The Case for Global Small Cap Equities

Learn about the benefits of an active manager allocation, and see how momentum exposure in global small cap can boost long-term returns

Global small cap stocks have typically outperformed large and mid cap stocks over the long-term. Looking at rolling 10-year periods, the MSCI ACWI Small Cap Index has outperformed the MSCI ACWI Index (mid & large cap) 82% of the time, and by an average of +241 basis points annually (reference analysis on page 2). While the return premium from investing in small cap is compelling, we believe the strongest case for global small caps stems from active managers' proven ability to generate consistent alpha.

That said, the economic backdrop has led investors to shy away from economically sensitive areas of the market like small caps, in favor of the perceived safety of large cap stocks. Our analysis finds that small cap stocks typically lag in market corrections, but then go on to add significant value in the subsequent recovery periods. If history is any guide, now may be an opportune time to introduce or increase an allocation to small cap stocks.

In this analysis, we explore the benefits of a dedicated allocation to an actively managed global small cap strategy. We demonstrate small caps' outperformance over time and discuss why active managers have been able to consistently add alpha. We discuss the sheer size of the opportunity set as well as how it offers a differentiated source of returns and exposures that is complementary to large cap. Finally, we look at what factor exposures have worked best in the global small cap universe.

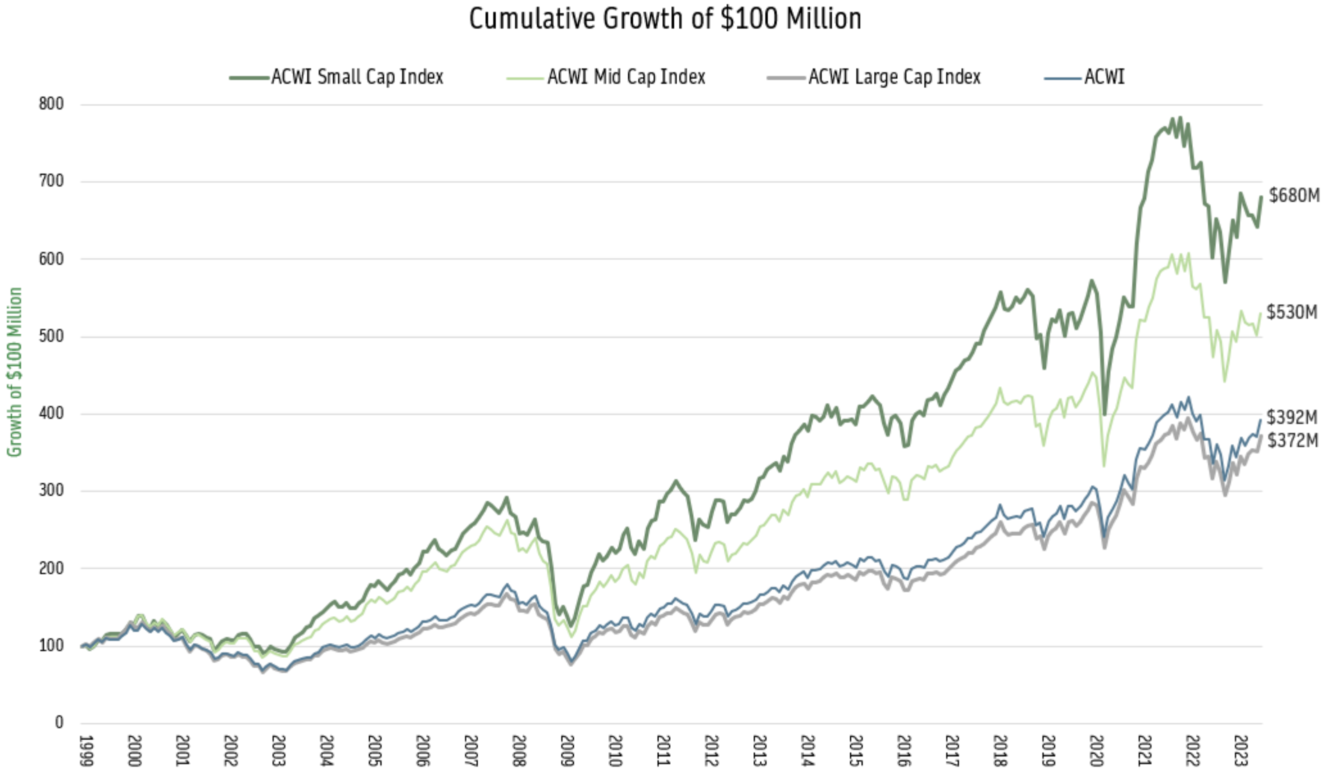
Evidence of the Small Cap Premium

