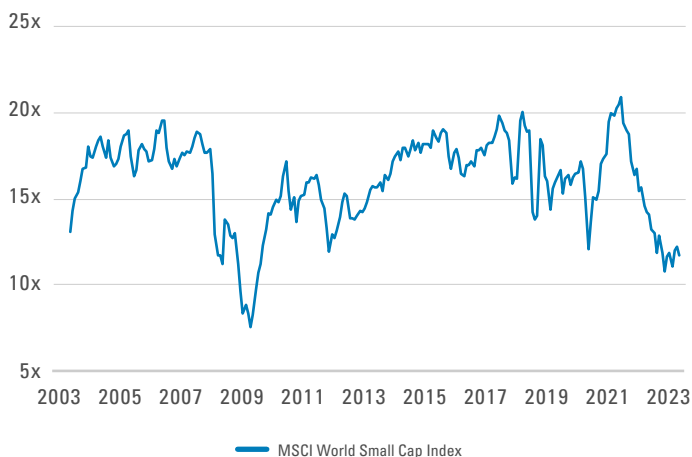


Small-cap stocks globally are attractively valued and have historically generated better returns than large-caps. They offer a broader, more diverse, less correlated, and undiscovered universe of opportunities.

Today is a particularly attractive entry point for small-cap stocks around the world. Despite rising over 80% since the depths of COVID, the MSCI World Small Cap Index is at a near 20-year low current PE of 11.9x (Exhibit 1). Additionally, global small-cap stocks are also trading at near generational lows relative to global large cap stocks.¹

Exhibit 1: Small Caps Globally at Compelling Valuations

Past 20 Years World Small Cap P/E Ratios

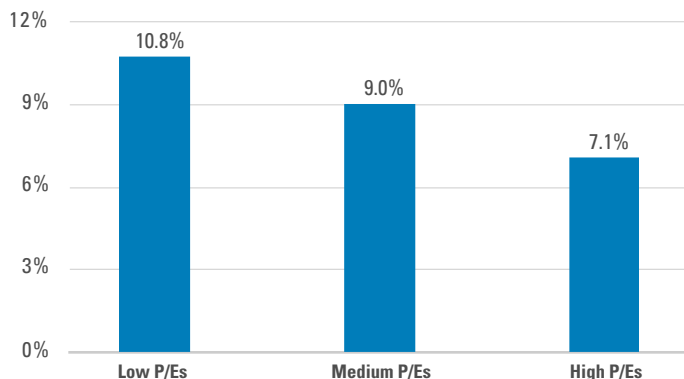


Source: FactSet, Pzena analysis
Trailing price/earnings data from March 31, 2003 – March 31, 2023.

Intuitively periods of low valuation should be good starting points, and not surprisingly, buying small-cap stocks when they trade at low PEs has generated the greatest forward returns (Exhibit 2).

Exhibit 2: Low Valuation Has Generally Worked Best

Average Forward 10-YR Annualized Returns by P/E
MSCI World Small Cap Index (March 31, 2003 - March 31, 2023)



Source: FactSet, Pzena analysis
Monthly trailing price/earnings data broken out by tertiles to calculate average 10-year forward performance. All total return data in US dollars. Past performance is not indicative of future returns. Does not represent any specific Pzena product or service.

It is an especially attractive time for global small-cap value, as valuation spreads² are wide, at the 93rd percentile over the past 50 years, despite contracting over the past fifteen months. Historically, wider spreads have been a particularly good entry point for value portfolios.

WHY SMALL CAP

Small-cap investing is a close cousin of value investing. While small-cap investors search among undiscovered stocks, value investors search among underappreciated stocks. As such, it should not be surprising that pairing small-cap with value investing has generated superior historical returns globally. Small-cap investing is especially attractive for active investors because it is a less crowded corner of the equity universe.

