Narrator

[Music] Welcome to Pzena Perspectives brought to you by Pzena Investment Management, a global value manager known for our commitment to fundamental research and disciplined value investing. This podcast is presented by Pzena Investment Management LLC, an SEC-registered investment adviser and is intended for institutional investors only. The views expressed reflect the current views of Pzena as of the date hereof and are subject to change. There is no guarantee that any projection, forecast, or opinion in this material will be realized. Past performance is not indicative of future results. In the UK, this podcast is for professional clients only. This marketing communication is presented by Pzena Investment Management Limited, which is an appointed representative of Victoria and Partners LLP. Victoria and Partners LLP is authorized and regulated by the Financial Conduct Authority.

On today's episode, Director of Client and Portfolio Services sits down with Portfolio Manager Evan Fox, CFA to discuss market dispersion, valuation trends, and where we believe opportunity lies in global small cap stocks.

Tyler Zedalis

Welcome everyone and thanks for joining us today. My name is Tyler Zedalis and I'm on the client service team here at Pzena Investment Management. Today I'm joined by Evan Fox, who's a portfolio manager on both our U.S. and Global Small Cap strategies. Evan, how are you? Good to see you today.

Evan Fox

Doing well. Thanks for being here.

Tyler Zedalis

So, I know you're eager to talk about our portfolio companies and the broader opportunity you're seeing in the global small cap space, but I wanted to first take a trip down memory lane here. You're in your 19th year at the firm. You started at Pzena as a research analyst right out of undergrad. So if that wasn't daunting enough, a few years later you joined the PM team on the U.S. Small Cap Focused Value strategy, which is one of the firm's flagship products, and you actually replaced none other than Rich Pzena. So what was that like?

Evan Fox

So it was definitely an exciting opportunity in my career progression. I think what's really interesting and important to know about how our team works is that it really is a clear process that we're working on that we repeat no matter where we're investing around the world. And so from day one as an analyst, you're learning how to find opportunities and really think about what is causing the short-term issues versus the longer-term opportunities for these companies. When I did become a portfolio manager, while yes, it's intimidating to step into Rich Pzena's shoes, we also have a three-person team on the small cap product. And so I was joining with Ben Silver and John Flynn, both of whom had been on it for many years. And it's not that key-man story. It's really understanding more broadly how we work together as an organization. I'll also just flag that one of the things we do to help prepare anyone for taking on these responsibilities that's interesting and unique here is we rotate sector coverage every 3 to 5 years and so I'd actually covered a lot of different industries to really understand different business models which put me in that good position.

Tyler Zedalis

So before an analyst becomes a PM you feel like they're well-rounded. They've covered a lot of different industries and they're already well prepared to actually manage a portfolio.

Evan Fox

Exactly. That's really an important part of what we do and why also you can make the argument that anyone could join any of the products. Meaning that it's the exact same process that we're doing in emerging markets, Japan, small cap, large cap, or anywhere else.

Tyler Zedalis

Thanks, Evan. I appreciate the candor. So, now let's talk stocks. A few weeks ago, I sat down with Jason Doctor for a podcast he's on our international small cap strategy and we discussed some of the things he's seeing in the international small cap world. I started that discussion with an observation of how historically expensive the U.S. market is. But that's not really the whole story, is it?

