Strength in Numbers

The Case for Global Small Cap Equities

Global small cap stocks have historically outperformed large and mid cap stocks. The MSCI ACWI Small Cap Index has outperformed the MSCI ACWI Index (mid & large cap) 96% of the time on a rolling 10-year basis, and by an average of +266 basis points annually. While the small cap premium makes a case for the asset class, we believe the strongest argument comes from the dynamics inherent in the global small cap universe, making it fertile ground for active managers to outperform.

In this analysis, we explore the benefits of a dedicated allocation to an actively managed global small cap strategy. We discuss the sheer size of the opportunity set as well as how it differs from large cap. We highlight the magnitude of the alpha opportunity, and conclude with how EAM leverages its expertise to approach global small caps.

Key Takeaways

- The opportunity set offers diverse exposures compared to mid and large cap with wide dispersion in stock returns
- Global small cap returns have historically outperformed large cap over longer-term time periods
- Median active managers have demonstrated consistent success adding alpha in global small cap
- We believe a targeted and efficient approach to research is important for unlocking value in this inefficient space.

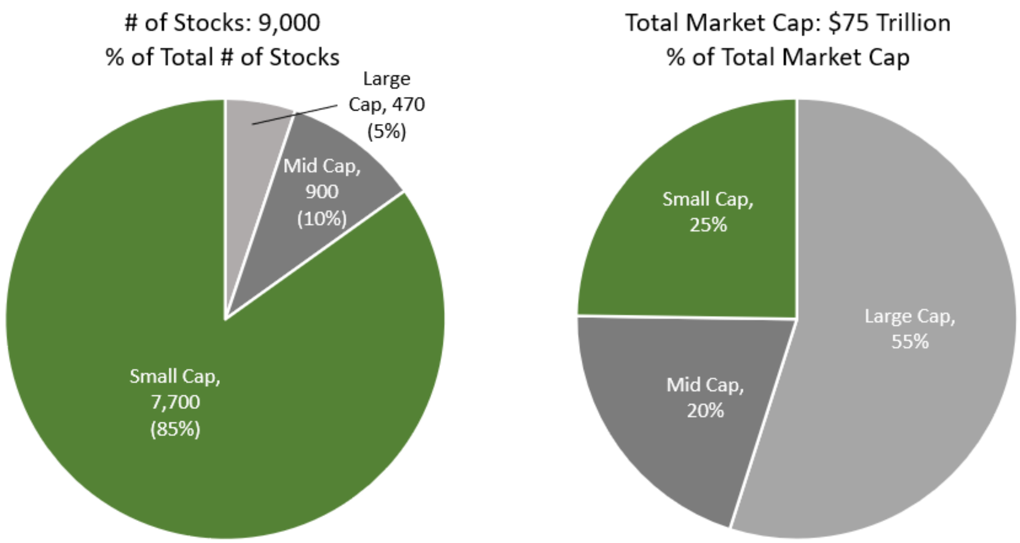
A Vast, Diverse Opportunity Set

Global small cap's defining characteristic is the breadth of the universe. Spread across 46 countries in both developed and emerging markets, the global small cap equity universe presents a broad and diverse opportunity set of roughly 7,700 public companies, or 85% of the total equity market universe. By number of constituents, the global small cap universe is over five times larger than mid- and large-cap *combined.* Despite this impressive breadth, the number of investment strategies dedicated to global small cap equities remains relatively limited. According to eVestment, just 6% of all global equity products fall under the Global Small Cap classification, while the majority are Global All Cap. Further, 90% of Global All Cap managers have a benchmark of MSCI ACWI, which according to MSCI represents only mid and large cap stocks, and has just 9% in stocks less than $10 Billion in market cap. This discrepancy results in a natural large-cap bias in most all-cap strategies, therefore missing out on what we believe is the most vibrant sector of the market.

Figure 1:

The global small cap universe is over 5x larger than mid and large cap *combined*

Most Publicly-Listed Stocks are Small Cap



Source: FactSet universe as of December 2019. Excludes mainland China and OTC (bulletin board) stocks. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

Differentiated Returns

Importantly, the universe offers compelling diversification potential compared to its larger cap counterpart. This broad collection of small companies, often focused on a narrow set of products or services and geographies, creates a different, complementary equity exposure relative to large cap. At the sector level, over 35% of the index in global large cap is concentrated in financials and information technology, while small cap exposures are more balanced by sector with higher weights in industrials and real estate.

