

GLOBAL SMALL CAP

Global 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 around the world. Despite rising over 80% since the depths of COVID, the MSCI World Small Cap Index is at a near 15-year low current PE of 12.6x (Exhibit 1).

Exhibit 1

Small Caps Globally at Compelling Valuations World Small Cap P/E Ratios

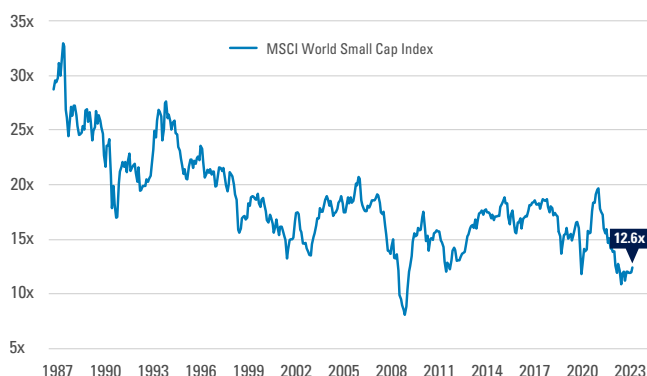


Exhibit 1 Source: Empirical Research Partners, Pzena analysis
Universe is the MSCI World Small Cap. Trailing price/earnings data from January 31, 1987 – June 30, 2023.

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

Exhibit 2

World Small & Large Cap Relative P/E Ratio

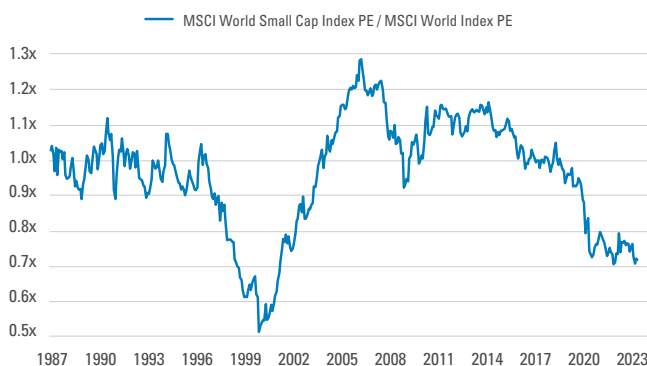


Exhibit 2 Source: Empirical Research Partners, Pzena analysis
Large Cap = MSCI World universe. Small Cap = MSCI World Small Cap universe.
Trailing price/earnings data from January 31, 1987 – June 30, 2023.

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: Globally, small-cap stocks have beaten their large-cap equivalents by nearly 100 basis points per year since 1975, and small-cap value stocks have beaten the style-neutral broader small-cap index by nearly 300 basis points per year (Exhibit 3).

Exhibit 3

The Small Cap Advantage MSCI World Annualized Returns Since 1975

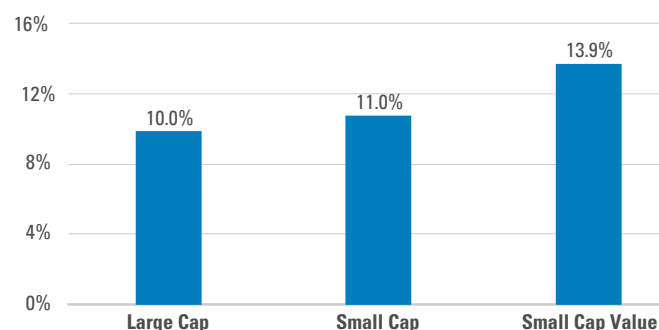


Exhibit 3 Source: Sanford C. Bernstein & Co., MSCI, Pzena analysis
Large Cap = MSCI World Index. Small Cap = Bernstein's MSCI World Small Cap universe (cap-weighted returns). Small Cap Value = Cheapest quintile price to book of the MSCI World Small Cap universe (equal-weighted returns). All total return data in US dollars from January 1, 1975 – June 30, 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 global small-cap value. Intuitively, periods of low valuation should be good starting points, and not surprisingly, buying 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 94% of the time over the past 50 years, despite contracting since the beginning of 2021. 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 Small Cap Index (March 31, 2003 – June 30, 2023)

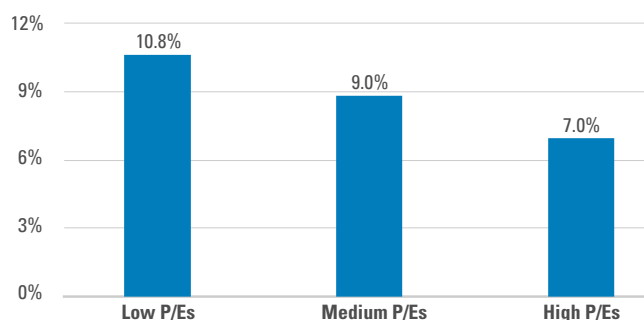


Exhibit 4 Source: FactSet, Pzena analysis
Monthly trailing price/earnings data broken out by tertiles to calculate average 10-year forward performance.
All total return data in US dollars. Does not represent any specific Pzena product or service. Past performance is not indicative of future returns.

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 Global Small Cap

Price/Normal Quintile ¹	Q1 cheapest	Q2	Q3	Q4	Q5 expensive
Historical Return on Equity ²	11%	12%	11%	8%	-6%
Historical Revenue Growth ²	11%	11%	13%	14%	20%
Forward P/E ³	8x	13x	18x	28x	NM*

Ken French Price/Book Quintile ⁴	Q1 cheapest	Q2	Q3	Q4	Q5 expensive
Annualized Return Since 1990 ⁵	12.3%	8.7%	8.1%	4.9%	1.2%

Exhibit 5 Source: FactSet, Kenneth R. French, Pzena analysis

*Not Material

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 June 30, 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 – June 30, 2023 (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.

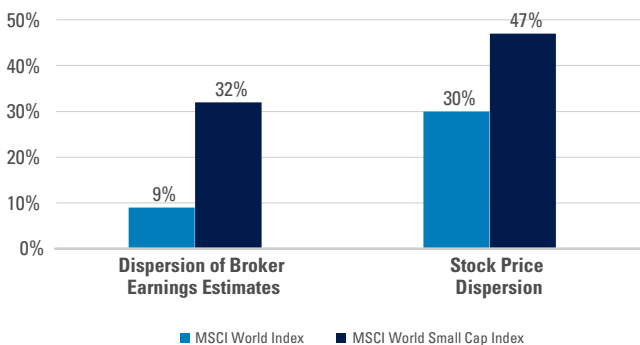
Undiscovered: Part of the explanation for the outperformance of small cap value, and small cap more generally, can be chalked up to a lack of attention. Valuation distortions can be more pronounced in small companies, which attract less focus from equity research firms than large companies. Twenty-eight percent of global small-cap stocks are followed by three or fewer analysts compared with just 2% of global 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 strategy with a dearth of analyst coverage, like Global Small Cap Value, a dedicated research team with a disciplined process must 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 June 30, 2023.
The standard deviation of returns for all holdings in the index; calculated annually. Data from December 31, 2003 - December 31, 2022.*

1. Source: Factset

THE PZENA ADVANTAGE

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

We utilize our proprietary screening tool 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 significant 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. We focus on purchasing good companies trading at steep discounts due to temporary distress, which is often idiosyncratic and company-specific in nature.

We pair our rigorous fundamental research with a structured process to discover ideas across a broad, underfollowed, underallocated universe—giving us the opportunity to achieve meaningful long-term outperformance.

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