Evan Fox

No. I think what's really important to remember is that the U.S. market is not just the S&P 500. It really is a much longer list of stocks and there's roughly 3,500 stocks that are listed in the U.S. today. And when we're thinking about small caps, the way we think of it is kind of stocks 1,000 to 3,000. So we have that 2,000-stock universe to look at and that we've been doing since the firm was founded 30 years ago. What's really interesting is if you look at that 2,000-stock universe today, it adds up to about 3.3 trillion in market cap versus Nvidia alone is four and a half trillion. So we've really reached this point where the market has such extreme concentration where the top few names are humongous compared to the entire rest of the market. What's also really important to your point of thinking about the valuation of the market is it's not impossible to have where the high end of the market is expensive but you have a lot of opportunities in other places. We've actually done quite a bit of work looking at the relative valuations on a price-to-earnings basis of small caps versus large cap stocks going back to the 1960s. So we have some 60-year of history there. And what you'd see is that right now small caps are among the widest discount that we've ever seen. Levels that we only saw in the early 1970s during the Nifty-50 period and that we saw around 2000 in the peak of the dot bubble. So now we're seeing some 30% discount of small caps compared to large caps. I think it goes to some of the questions we sometimes get of why should small caps get a premium valuation over large caps. We're in a place now where they're actually getting a huge discount and so we just feel that it's incredibly cheap. And I'll just make the comment that while we only have clean data going back to the 1980s as opposed to 1960s on a global small cap basis, the lines are almost identical where the gap is slightly bigger in the U.S. than it is in non-U.S. But on a global basis as well, small caps are quite cheap compared to large caps.

Tyler Zedalis

Yeah, it is vexing to me to look at the small cap discount versus large caps today because historically they've traded at a premium. But I think there's also a narrative out there that smaller companies are generally highly indebted. They have weaker balance sheets. They have lower profitability than large cap companies. So is there any validity to that?

Evan Fox

You know, it's interesting because it goes to that point of whether you want to view all of small caps as one single asset or if you want to look at it as 2,000 unique opportunities where you can really find those individual names that are attractive. When you look at the Russell 2000, which is really the universe that most people think of for small cap and is roughly matches how we think about it, a little over 40% of them are unprofitable today. Now, a lot of these are in biotech and other areas. So that certainly is a true fact that a lot of the market is unprofitable, but that doesn't mean that that's where we're finding our opportunities today. I'll also even say on the indebtedness stat that a lot of the debt is actually concentrated in a relatively small number of names. And so it's an interesting place where you have this big dislocation where you have a number of highly levered companies. You also have a lot of unprofitable companies. But then you still have a thousand-plus other companies that are in there that we can take advantage of. I also just want to add that there's a comment you made earlier that sometimes these are smaller weaker companies. When we think of smaller companies, it doesn't mean that they're necessarily subscale competitors against bigger players. If they are, they would lose.

Instead, so many of the companies that we invest in are leaders in some sort of niche market. Whether it's Envista, which is a leading dental product manufacturer, whether it's American Woodmark and MasterBrand that are two of the biggest kitchen cabinet manufacturers, we have so many companies that we invest in that we find opportunities that are leaders in some smaller markets where there aren't bigger competitors and it doesn't make sense for bigger competitors to go after these markets because they're just not big enough.

Tyler Zedalis

And, you know, continuing to play devil's advocate here, there's something else you hear a lot about small caps and it's particularly topical today given the macro environment, and it's that they're more susceptible to tariff risks and that's still top of mind for investors. So do you feel that way about the companies that we're invested in?

Evan Fox

It's a good question and I think that is a perception that U.S. companies that are small caps tend to have less sophisticated supply chains, maybe less international or global in how they're structured. And what I'd say is actually a lot of the companies that we're invested in are being punished for concerns like that, but don't actually have that as their true reality. You know, maybe a good example I'd give is a company Spectrum Brands. They have a range of businesses. They make a range of bug sprays and insecticides and things like that, like the Cutter brand for mosquitoes. They also do a whole bunch of pet products, including dog and cat treats, but also aquariums and some glow-in-the-dark fish. And then they have an appliance business. And the appliance business is what people are focused on. This is some blow dryers. They own the Foreman grill. I don't know if you still have one of those from college, but I admit I just used my 20-some-year-old one to make dinner for my son last night.

Tyler Zedalis

It's in the garage.