Our experience suggests an even more important difference occurs within sectors at the industry level. For example, given the scale necessary to compete in the global smartphone industry, a small company typically cannot successfully design, build and market a smartphone. Instead, we find smaller cap companies competing within the supply chain of the smartphone manufacturer and selling complementary services. The same can be said for other capital-intensive industries like autos, aerospace or telecom services. In financials, large caps include global universal banks and multinational insurance companies while small cap financials consist of community banks and alternative finance companies. In healthcare, we see large cap dominated by big pharma while small caps are focused on biotechnology or contract research. The result of this phenomenon is an equity exposure that is different and complementary to that of large cap.

Evidence of a Small Cap Premium

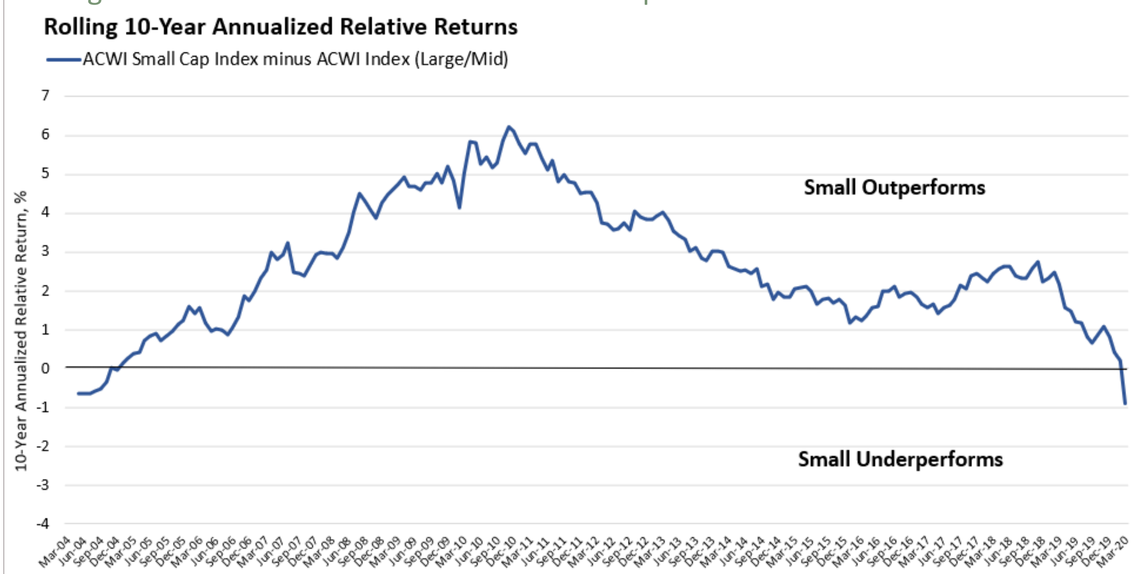
Academic researchers have repeatedly found that small cap equities have higher risk-adjusted returns than their large cap peers. Theories as to why the small cap premium exists can be divided into two general camps: 1) the market misprices small cap stocks and 2) small cap stocks are inherently riskier and therefore should earn commensurate return. The truth is likely some combination of the two theories.

An analysis of long-term returns finds that the additional risk associated with small cap stocks is well compensated over the long-term. Since inception of the MSCI ACWI Small Cap Index, it has outperformed the MSCI ACWI Index (large and mid cap stocks) on a rolling 10-year basis 96% of the time and by an average of +266 basis points annually. Indeed, factors and styles do fall out of favor occasionally, and the past few years are an example of small caps failing to deliver a premium. The global equity drawdown in the first quarter of 2020 was especially severe for small cap stocks. In response to the COVID-19 pandemic, many governments throughout the world took the unprecedented step of closing or restricting large parts of their economies. Without the depth of resources available to many large firms, small companies face a more uncertain future and that is reflected in recent stock performance. In the first quarter of 2020, the MSCI ACWI Small Cap Index underperformed MSCI ACWI by 890 basis points.