THE SMALL-CAP ADVANTAGE

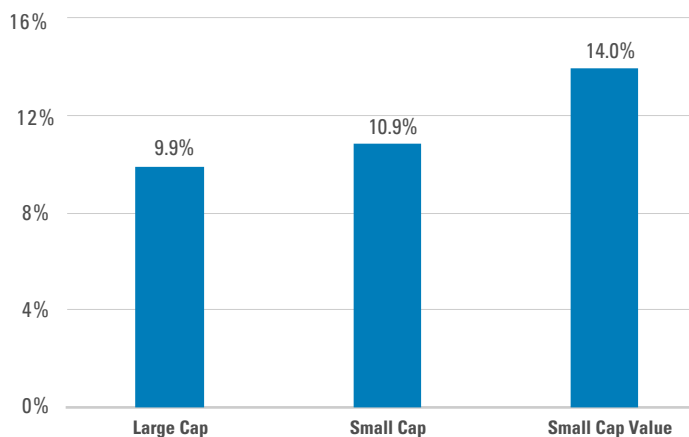
Small-cap stocks, especially those outside the US, provide access to a wide array of currencies, economies, regulatory regimes, languages, and market cycles. Understanding these nuances across different geographical areas can present lucrative opportunities; however, specific skills and judgment are required. Historically, although small caps have exhibited higher short-term volatility than their large cap counterparts, they have generated better returns while offering a broader, more diverse, less correlated, and undiscovered universe of stocks.

Performance: Globally, small-cap stocks have beaten their large cap equivalents by more than 100 basis points per year since 1975, and small-cap value stocks have beaten the style neutral small-cap index by more than 300 basis points per year (Exhibit 3). This phenomenon is equally powerful across US and non-US markets, which shouldn't be too surprising to investors, as the outperformance of both value and small-cap stocks has been well-documented in academic literature (Fama & French 1993, extended in 1998 to include international markets).

¹ MSCI World Small Cap Index vs MSCI World Index current P/E ratio.
Source: FactSet.

² Dispersion between cheapest and most expensive quintiles based on price to book within the MSCI World Small Cap universe. Source: Sanford C. Bernstein & Co., Pzena analysis

Exhibit 3: The Small-Cap Advantage
 MSCI World Annualized Returns Since 1975



Source: Sanford C. Bernstein & Co., MSCI, Pzena analysis
 Large Cap = MSCI World Index.
 Small Cap = Bernstein's MSCI World Small Cap universe (cap-weighted returns)
 Small Cap Value = Cheapest quintile price to book of the MSCI World Small Cap universe (equal-weighted returns).
 All total return data in US dollars from January 1, 1975 – March 31, 2023. Past performance is not indicative of future returns. Does not represent any specific Pzena product or service.

Undiscovered: Part of the explanation for the discernible outperformance can be chalked up to a lack of transparency. Valuation distortions can be more pronounced in smaller companies, which attract less attention from brokerage/equity research firms than large companies. 28.0% of global small-cap stocks are followed by three or fewer analysts compared with just 2.4% of global large cap stocks.¹ Thin analyst coverage usually manifests in more frequent and measurable short-term pricing deviations, as traders naturally have less reliable and readily available information on which to base investment decisions.

This lack of analyst coverage is, in part, due to the small-cap universe containing three times as many stocks as the universe of mid/large cap. Therefore, it takes a dedicated research team with a disciplined process to canvas the globe and sift through the broad and diverse universe to find truly outstanding opportunities.

Less Correlated: While large cap indices are highly correlated, the breadth and diversity of global small-cap stocks offer the opportunity to build more differentiated portfolios. This is particularly true for global small-cap value stocks, which are far less correlated with their large cap cousins and therefore,

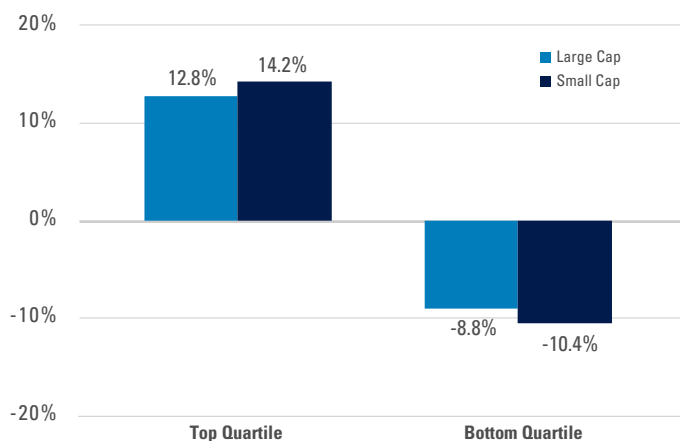
¹ MSCI World Small Cap Index and MSCI World Index. Source: FactSet, Pzena analysis

offer a higher level of overall portfolio diversification. The average rolling five-year correlations of monthly returns between the MSCI World Small Cap Value Index and the MSCI World and Russell 1000® indices are 0.79 and 0.56, respectively.²

ACTIVE ADVANTAGE IN SMALL CAP

With limited capacity as a gating factor to asset gatherers, small cap is a less crowded space, with active large cap managers outnumbering small-cap managers by almost eight to one. Manager selection is crucial, as the excess return of the best quartile of small-cap managers exceeds large cap managers by 140 basis points on average over rolling five-year periods across the past 20 years. Among the worst performing managers, small cap underperformers trail large cap by 160 basis points on average (Exhibit 4), again highlighting the importance of manager selection and the opportunity for active management.