Evan Fox

Perfect. Well, they last forever. And what's interesting is this stock is down some 50% on tariff concerns just this year so far. But what's really important is that the appliance part of the business is heavily produced in Asia and shipped in and around the world and has those tariff concerns while the bug spray, the lawn care, the whole the other 60% doesn't have that. What's also really important is that the nature of this business is actually 80% of the appliance profits are outside the U.S. Only 20% are in the U.S. So this is one where 40% of the company's business is really exposed to these tariff risks. Twenty percent of that is where they're actually making money in the U.S. and the stock's down 50%. That's those kind of examples that we can take advantage of.

Tyler Zedalis

So this is really sentiment-driven and this is not the only example of a stock in the portfolio where the market is sort of misinterpreting these risks from these headline risks from the administration.

Evan Fox

Right. It's really often that people bucket all these stocks together and they're not digging in to really understand the specifics of them.

Tyler Zedalis

Well, I do really want to hear more about glow-in-the-dark fish, but in the interest of time, I want to ask you another common question I get from clients, and this should come as no surprise to you as a small cap portfolio manager. But I hear a lot of clients asking when are small caps going to turn and do what they've historically done, which is frankly outperform large caps. So can you turn on your crystal ball and tell us when?

Evan Fox

I wish I could. I really wish I could, but we're not market timers. When you think of what's gone on with small caps, the long-term Fama-French research would show that small caps have outperformed, but they haven't for last 15 years or so. They've gone through a challenging period, and we spoke earlier about how the relative valuations of small caps are among the lowest they've been. I think there's a range of reasons for this. Some of it is lack of sell-side coverage. Ever since MiFID and some of the regulatory changes there, we've seen fewer analysts that are looking at these companies, some of them have become less liquid for that very reason. We often see that there will only be a few analysts that are covering it, if any. I give an anecdote I remember from a couple of years ago where one of the investments that we have put out an 8-K, a regulatory filing, saying that their president was leaving. It was one of these one-sentence releases with not much color. And so I called the treasurer of the company and I asked, "Can I get some more detail? What happened here?" Got a little bit of color. And then I asked her, "Have you gotten a lot of calls on this because I haven't seen it in the press. I haven't seen any notes or anything about it." And she said, "Well, my regulars have called." And I said, "Oh, who are your regulars?" And she goes, "You." And when you hear that, it just goes to the point that sometimes these are just not really followed. And it's an interesting point there. The other one that I would just expand upon a little bit when you were asking about how we think about what the performance could be going forward is we have done some work looking at what's happened following periods when the valuation dislocations have been this wide and small caps have been this cheap versus large cap and we did it as a little bit of a scatter plot looking at the discount of small versus large and then what happened in the ensuing five years and it's pretty incredible to see that the history would show that when we're at these valuations, small caps have outperformed large caps by an average of 10 to 15 percentage points a year for the ensuing five years, kind of ranging from 5 to 18% or so. Now, obviously, every cycle looks different, and we're not saying that it'll be exactly the same or anything close to that, but it's really interesting to note that the absolute level of valuations between small cap and large cap really does open the doors and create opportunity for how big of an order of magnitude relative change we could see going forward.

Tyler Zedalis

Yeah. And I find it interesting that a lot of those periods where, you know, you heard these "small caps are dead" calls, right? It was the dot-com era, it was the Nifty-50 era. After large caps peaked, you really saw a sustained period of small cap outperformance, and it was quite powerful.

Evan Fox

Yeah. And I think what's even interesting from some of the conversations we've had with consultants and prospects and things like that is that as small caps have become a smaller and smaller percentage of the market, right? I think we're at a point where the Russell 2000 as a percentage of the S&P 500 is around 4% when it's averaged almost three times that throughout its history. A lot of allocators are actually just saying we don't want to put our time into researching small caps. We're not going to put as much weight into it and we're not missing out on as much. And the number of people who have said that have really made us realize that there's a lot of money sitting on the sidelines or sitting in mega caps that could move into small cap if the performance starts to turn, which makes us think that some short-term performance like we did see a bit of in the third quarter doesn't mean that we're anywhere near the ending innings of this.