Academic researchers have 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. While performance of any asset class may fall out of favor occasionally, our analysis shows that if you have a longer-time horizon, small caps outperform *most* of the time. Since inception of the MSCI ACWI Index (large/mid cap stocks) in January 1999, the MSCI ACWI Small Cap Index has outperformed in 82% of rolling 10-year periods, and by 241 basis points annualized. For the same period, the global small cap index returned 8.14% annualized through June 30, 2023, outperforming the MSCI ACWI Index by 285 basis points annualized over that time. Said another way, if you invested $100 Million in small cap in January 1999, you would have $680 Million compared to $372 Million invested in large/mid cap.

Smaller market cap stocks have historically outperformed mid and large cap

	Rolling 3-Year Periods	Rolling 5-Year Periods	Rolling 10-Year Periods
% of the time small cap has outperformed ACWI	73%	77%	82%
Average annualized basis points outperformance	266	253	241



Source: MSCI Net Index returns back to inception of the MSCI ACWI Index in January 1999 through June 2023. The analysis of rolling periods is calculated using a monthly series of 3, 5, and 10 year annualized returns for the MSCI ACWI Small Cap Index compared to the MSCI ACWI Index.

As with all asset classes, small cap leadership comes in cycles. Typically, small cap stocks tend to underperform during market downturns but they often experience significant outperformance during recovery periods. We identified seven drawdown periods when the MSCI ACWI Small Cap Index fell more than 20% and looked at performance compared to the MSCI ACWI Index in both the drawdown and subsequent recoveries. This analysis of the last 20+ years indeed shows that in six of the seven drawdown periods, small cap underperforms, while in five of the seven recoveries, small cap leads in the correction.

Small cap typically underperforms in market corrections, and leads significantly in the recovery periods