Exhibit 4: Manager Selection Matters More in Small Cap
 Average Rolling 5-Year Alpha
 Best and Worst Quartile of Managers



Source: eVestment, Pzena analysis
 Large Cap = Managers within the Global Large Cap Equity universe.
 Small Cap = Managers within the Global Small Cap Equity universe.
 Managers grouped on a monthly rolling basis. Alpha is calculated using the managers' gross of fees return minus their preferred benchmark. All returns annualized in US dollars from January 1, 1999 – December 31, 2022. Past performance is not indicative of future returns. Does not represent any specific Pzena product or service.

² Data from January 1, 2001 – March 31, 2023. Source: FactSet, Pzena analysis

We believe the reason for this disparity goes back to the underfollowed nature of small-cap stocks. With less Wall Street analyst coverage, earnings estimates and annual returns are more dispersed. The dispersion of broker earnings estimates¹ is 17% for MSCI World Index compared with 29% for MSCI World Small Cap Index, while the stock price dispersion is 30% for MSCI World Index and 47% for MSCI World Small Cap Index.² This greater dispersion creates opportunities for active managers to outperform through fundamental research.

The earnings and return dispersion are partially driven by money losing businesses. With the percentage of loss making small caps near a 20-year peak at 43% for US small cap and 23% for global small cap,³ the ability to sift through these businesses to find companies merely facing temporary issues, versus fundamentally bad businesses, is crucial to outperforming. Many people perceive small-cap companies to be subscale competitors to larger peers, but in reality, many are leaders in niche businesses. It takes deep fundamental research to differentiate between good businesses and subscale competitors lacking competitive advantage.

Equally crucial to outperforming is maintaining the discipline to invest in good businesses trading at steep discounts to their fundamental values, while avoiding overpaying for fundamentally bad businesses in the hopes of finding the rare small cap that someday may become the next Apple. The current fundamentals of the cheapest quintile of small-cap stocks are significantly better than the so called “glamour stocks” or most expensive stocks, and have also performed significantly better historically (Exhibit 5).

Exhibit 5: Similar Fundamentals at Different Valuations in Global Small Cap

Price/Normal Quintile ¹	Historical Return on Equity ²	Historical Revenue Growth ²	Forward P/E ³
Q1 (cheapest)	10%	12%	8x
Q2	11%	11%	12x
Q3	11%	13%	18x
Q4	8%	15%	26x
Q5 (expensive)	-3%	19%	NM

Ken French Price/Book Quintile ⁴	Annualized Return Since 1990 ⁵
Q1 (cheapest)	12.4%
Q2	8.1%
Q3	8.1%
Q4	4.9%
Q5 (expensive)	1.3%

Source: FactSet, Kenneth R. French, Pzena analysis

¹ Valuation quintile buckets based on Pzena’s price-to-normalized earnings estimates.

² Trailing 10-year period.

³ Consensus FY1 estimates per FactSet. Universe used for top table is the MSCI World Small Cap; data as of March 31, 2023.

⁴ Quintiles based on price/book within the smallest 20% of stocks of Ken French’s Developed Market universe.

⁵ Total return annualized in US dollars from July 1, 1990 – December 31, 2022 (cap-weighted returns).

Past performance is not indicative of future returns. Does not represent any specific Pzena product or service.

CONCLUSION

Global small-cap stocks are a relatively underappreciated and underexploited corner of the global equity market. Given their historical record of delivering superior returns and trading near 20-year lows, we believe they warrant further attention from investors seeking a more diversified and distinctive asset class, particularly given today’s valuation opportunity.

¹ The average standard deviation of all broker FY1 EPS estimates for each stock in the index as of March 31, 2023. Source: FactSet, Pzena analysis

² The standard deviation of returns for all holdings in the index; calculated annually. Data from December 31, 2003 - December 31, 2022. Source: FactSet, Pzena analysis

³ Based on latest reported fiscal EPS of each stock in the Russell 2000 Index and MSCI World Small Cap Index. Source: FactSet, Pzena analysis

FURTHER INFORMATION

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