

INTERNATIONAL SMALL CAP

PZENA Investment
Management

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For Professional Investors Only

International small-cap stocks 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.

We believe today is a particularly attractive entry point for small-cap stocks internationally. Despite rising over 50% since the depths of COVID, the MSCI World ex USA Small Cap Index is at a near 20-year low current PE of 11.6x (Exhibit 1).

Exhibit 1

Small Caps at Compelling Valuations Past 20 Years World ex USA Small Cap P/E Ratios

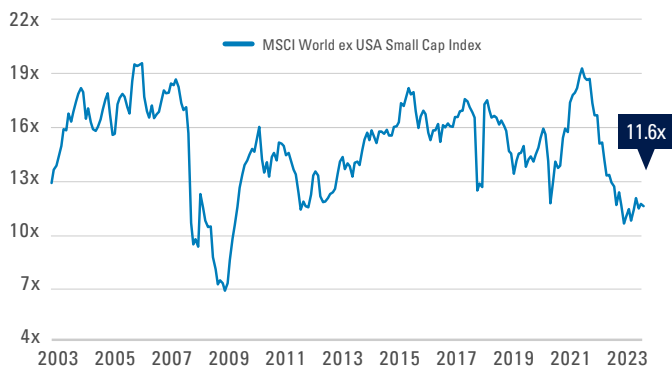


Exhibit 1 Source: FactSet, Pzena analysis
Trailing price/earnings data from March 31, 2003 – May 31, 2023.

International small-cap stocks are also trading at near generational lows relative to international large-cap stocks (Exhibit 2).

Exhibit 2

Past 20 Years World ex USA Small & Large Cap Relative P/E Ratio

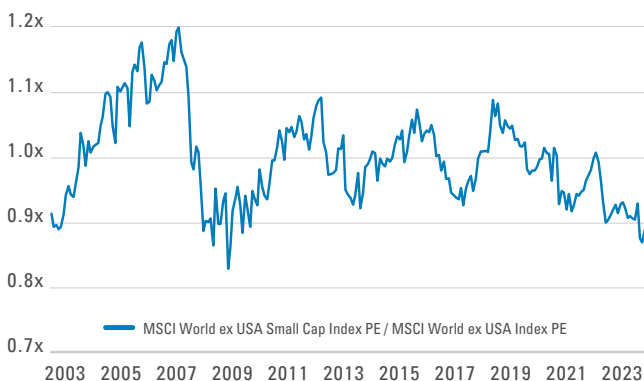


Exhibit 2 Source: FactSet, Pzena analysis
Trailing price/earnings data from March 31, 2003 – May 31, 2023.

WHY SMALL CAP?

Small-cap investing is a cousin of value investing. While small-cap investors search among undiscovered stocks, value investors search among unpopular stocks. As such, it should not be surprising that pairing small-cap with value investing has generated superior historical returns.

THE SMALL-CAP ADVANTAGE

Small-cap stocks, especially those outside the US, provide access to a wide array of niche businesses, 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 risk-adjusted returns while offering a broader, more diverse, and less correlated universe of stocks.

Performance: International small-cap stocks have beaten their large-cap equivalents by over 70 basis points per year since 1975, and small-cap value stocks have beaten the style neutral broader small-cap index by nearly 480 basis points per year (Exhibit 3).

Exhibit 3

The Small Cap Advantage MSCI World ex USA Annualized Returns Since 1975

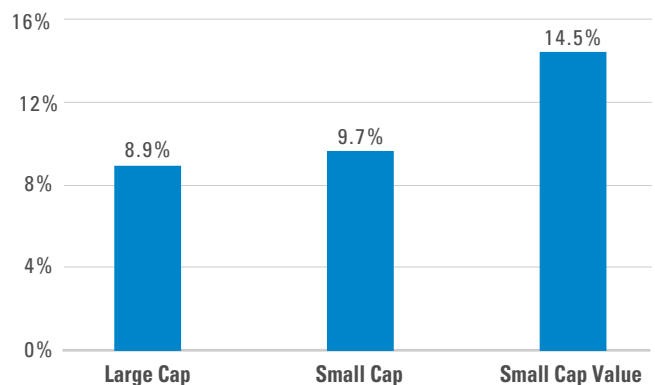


Exhibit 3 Source: Sanford C. Bernstein & Co., MSCI, Pzena analysis
Large Cap = MSCI World ex USA Index. Small Cap = Bernstein's MSCI World ex USA Small Cap universe (cap-weighted returns). Small Cap Value = Cheapest quintile price to book of the MSCI World ex USA Small Cap universe (equal-weighted returns).
All total return data in US dollars from January 1, 1975 – May 31, 2023. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

THE VALUE OPPORTUNITY IN SMALL CAP

We believe it is an especially attractive time for international small-cap value. Intuitively periods of low valuation should be good starting points, and not surprisingly, buying international small-cap stocks when they are cheap has historically generated the greatest forward returns (Exhibit 4). Additionally, the valuation spread between the cheapest and most expensive stocks is wider than it has been 87% of time over the past 50 years, despite contracting since the beginning of 2022. Wider spreads indicate a rich opportunity set of cheap stocks for value investors. Therefore, the dispersion allows disciplined value investors to take profits on holdings that have appreciated, and rotate into new, deeply undervalued opportunities.