Figure 2:

Global small cap equities have outperformed large and mid cap over most longer-term periods

Long-Term Relative Returns of Global Small Cap



Source: MSCI index returns going back to inception of the MSCI ACWI Small Cap Index in May 1994 through March 31, 2020

As of this writing, most economies have not yet been completely re-opened and the totality of the toll on small cap fundamentals is not yet known. But what small companies lack in resources and diversity they make up for in agility and focus. The strongest companies will adapt to survive and new firms will emerge to take advantage of fresh opportunities. In fact, in past equity drawdowns of this magnitude, small caps have led the market on way back up. In the last 25 years, there have been three drawdown periods where the MSCI ACWI Index was down more than 20%. Emerging from those drawdowns, the MSCI ACWI Small Cap Index returned on average 58%, 116% and 158% cumulative over the subsequent 1-, 3-, and 5-year periods, respectively. Further, in those periods, the small cap index outperformed the MSCI ACWI Index by an average of 15%, 33%, and 43% over the subsequent 1-, 3-, and 5-year periods, respectively.

While no one can be certain, the empirical data and plausible explanations for the existence of the small cap premium lead us to believe it is likely to re-emerge in the future. Today's dislocation may represent a timely opportunity for investors wishing to either introduce an exposure to global small caps or increase an existing exposure.

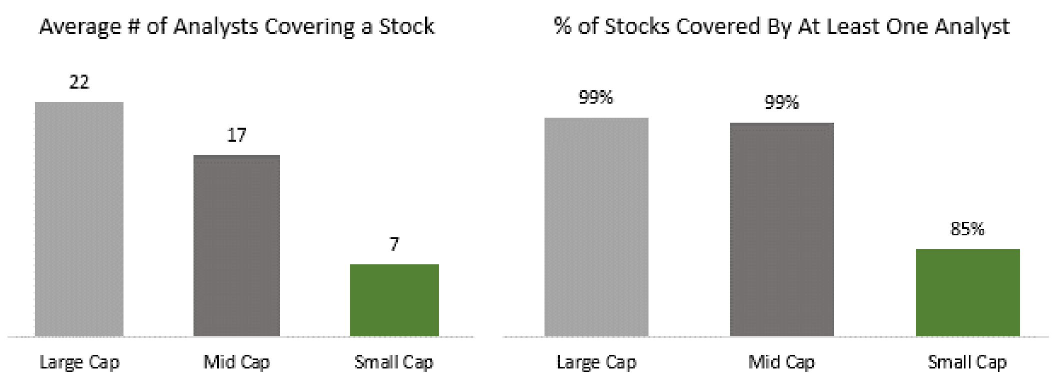
Fertile Ground for Active Management

The return premium from investing in small cap is compelling, but we believe the strongest case for global small cap stems from the opportunity for active managers to generate consistent alpha. As previously mentioned, the opportunity set is vast with 85% of all publicly-listed stocks falling into the small cap category. Among these companies, 15% of them are completely uncovered by sell-side research analysts. On average, global small cap stocks are covered by 7 analysts relative to large cap at 22 analysts. The result is information inefficiencies that create opportunities for managers to exploit mispricing.

Figure 3:

Small cap stocks have considerably lower research coverage

Research Coverage

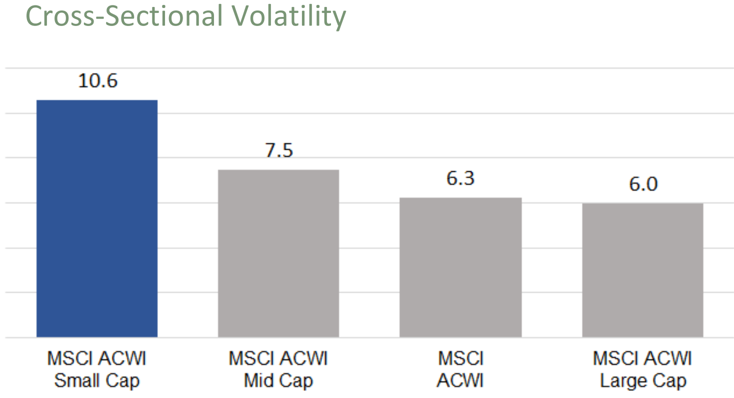


Source: FactSet universe as of December 2019. Excludes mainland China and OTC (bulletin board) stocks. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