Tyler Zedalis

Not to mention something like $7 trillion sitting in money-market funds, which is a record by the way.

Evan Fox

Yes, for sure. That's a good point.

Tyler Zedalis

I want to actually take a step back and get back to this comment you made about lack of sell-side coverage because I think that's really interesting. Can you give me an example of a stock that we hold that you think most people just haven't even heard of before?

Evan Fox

Yeah, there's quite a few, but maybe one that stands out is Douglas Dynamics. Their ticker is PLOW, which is helpful for remembering what they do because they're a leader in making snow plows.

Tyler Zedalis

That's fitting.

Evan Fox

Yes, exactly. It's always nice when they have good creative tickers that actually match what they do. This is one that has maybe two or three analysts that are covering it compared to Nvidia has, I believe, it's 66 right now. I'm sure the 65th and 66th, they're adding a lot of incremental value. And what we've really seen in this is that snow has been below trend for the last several years, especially in the Northeast and Midwest. For those of us who live in the area, that's excellent. I appreciate that I haven't had to use my snowblower very much the last few years, but for companies like Douglas and for all the landscapers that work throughout the winter clearing snow, this has been a challenge. It's led to the equipment not wearing out as much, but also it's led to the landscapers not having as much cash flow that they want to reinvest into replacing their snow plows. Now, Douglas hasn't just been sitting still. They also have another half of their business that makes a range of specialty vehicles. They've really been taking out a lot of costs. They have an incredibly efficient operation. The management team, when we've toured their facilities, really has been top-notch when it comes to working through some of these challenges. And so now this is one where it really is a good business, a bit of a coiled spring for when we do start seeing weather turn and we start seeing more snowfall and things like that that are more in line with history or even we can call it snow volatility in terms of different areas that do see that weather. The company can really capitalize with the amount of orders that they could see and just an older install base of plows that are out on the roads. So hopefully that's helpful.

Tyler Zedalis

Well, you're right, Evan. Definitely haven't heard of Douglas Dynamics, but given the ticker, I'll certainly remember it now. So, I already established with Jason that small caps outside the U.S. are uniquely cheap, and you're making the case today that U.S. small caps are also cheap. So, we're certainly finding plenty of opportunities to add to our global small cap portfolios. How are we finding these opportunities? How are you sourcing them?

Evan Fox

One of the things that's really interesting about investing in small cap is that it is a rich pool with a lot of different names. And so you need that process to be able to find those opportunities. We're looking at roughly a 2,000-stock universe in the U.S., some 3,000 stocks outside the U.S. that are in the small cap space. And that's where having our roughly 30-person analyst team allows us to use our screening tool to find names that could be interesting and to go through them in a lot of detail. Because as I said before, there's fewer sources of third-party information about these companies. And so the relative value of having that team of analysts with intellectual curiosity who really want to dig into why these businesses exist, which is always a key question with these small caps and what is their competitive positioning, what do we need to believe for them to be interesting, what are the challenges — that's really an exciting part of what we're doing. And it's one that we've done throughout our entire history. And maybe I'm a little biased, but I would argue it's even more fun in small cap than large cap when these are names that no one's heard of and that there's a lot more unique information that you can get.

Tyler Zedalis

Well, I don't think you're biased. I think it makes a lot of sense when you think about the benefit of active management. It sounds like when you're talking about smaller companies with less information, they're less efficient, there's less sell-side coverage — active management, if you're willing and able to do the fundamental research, it really gives you an advantage.

Evan Fox

It does. And especially, as we said before, that some 40% of the companies are unprofitable. There's really a mix of companies that are in the small cap universe more broadly. And there's a lot of money across the cap spectrum that's moved into passive, which is trying to look at small cap as just a factor rather than really understanding the unique opportunities that you can find within it.

Tyler Zedalis

Are there any other key themes you're seeing in the global small cap world?