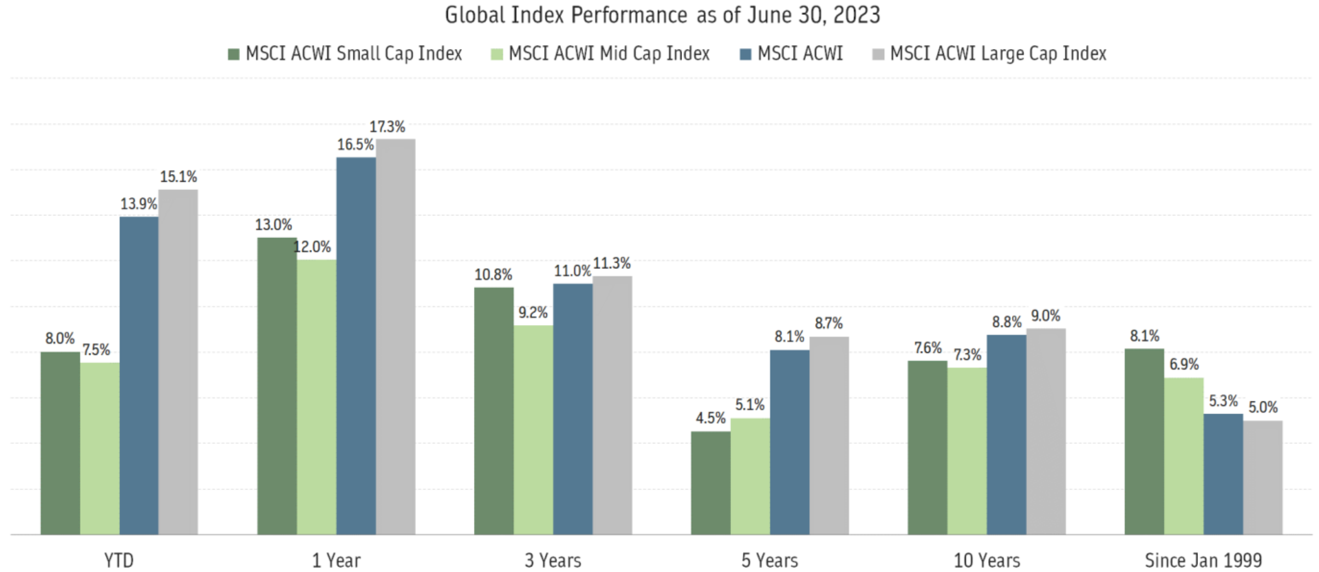
Drawdown Periods		Duration (~# of months)	MSCI ACWI Small Cap Index	MSCI ACWI Index
Feb 2, 2001	Oct 9, 2002	20	-31.4%	-41.8%
Jul 16, 2007	Mar 9, 2009	20	-60.8%	-58.4%
May 2, 2011	Oct 3, 2011	5	-27.0%	-22.6%
Jun 24, 2015	Feb 11, 2016	8	-21.4%	-18.4%
Jan 29, 2018	Dec 25, 2018	11	-22.7%	-19.3%
Jan 21, 2020	Mar 23, 2020	2	-40.9%	-33.5%
Nov 9, 2021	Sep 26, 2022	11	-29.8%	-25.1%
Average Drawdown		**11**	**-33.4%**	**-31.3%**

Recovery Periods		Duration (~# of months)	MSCI ACWI Small Cap Index	MSCI ACWI Index
Oct 10, 2002	Jul 13, 2007	58	250.0%	166.4%
Mar 10, 2009	Apr 29, 2011	26	172.1%	116.5%
Oct 4, 2011	Jun 23, 2015	45	88.2%	73.5%
Feb 12, 2016	Jan 26, 2018	24	68.0%	61.9%
Dec 26, 2018	Jan 20, 2020	13	32.4%	35.7%
Mar 24, 2020	Nov 8, 2021	20	136.1%	102.8%
Sep 27, 2022	Jun 30, 2023	9	19.6%	23.6%
Average Recovery		**28**	**108.2%**	**80.7%**

Source: Daily returns as far back as available for the MSCI ACWI Index (Net) and MSCI ACWI Small Cap Index (Net), January 2001 through June 2023.

One exception is the most recent recovery, where mega cap companies have soared. In the MSCI ACWI Index, the largest companies by market cap (>US$450 Billion) are up 34% so far in 2023, while small and mid cap companies have failed to keep pace. We saw such divergence in the early months of the pandemic as well, where small cap stocks fell disproportionately relative to large caps. This suggests that the current period of small cap underperformance may represent a timely opportunity for investors wishing to either introduce an exposure to small caps or increase existing exposure.

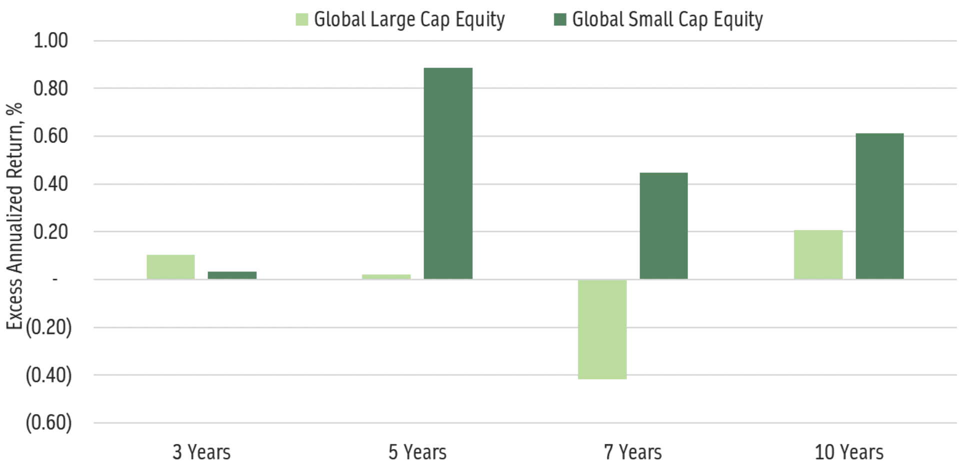
Recent dislocation between large and small cap may be an opportunity