Another attractive characteristic of the small cap universe is its high degree of cross-sectional volatility, which is to say, these stocks tend to act very differently from one another. Small companies typically address specific markets and sell a narrow set of products and services. Their success or failure is often driven by company-specific factors and the result is a wide range of outcomes. Figure 4 illustrates the difference in cross-sectional volatility between small cap and larger cap stocks. The higher level of cross-sectional volatility in small cap highlights a rich environment for active managers to identify companies that are positioned to outperform.

Figure 4:

Higher cross-sectional volatility highlights the active management opportunity

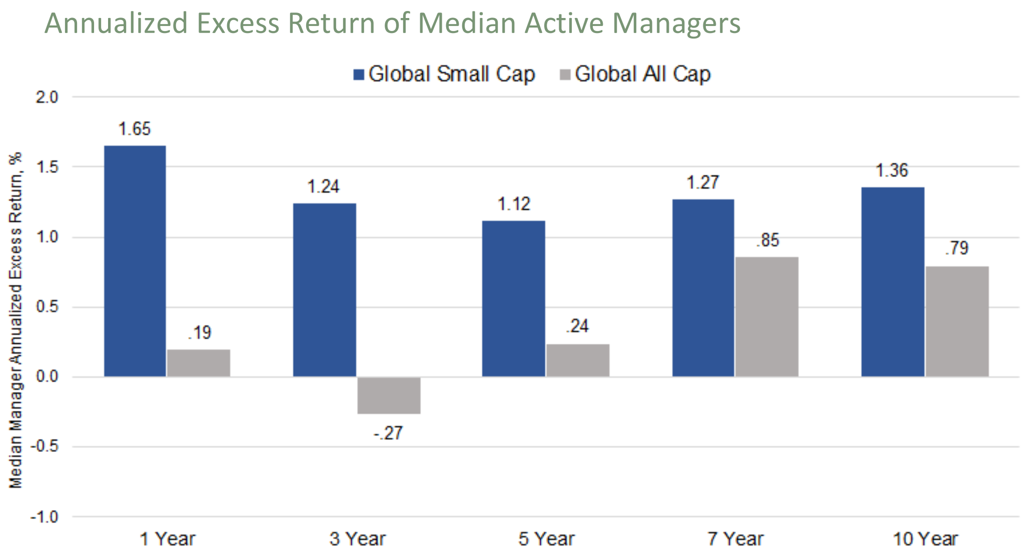


Source: Cross-sectional volatility calculated using monthly data from Factset for the last 5 years ending December 31, 2019

These dynamics have resulted in a large, inefficient market where the potential for overlooked and mispriced securities is far greater than in large cap. Skilled active managers have the opportunity to exploit these types of situations to generate consistent excess returns beyond what might be expected in a large cap strategy. Figure 5 confirms that global small cap active managers have been able to add significantly more alpha than their larger cap peers.

Figure 5:

Small cap managers have added impressive excess returns compared to larger cap peers