Evan Fox

I'd say one that's really starting to pick up over the last few months is M&A. We're seeing more companies getting acquired, more transactions going on. A lot of this is that the current administration is more supportive of acquisitions and of allowing things to go through regulatory approval process, and especially for small cap companies they can be targets of larger companies that can be pretty interesting, but even if it's just mergers that can be good too. I mean when we just look at what's happened over the course of the last few months, we had Steelcase, which is one of the largest office furniture manufacturers in the world, getting acquired by HNI, one of their competitors. Another example of two names that are in our portfolio that are actually merging are MasterBrand and American Woodmark. These are two companies that are leading manufacturers of kitchen cabinets. It's a relatively consolidated market. If anything, the market's getting better because there was some import competition that now is facing much higher tariffs. And as these two companies come together, they can take out a whole bunch of costs and position themselves well going forward. You know, we've been in this tough demand environment where housing turnover has been at some of the lowest levels. I believe 2024 was the lowest level in 30 years. And when you look at when people change their kitchen cabinets, part of it is when you build a new house and some of it is when you move into a house and you want to renovate. And so we're really at depressed demand, but these companies can take advantage of it. I'll also add we've seen some in the financial space and I'll just make an anecdote that we just had Fifth Third that's merging with smaller competitor Comerica in the regional banking space and while these are more mid cap companies one of the things that the Fifth Third CEO had said recently when we were meeting with him was that now the regulatory period is much shorter. When you think that it's going to take a year and a half to review a transaction and see if you can get through, you have to price for that discount because you risk employees getting poached, operational distraction along the way. When you think you can get a deal done in months rather than a year-plus, you're more likely to do a deal. You're willing to offer a higher price because the inefficiencies are much lower. And that's played out as they just announced this transaction.

Tyler Zedalis

So M&A is just really another way that we can realize value from our portfolio companies.

Evan Fox

Correct. And we're not saying that necessarily our companies will get acquired, but during periods in the past we have seen it happen. And it is one where when we look and we say that the market's really undervalued and a lot of these names are cheap, the most obvious thing is that the stock appreciates because the rest of the public market realizes it. But a way that it could come through and crystallize immediately is someone acquiring them at a premium.

Tyler Zedalis

Got it. So Evan, the overarching takeaway I'm gathering here is that global small caps look very attractive from a valuation standpoint and they're extremely under-allocated to. So that's a pretty enticing combination.

Evan Fox

Yeah, I mean we're at this point where I think a concern that many people have is that a lot of the mega cap stocks in the more expensive parts of the U.S. market are getting more and more expensive and they're really getting priced to perfection. And I think what's really interesting for thinking about as a history lesson as to why value investing and some fundamental investing works is that often during these extreme periods, the market differentiates companies into what I'll call the haves and the have-nots. The haves are the companies that are immune from whatever is going on in the economy that can grow forever. And the have-nots are the ones that are not participating in it. We've seen this time and time again, whether you want to go back to the dot-com bubble or other periods over time. And what you actually find is that the quote-unquote have-nots aren't actually just sitting there twiddling their thumbs. What they're doing is they're taking out costs. They're becoming more efficient. They're figuring out how they can deal with whatever challenges they're facing. And the haves, the companies that are perceived to be immune from this, one are not typically immune from macro factors, and two, they end up not being able to get those same incremental returns as they get bigger and bigger — just the law of large numbers. And so we're at this really attractive point where the market's expensive, small caps are at a huge discount and give attractive market exposure and economic exposure at a fraction of the valuations of those much bigger companies.

Tyler Zedalis

Well, thanks for the chat, Evan. And to our listeners, please check out our third-quarter newsletter commentary for more of our insights on this topic. Great to speak with you.

Narrator

Thank you for joining us for today’s episode of Pzena Perspectives. If you’d like to hear more, be sure to subscribe to this podcast. And for more insights on value investing, visit our website at www.pzena.com

That’s www.pzena.com

[Music]