Fertile Ground for Active Managers

The return premium from investing in small cap is compelling, but we believe the strongest case for global small caps stems from the opportunity for active managers. Dynamics inherent in the asset class have resulted in a large, less efficient market where the potential for overlooked and mispriced securities is greater than in large caps. As such, skilled active managers have historically exploited these conditions to generate consistent excess returns beyond what might be expected in a large cap strategy. Indeed, eVestment median manager performance shows that global small cap managers have added more alpha than their large cap peers over longer periods of time.

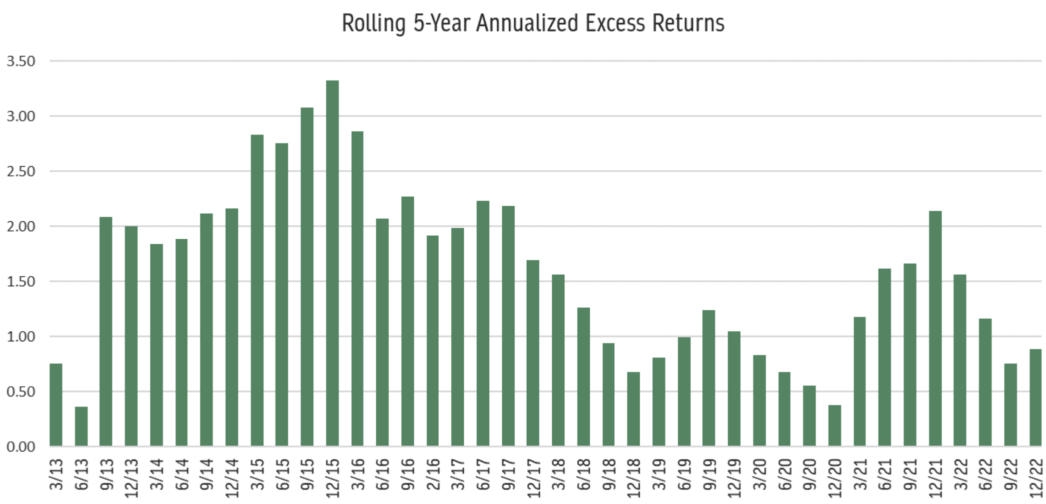
Global small cap active managers have had higher excess returns than their larger cap peers



Source: eVestment data as of December 31, 2022. Excess return of the median manager, gross of fees, within each respective peer group is shown. Calculated using the MSCI ACWI Small Cap Index as the benchmark for Global Small Cap, and the MSCI ACWI Large Cap Index as the benchmark for Global Large Cap.

Further, looking at rolling periods of median active manager excess returns shows the consistency of this outperformance. Over the last decade, the median global small cap active manager has added +163 basis points of excess return on average over rolling 3-year periods, and +161 basis points annualized on average over rolling 5-year periods.