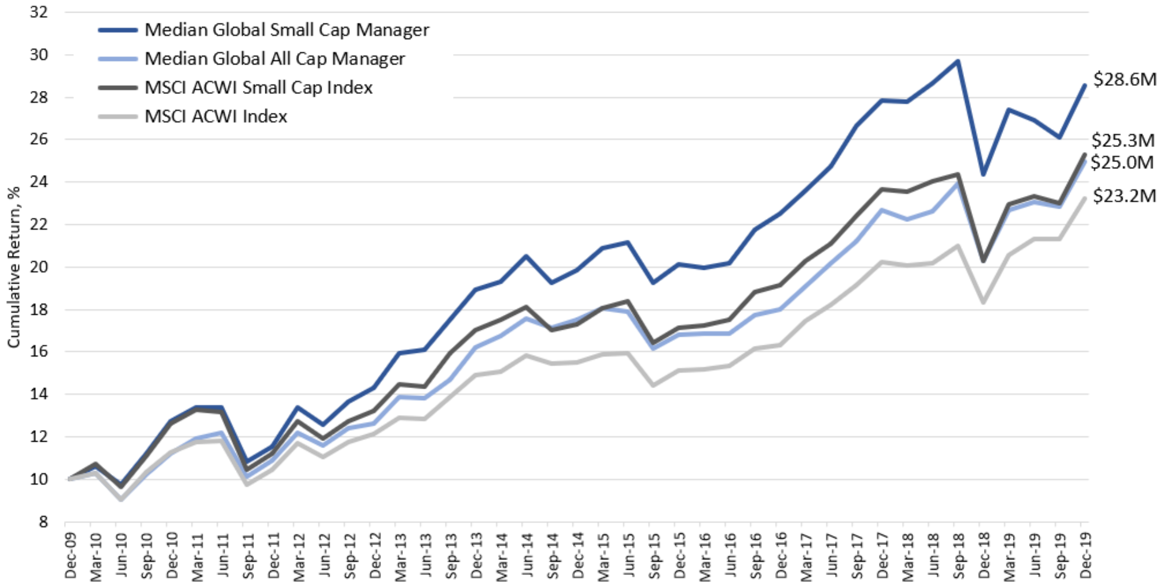
Source: eVestment data as of December 31, 2019. Return of the median manager, gross of fees, within each respective peer group is shown: Global Small Cap (MSCI ACWI Small Cap Index) and Global All Cap (MSCI ACWI Index).

This attractive alpha opportunity combined with the size premium indicates that an allocation to global small cap can add significant value relative to a global all cap allocation. A dedicated, actively managed global small cap strategy can help capture the full potential of the asset class, whereas an all cap approach risks significantly diluting this possible alpha opportunity. As shown in Figure 6, for the last 10-year period a $10 million investment in the median Global Small Cap manager would have yielded $28.6 million, or $3.6 million more than if invested in the median Global All Cap manager.

Figure 6:

The small cap return premium coupled with active manager alpha makes global small cap a compelling total return opportunity

Compelling Total Return Opportunity



Source: MSCI, eVestment data as of December 31, 2019. Return of the median manager, gross of fees, within each respective peer group is shown: Global Small Cap (MSCI ACWI Small Cap Index) and Global All Cap (MSCI ACWI Index).

EAM's Approach to Global Small Cap

EAM Investors was specifically structured to address the opportunities and challenges of global small and micro cap equities. We have decades of experience focused on these markets. Our investment philosophy and process is designed to exploit the inefficiencies that exist in these markets, from team structure to our approach to idea generation, portfolio construction, risk management and implementation.

We believe change creates mispricing. EAM invests in companies undergoing positive change that is underappreciated by the market. Change is ever-present but nowhere is it as impactful as in small and micro-cap companies. For these firms, earnings are often driven by just a few products or services; customer bases are more concentrated; addressable markets are defined by regions rather than continents. For example, a new management team, better corporate governance, a new product or a change in regulations can make a dramatic difference in a small company's earnings outlook.

We believe an objective process is important. The sheer size and rapidly changing dynamic of the global small cap universe can make it difficult for many managers to research each and every stock thoroughly. Thus, we believe a systematic and timely approach to screening the universe is paramount in helping managers identify and capitalize on those opportunities with the most potential. EAM's quantitative screening and fundamental research process is based on behavioral finance research that suggests investors tend to discount new information, following an anchor-and-adjust process.

In more inefficient markets, the anchor-and-adjust phenomenon is often exaggerated. The relative scarcity of media interest, sell-side coverage and active investors slows the dissemination of information creating mispriced opportunities that have historically been sizable and exploitable.

We believe timely, focused research is important. Capitalizing on these attractive entry and exit points requires an investment process that can focus research efforts on the strongest investment candidates: companies undergoing positive fundamental change. The gap between when there is a change in fundamental value and when that change is reflected in the stock price is often greatest after the release of new information. Understanding the key indicators of change and efficiently screening for those factors are essential to narrowing the investment universe to a list of candidates with the highest likelihood of being mispriced. Further, we believe that focused fundamental analysis of those opportunities in a disciplined and timely manner ultimately allows for the effective management of a global small cap portfolio.

