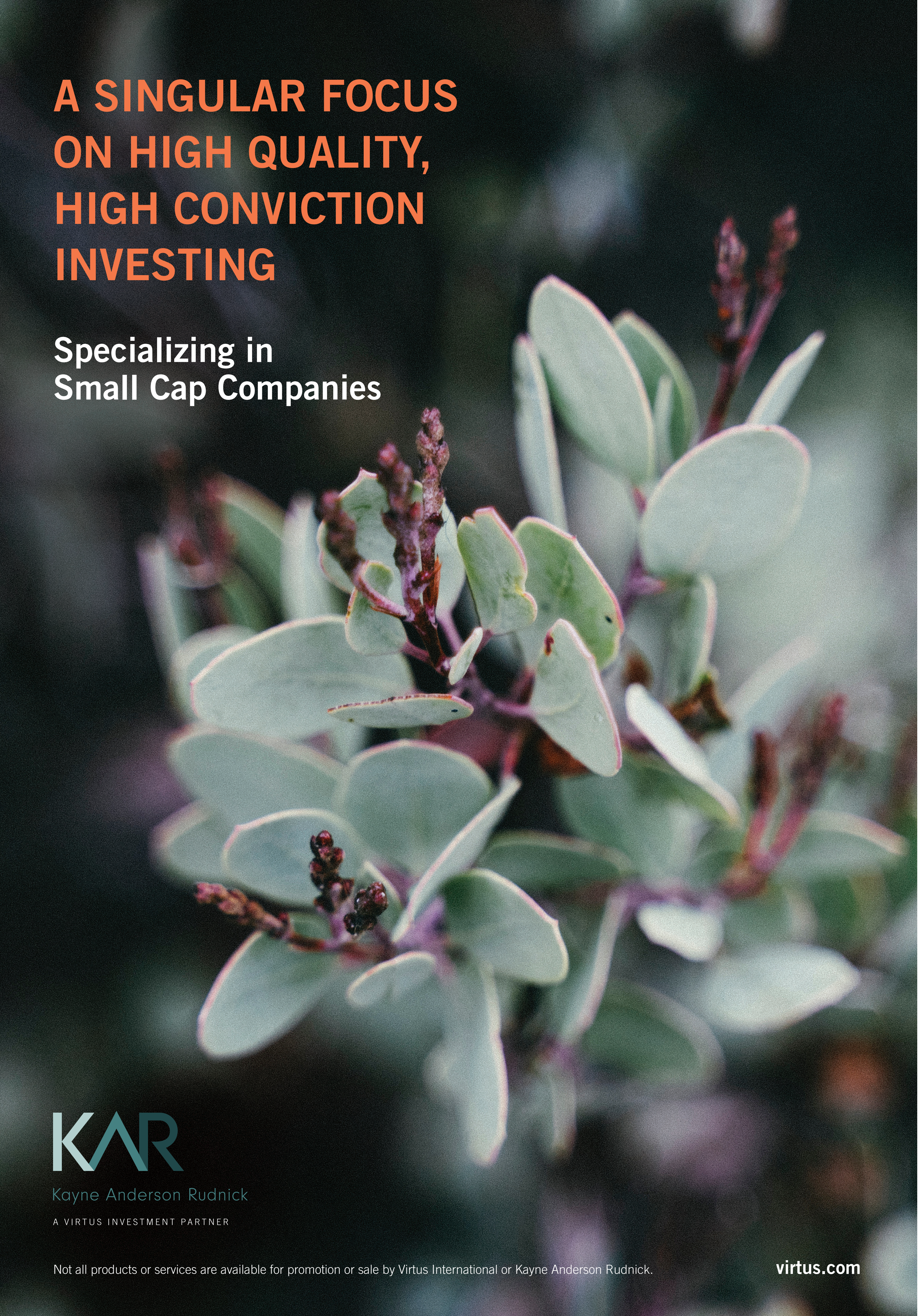
I represent LCP on the Investment Consultants Sustainability Working Group ("ICSWG") and the Net Zero Investment Consultants initiative ("NZICI"), where I enjoy collaborating to help accelerate the transition to a low carbon economy and help meet the broader global sustainability goals.

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE. Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.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