Active managers have consistently added value in global small cap



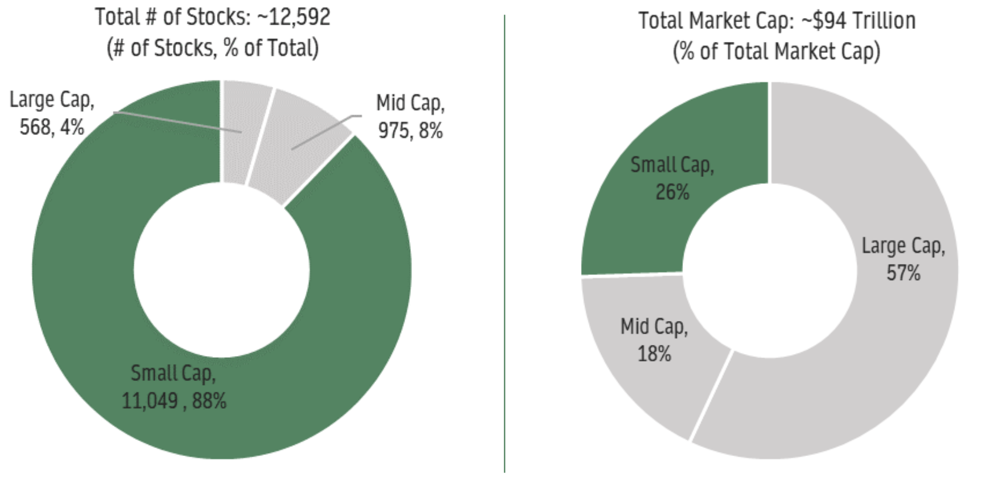
Source: eVestment data as of December 31, 2022. Excess return of the median manager, gross of fees, calculated using the MSCI ACWI Small Cap Index as the benchmark for Global Small Cap.

A Vast, Yet Overlooked Opportunity

Characteristics of the global small cap universe, including a broad universe of stocks, low research coverage, and high cross-sectional volatility, have likely contributed to active managers' consistent success.

Global small cap's defining characteristic is the breadth of the universe. Spread across 47 countries in both developed and emerging markets, the global small cap equity universe presents a broad and diverse opportunity set of over 11,000 public companies, or 88% of the total equity market universe. By number of constituents, the global small cap universe is seven times larger than mid and large cap combined.

Most publicly listed stocks are small cap

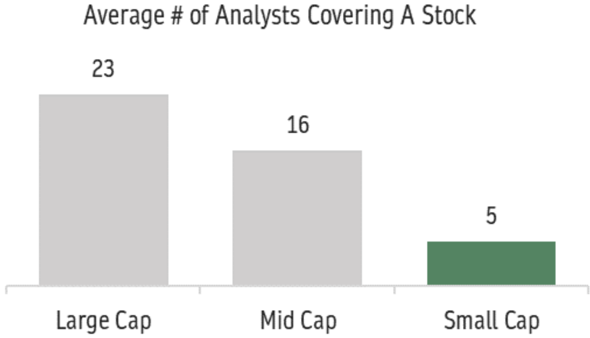


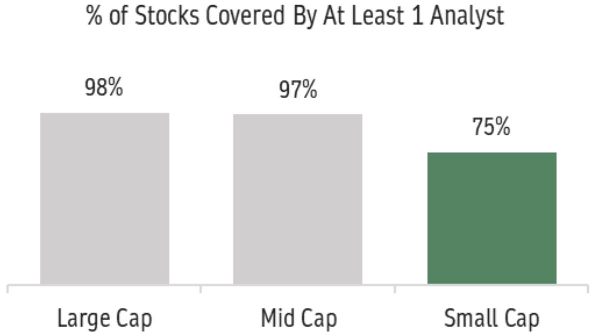
Source: FactSet universe as of December 31, 2022. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

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 actively-managed global equity products fall under the Global Small Cap classification. Investors may choose to own an All Cap strategy, believing it provides sufficient exposure to full market range of the global universe. However, most Global All Cap managers have a benchmark of MSCI ACWI, which represents only mid and large cap stocks, with just 8% 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 segment of the market.

Among these companies, 25% of them are completely uncovered by sell-side research analysts. On average, global small cap stocks are covered by 5 analysts relative to large cap at 23 analysts. The result is information inefficiencies that create opportunities for managers to exploit mispricing.