Exhibit 4

Average Forward 10-YR Annualized Returns by P/E

MSCI World ex USA Small Cap Index (March 31, 2003 - May 31, 2023)

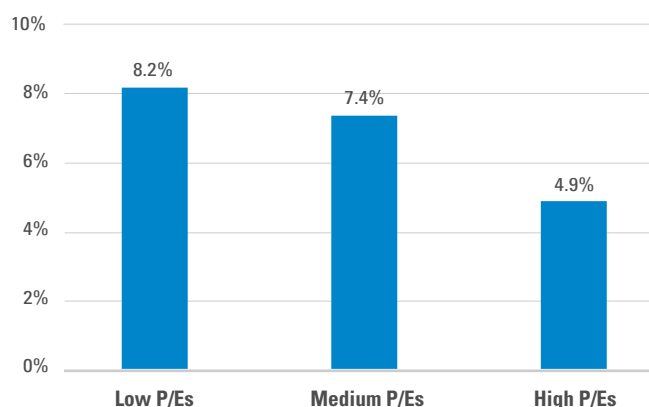


Exhibit 4 Source: FactSet, Pzena analysis
Monthly trailing price/earnings data broken out by tertiles to calculate average 10-year forward performance.
All total return data in US dollars. Does not represent any specific Pzena product or service.
Past performance is not indicative of future returns.

Furthermore, 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 International Small Cap

Price/Normal Quintile ¹	Historical Return on Equity ²	Historical Revenue Growth ²	Forward P/E ³
Q1 (cheapest)	10%	11%	8x
Q2	11%	10%	12x
Q3	10%	11%	14x
Q4	9%	12%	18x
Q5 (expensive)	4%	15%	31x

Ken French Price/Book Quintile ⁴	Annualized Return Since 1990 ⁵
Q1 (cheapest)	10.8%
Q2	5.8%
Q3	5.9%
Q4	3.9%
Q5 (expensive)	0.9%

Exhibit 5 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 ex USA Small Cap; data as of May 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.

ACTIVE ADVANTAGE IN SMALL CAP

As an underallocated, underfollowed asset class, small-cap investing is especially attractive for active management, because it is a less crowded corner of the equity universe.

Undiscovered: Part of the explanation for the outperformance of small cap value and small cap more generally, can be chalked up to a lack of attention. Valuation distortions can be more pronounced in small companies, which attract less focus from equity research firms than large companies. 37% of international small-cap stocks are followed by three or fewer analysts compared with just 3% of international large-cap stocks¹. Thin analyst coverage usually manifests in less company information available to the investment community, and the investment controversy not widely understood.

This lack of analyst coverage is, in part, due to the large number of companies within the small-cap universe relative to the large-cap universe. Therefore, to invest in a universe, like International Small Cap Value with a dearth of analyst coverage, 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 potential investment opportunities.

With less Wall Street analyst coverage, earnings estimates and annual returns are more dispersed (Exhibit 6). This greater dispersion and uncertainty around cashflows and earnings creates opportunities for active managers to outperform through deep fundamental research.

Exhibit 6

Less Research Coverage Drives Dispersion

Broker Earnings Estimates and Stock Price Dispersion

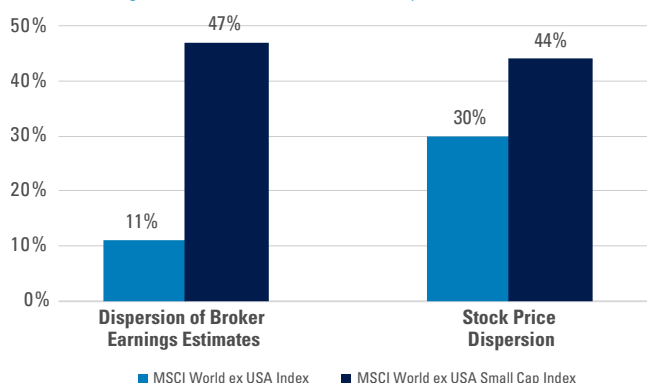


Exhibit 6 Source: FactSet, Pzena analysis
The average standard deviation of all broker FY1 EPS estimates for each stock in the index as of May 31, 2023.
The standard deviation of returns for all holdings in the index; calculated annually. Data from December 31, 2003 - December 31, 2022.

THE PZENA ADVANTAGE

As with all strategies at Pzena, we manage our International Small Cap Focused Value strategy with a focus on building concentrated portfolios of undervalued businesses, often experiencing temporary issues.

We utilize our proprietary screening program StockAnalyzer to sift through the cheapest 20% of the vast small-cap investment universe for potential research candidates and assign research priority to the most interesting companies.

Our 29 research analysts cover companies according to global industry. When we research a small cap company, our industry analysts often already have a deep knowledge of the competitive landscape, as well as the customer and supplier bases across the globe. The impact of this knowledge base is particularly crucial in the small cap universe, given the underfollowed nature and the unique dynamics of the companies in the universe, many of which operate in niche businesses.

The end product of our process is an educated estimate of normalized earnings, as well as a thesis for how company management can turn around the business. Crucial to outperforming is focusing on purchasing good companies trading at steep discounts, due to temporary distress, which is often idiosyncratic and company-specific in nature.

Our rigorous fundamental research paired with a structured process to uncover potential ideas across a broad, underfollowed, underallocated universe gives us the opportunity to achieve meaningful outperformance over the long run.

1. Source: Factset

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