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THE US ADVANTAGE

Accessing the Small Cap Market

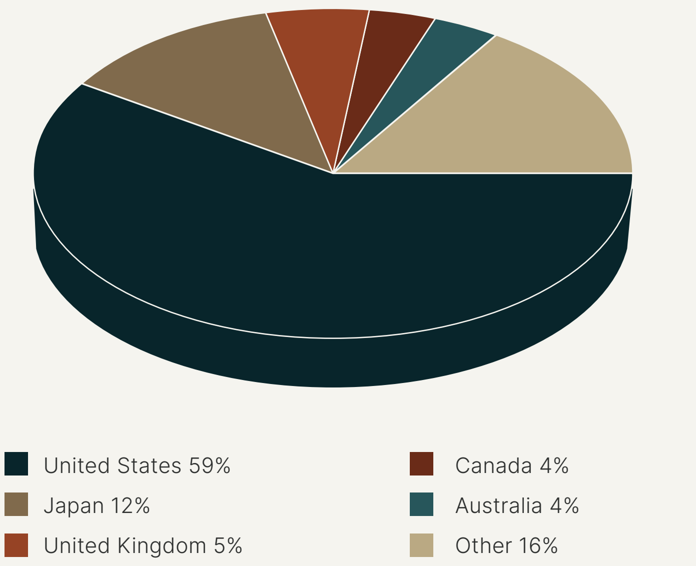
After a prolonged period of small cap underperformance relative to large caps, there are early indications that a leadership shift is occurring that potentially has several years to run, and as a result we believe now is an opportune time for investors to allocate capital to smaller companies. However, global investors are faced with a variety of choices when it comes to small cap equity investments and careful consideration must be given to several factors in order to make an informed choice. For investors looking to increase their small cap exposure in the year ahead, our research supports our belief that a US-centric approach offers several compelling advantages relative to a global approach.

Investors seeking exposure to the small cap market have traditionally decided between investing with a global manager or allocating to select regional managers. We suspect many investors believe that 'going global' is the safer bet as it offers the broadest geographic exposure (i.e., better diversification) in the most efficient manner. In short, investors believe they can cover all their bases with a single allocation rather than going through the effort of analyzing the nuances of specific regions and choosing the best managers within each region. However, based on our research, we think the investors deciding between these two options are ignoring what we believe is a third option – a US-only allocation – which has historically offered a high correlation to global strategies with superior risk-adjusted returns.

The US is 59% of the Small Cap Market[1]

It is important to note that the most used global small cap benchmark – the MSCI World Small Cap index – is predominantly comprised of US companies with approximately 59% of the index allocated to US-based companies. The second largest regional allocation in the global benchmark is Japan at just 12%. Thus, an investment in 'global' small caps is largely a play on the US market and returns of the global small cap benchmark are most highly correlated to returns of US small caps[2] (96% correlation over the long-term). In short, a bet on global small caps is essentially a bet on US small caps as the US offers the broadest and deepest collection of innovative smaller companies.

Country Weights[1]



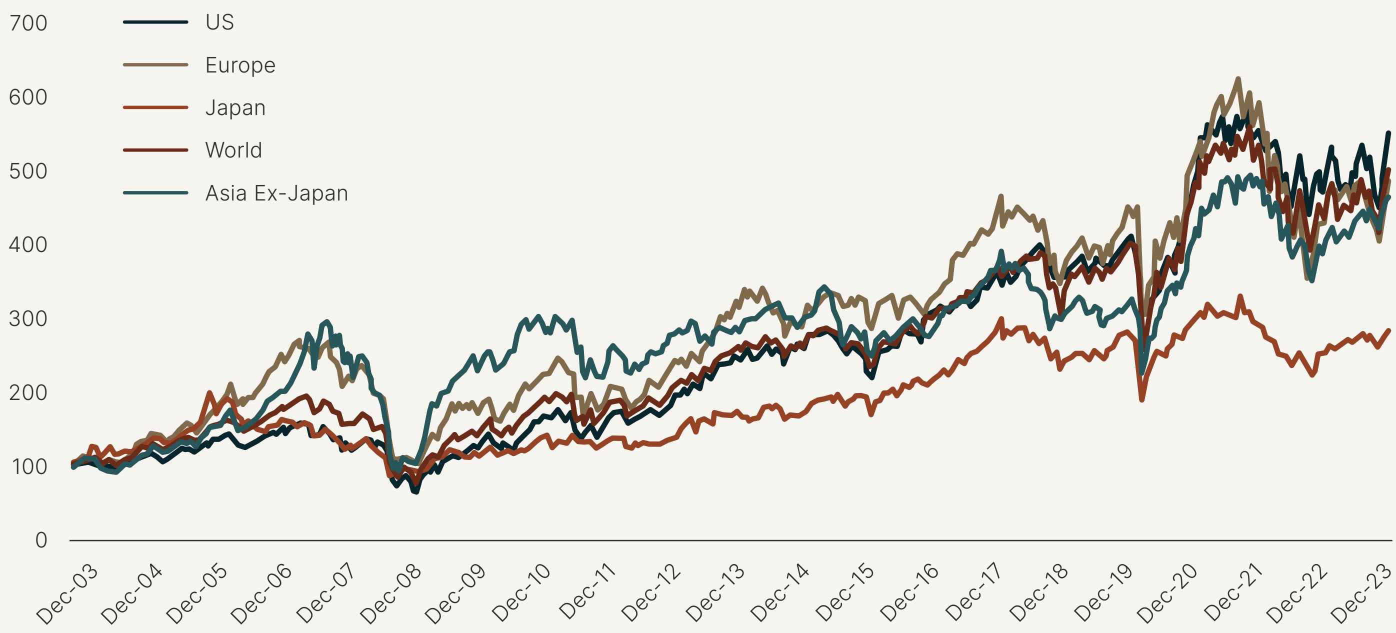
1 Country weights as of September 30, 2023 based on the MSCI Global Small Cap Index.
2 As represented by the MSCI US Small Cap Index