Lower research coverage compared to larger market cap segments

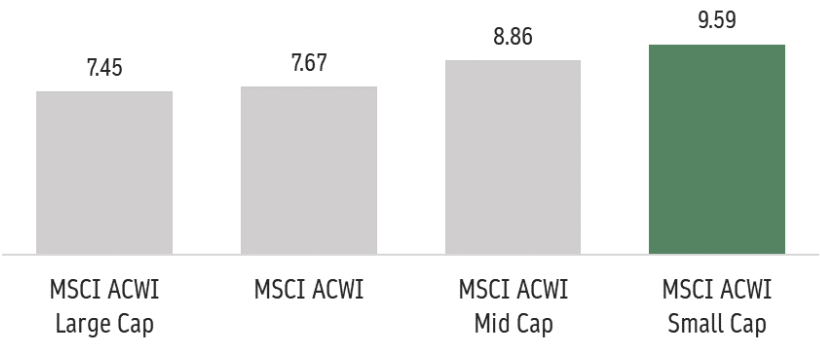




Source: FactSet universe as of December 31, 2022. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

Additionally, the asset class has a consistently higher degree of cross-sectional volatility compared to other equity asset classes, which is to say, these stocks tend to act very differently from one another. Micro cap companies typically address specific markets and sell a narrow set of products and services. Their success or failure is more often driven by company-specific factors, and the result is a wide range of outcomes. 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.

The higher level of cross-sectional volatility highlights the active management opportunity



Source: Calculated using monthly data from FactSet for the last 5 years ending December 30, 2022.

Manager Selection: What Style Exposures Work Best in Global Small Cap

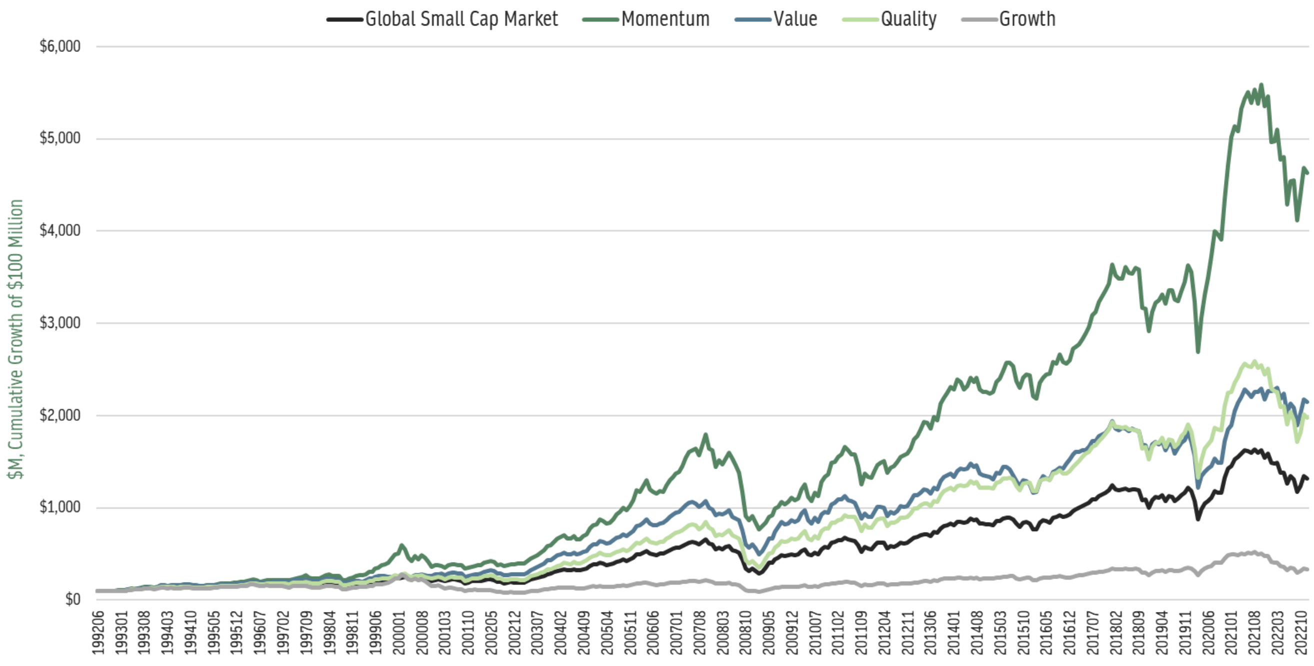
We have shown that an allocation to global small cap provides a compelling, complementary exposure for allocators that either have a large cap bias or are looking for additional alpha opportunity. When selecting a global small cap strategy, it is important to keep in mind that the investment approach matters.