We believe in building active, risk-aware portfolios. EAM builds high active share portfolios without unnecessary concentration. Small companies are fundamentally volatile and typically more sensitive to external shocks than their large cap peers. EAM's thoughtful portfolio construction and investment in risk measurement technology are designed to protect clients' capital in difficult markets.

We believe a deliberate trading strategy adds alpha. EAM's trading strategy is a natural extension of the core philosophy and a crucial element of the firm's process. Opportunities created by change are available but fleeting; capturing them takes skill. EAM's equity traders have an average of over 20 years of experience transacting in small and micro cap equity markets using state of the art technology and personal relationships to source liquidity and avoid eroding alpha with transaction costs.

Conclusion

Global Small Cap presents a compelling, complementary allocation for allocators that either have a large cap bias or are looking for additional alpha opportunity. We believe the dynamics of the universe have led the median manager to add significant alpha historically. EAM uses an investment process and philosophy which was purpose-built for the intricacies of the global small cap equity market. Our historic success is shown by positive inception-to-date alpha through 12/31/2019 for all seven of EAM's strategies[1], which span the global small cap equity universe.

Global Opportunities is EAM's global small cap strategy. It leverages the collective experience of EAM's portfolio managers and analysts to construct a portfolio of the strongest ideas from a global perspective. Global Opportunities' performance track record ranks top-decile[2] since inception among global small cap equity peers as of 12/31/2019.

EAM Global Opportunities Performance as of March 31, 2020

	March 2020	Q1 2020	1 Year	2 Year	ITD*
EAM Global Opportunities (Gross)	-19.88%	-23.48%	-12.41%	-5.43%	5.61%
EAM Global Opportunities (Net)	-19.93%	-23.63%	-13.07%	-6.14%	4.82%
MSCI ACWI Small Cap Index	-21.02%	-30.19%	-23.06%	-13.49%	-6.32%

**Inception of the EAM Global Opportunities strategy is July 1, 2017. All periods greater than 1 year are annualized.*
Please see important performance disclosures on page 10.

[1] EAM's strategies and their inception dates are as follows: US Small Cap Growth, 10/2/2007; US Micro Cap, 10/2/2007; US Ultra Micro Cap, 10/2/2007; International Small Cap, 4/1/2011; Emerging Markets Small Cap 5/1/2012, International Micro Cap 6/1/2014; Global Opportunities, 7/1/2017. Full composite disclosures are available upon request. Please contact EAM Investors for additional information: info@eaminvestors.com 760-479-5080

[2] Performance is ranked against the eVestment Global Small Cap peer universe as of December 31, 2019, gross of fees.

About EAM Investors, LLC

EAM Investors, LLC specializes in active small and micro cap equity strategies in inefficient global markets. By using a time-tested philosophy and a disciplined, focused, and objective investment process, EAM believes they can add consistent alpha to their portfolios. The firm's culture is focused on teamwork, with all team members conducting research and an open office architecture promoting effective communication, debate, and real-time decision making. Portfolio managers have a long-standing working relationship and a strong dedication to each other and the investment process.

Nicholas A. Dame, CFA

Nicholas Dame serves as Portfolio Manager for EAM's Global Opportunities strategy. Prior to the launch of Global Opportunities in 2017, Nicholas served as a Senior Analyst for EAM's US and Non-US small and micro cap strategies. Prior to joining EAM in 2014, Mr. Dame was with Victory Capital Management for six years as a Senior Equity Analyst-Global Generalist where he was responsible for sourcing investment ideas from all geographies and all sectors. At Victory, he also had portfolio management responsibilities for incubating their Global Dividend Equity Portfolio. Additional experience includes research positions at Nakoma Capital Management and American Century Investment Management. Mr. Dame has 14 years of investment experience. He holds an MBA from the University of Wisconsin and a BS in Business Administration from the University of Missouri. Nicholas is a CFA charter holder.