US Small Caps Have Historically Provided Greater Risk-Adjusted Returns

More importantly, the return profile of US small caps has historically been vastly superior to that of global small caps. Over the past 20 years, US small caps have delivered annualized returns of approximately 9%, more than 50bps ahead of global small caps. While that might not seem significant, the compounding effect is sizeable – on a cumulative basis over the past 20 years US small caps have returned 456% vs. 403% for global small caps. This return disparity is even more substantial on a 1-, 3-, 5-, and 10-year basis as shown in the table below.

The data clearly illustrates that global small cap returns have been dragged down by lower returns of the non-US regions in the benchmark. To wit, US small cap returns have handily outpaced the returns of the other major geographic constituents of the global benchmark, namely Europe and Japan. We believe this is partially due to the innovative nature of the US economy which affords smaller companies significant top-line growth opportunities which in turn lends operating leverage and thus margin expansion opportunities.

20 Year Total Returns – USD



	1 Year	3 Year	5 Year	10 Year	20 Year
US	18.1%	5.2%	10.7%	8.5%	9.0%
Europe	16.2%	-0.1%	7.2%	5.0%	8.4%
Japan	12.3%	-1.5%	3.1%	5.4%	5.4%
World	15.6%	3.1%	9.0%	7.0%	8.4%
Asia Ex-Japan	20.2%	5.0%	9.0%	5.1%	8.0%

Returns data is based on weekly total returns ending 12/22/2023. Each region is represented by the respective MSCI net total return indices.

Regional Specialists Have the Potential To Outperform Global Generalists

While absolute performance is undoubtedly important to investors, we believe the focus of quality investing should be on risk-adjusted returns. In this regard, the US again outshines both global and regional small caps, generating better returns per unit of risk taken over a longer-term time. Said another way, investors can get better returns in US small caps without going too far out the risk curve to do so. Additionally, when times are tough US small caps have generally held up better than small caps in other regions, with the largest annual drawdown for the US index less than all other indices with the exception of Japan.

	Standard Deviation	Returns/ Standard Deviation	Largest Annual Drawdown	Correlation with Global
US	18.6%	0.48	-36.2%	96.1%
Europe	25.7%	0.33	-51.9%	91.0%
Japan	17.3%	0.31	-21.1%	60.7%
World	19.9%	0.42	-41.9%	100.0%
Asia Ex-Japan	34.0%	0.23	-59.4%	72.1%

Data for past 2003-2023.. Each region is represented by the respective MSCI net total return indices.

A key final distinction is the advantage that small cap managers have investing exclusively within their home market. 10 year performance data through September 2023 shows that US managers have outperformed global managers by 150 basis points annually despite the high correlations between US and global benchmarks. Note that this is based on a sample size of 620 US managers and 63 global managers. We view this as evidence that investing closer to home allows managers to better leverage the information inefficiency in small cap markets than selecting stocks away from their core geography.

CONCLUSION - WHY CHOOSE THE US?

While US small caps have performed admirably relative to small caps in other regions historically, there is no guarantee that trend will continue. However, we believe both short-term and longer-term structural drivers of outperformance are in place for US smaller companies. In our view, the acceleration of both reshoring and deglobalization, the potential benefits from underinvestment in capital, the Inflation Reduction Act, the Infrastructure and Jobs Act, and the Chips Act will be long-term secular demand drivers which will benefit the US small cap asset class for years to come.

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The MSCI World All Cap Index captures large, mid, small and micro cap representation across 23 Developed Markets (DM) countries*. With 12,106 constituents, the index is comprehensive, covering approximately 99% of the free float-adjusted market capitalization in each country.

The MSCI USA Small Cap Index is designed to measure the performance of the small cap segment of the US equity market. With 1,791 constituents, the index represents approximately 14% of the free float-adjusted market capitalization in the US.

The MSCI AC Asia ex Japan Small Cap Index captures small cap representation across 2 of 3 Developed Markets countries* (excluding Japan) and 8 Emerging Markets countries* in Asia. With 1,682 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

The MSCI Japan Small Cap Index is designed to measure the performance of the small cap segment of the Japanese market. With 863 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Japan equity universe.

The MSCI AC Asia ex Japan Small Cap Index captures small cap representation across 2 of 3 Developed Markets countries* (excluding Japan) and 8 Emerging Markets countries* in Asia. With 1,682 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

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