Adam D. Rubin, CFA

Adam Rubin serves as Portfolio Manager for EAM's Global Opportunities strategy. Prior to the launch of Global Opportunities in 2017, Adam served as a Senior Analyst for EAM's US and Non-US small and micro cap strategies. Prior to joining EAM Investors in 2014, Mr. Rubin was a Research Analyst at Rice Hall James & Associates, an institutional US small cap equities manager. Previously, Adam was a Research Analyst at Paramo Capital Partners, a long/short equity hedge fund. Mr. Rubin also spent four years as a Research Associate at Brandes Investment Partners, LLC, focused on global equities. Adam has 13 years of domestic and international equity research experience. He holds an MBA from the Anderson School of Management at the University of California, Los Angeles and a BBA from the Stephen M. Ross School of Business at the University of Michigan. Adam is a CFA charter holder.

Travis T. Prentice

Travis Prentice serves as CEO and Chief Investment Officer of EAM Investors, a firm he co-founded in 2007. In addition, he serves as Portfolio Manager for EAM's US strategies and, as CIO, has oversight over all strategies at EAM. Prior to founding the firm, Mr. Prentice was a Partner, Managing Director and Portfolio Manager with Nicholas-Applegate Capital Management where he had lead portfolio management responsibilities for their Micro and Ultra Micro Cap investment strategies and a senior role in the firm's US Micro/Emerging Growth team. Travis has 22 years of institutional investment experience specializing in small and micro cap equities. He holds an MBA from San Diego State University and a BA in Economics and a BA in Psychology from the University of Arizona.

Michele C. Rodrigues

Michele Rodrigues serves as a Senior Associate, Product Specialist. Prior to joining EAM in 2014, Ms. Rodrigues was with Fidelity Investments for eleven years most recently serving as a Portfolio Associate and Portfolio Analyst, where she provided multiple portfolio managers with support by monitoring and analyzing portfolio positioning, risk metrics, characteristics and performance. Additional positions at Fidelity included Operations Analyst and Senior Control Accountant. Michele has 15 years of investment experience. She holds an MBA from Northeastern University and a BS in Finance from Bentley University.

Disclosures

Past performance does not ensure future results, and there is no assurance that the portfolios will achieve their investment objectives.
Gross and net returns are presented net of brokerage commissions and include income from interest and dividends as well as capital gains less applicable withholdings. The returns do not reflect the deduction of other taxes a typical investor may accrue or custodial fees. The U.S Dollar is the currency used to express performance. Net returns are net of the maximum annual management fees of 0.75% for the EAM Global Opportunities Strategy. All periods greater than 1 year are annualized.

The MSCI ACWI Small Cap Index captures small cap representation across 23 Developed Markets (DM) countries and 24 Emerging Markets (EM) countries. The index is designed to measure small cap equity market performance in the global developed and emerging markets. The MSCI ACWI Small Cap Index has been chosen as a benchmark to the EAM Global Opportunities strategy because the Advisor believes that it is the most appropriate broad-based securities index available to be used for comparative purposes given the investment strategy of the portfolios.

The performance of the Indexes reflects dividends net of foreign tax withholdings applicable to a typical foreign investor and capital gains but does not reflect the deduction of any investment management fees or other expenses or taxes. The indexes are unmanaged and cannot be invested in directly.

Under no circumstances does the information contained within represent a recommendation to buy or sell securities. The securities identified in the materials are used for illustrative purposes in the discussion of our investment philosophy and processes. We may or may not have held, currently hold, or will hold any of the securities.

The portfolios are actively managed and holdings are subject to change. We believe the information presented is reliable, but we do not guarantee its accuracy. The opinions expressed will evolve as future events unfold. The investment risk of the portfolios may be increased by the portfolios' ability to invest in smaller company stocks, and IPOs. Investing in growth stocks involves certain risks, in part, because the value of securities is based upon future expectations that may or may not be met. Small company stocks are generally riskier than large company stocks due to greater volatility and less liquidity.

The information regarding EAM Investors is presented by NLCG Distributors, LLC, and entity deemed by the US securities laws to be under common control with EAM Investors.