First, the sheer size and rapidly changing dynamic of the small cap universe can make it difficult for many managers to research each and every stock thoroughly. Thus, we believe the incorporation of a systematic investment process is paramount in helping managers identify and capitalize on those opportunities with the most potential in a timely fashion.

Additionally, while the universe of stocks may be fertile ground for active managers, style and factor biases can significantly impact results.

We conducted a study using historical Fama-French data to look at factor performance and risk within the global small cap universe. While all factors/styles go through periods of underperformance, our results show remarkable persistence in the outperformance of the momentum factor. Since the start of our data set in July 1992 through December 2022, the cumulative growth of momentum is more than double that of value, quality and growth in the global small cap market. Additionally, over the same period, momentum wins on a risk-adjusted basis with the highest Sharpe ratio and information ratio among each of the factors. This data would suggest that selecting a manager with the added tailwind of momentum exposure may prove beneficial over time.

In global small cap, outperformance of the Momentum factor has been remarkably persistent



Source data: *https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html*

Analysis is for the period July 1992 – December 2022. To calculate Market returns for the Global Small equity universe, we construct monthly returns series assuming an 88% weight for developed markets and 12% weight for emerging markets. For the developed portion: small cap represents the bottom three market cap quintiles. The emerging markets portion includes the full universe of securities. The factors displayed are referenced by Ken French as follows: Value (High Book/Market), Momentum (High Prior Return), Growth (Low Book/Market), and Quality (High Operating Profitability).

Momentum has outperformed other factors on a risk-adjusted basis

	Momentum	Value	Quality	Growth	Market
Return (Annualized)	**13.4%**	10.6%	10.3%	4.0%	8.8%
Trailing 1-Year Return (Annualized)	-15.3%	-5.3%	-21.1%	-30.4%	-16.8%
Trailing 3-Year Return (Annualized)	8.5%	5.7%	1.3%	-1.9%	2.6%
Trailing 5-Year Return (Annualized)	6.2%	2.9%	1.3%	0.5%	2.1%
Volatility (Annualized)	**18%**	16%	17%	19%	16%
Tracking Error (to Market)	**7%**	4%	3%	7%	--
Sharpe Ratio	**0.61**	0.52	0.48	0.09	0.40
Information Ratio (to Market)	**0.64**	0.43	0.54	-0.68	--
T-Stat (Excess Returns)	**3.45**	2.11	2.90	-3.13	--

Source data: *https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html*

Analysis is for the period July 1992 – December 2022. To calculate Market returns for the Global Small equity universe, we construct monthly returns series assuming an 88% weight for developed markets and 12% weight for emerging markets. For the developed portion: small cap represents the bottom three market cap quintiles. The emerging markets portion includes the full universe of securities. The factors displayed are referenced by Ken French as follows: Value (High Book/Market), Momentum (High Prior Return), Growth (Low Book/Market), and Quality (High Operating Profitability).

EAM's Expertise

EAM has been able to navigate the large selection universe of global small cap stocks by utilizing a systematic approach designed to deliver consistent and predictable return streams. Our Informed Momentum approach combines momentum with stock selection, tailored risk management, and efficient implementation to deliver alpha. This approach is the foundation of our firm and has been applied consistently across all EAM's strategies since inception in 2007. Historically, our success is shown by positive inception-to-date alpha through 6/30/2023 for all EAM's strategies, which span the small cap equity universe worldwide.

Strong inception-to-date alpha	Benchmark-like volatility with beta at or below 1.0	Favorable upside and downside capture ratios	Excess return correlations complement traditional styles	Consistent exposure to stock-specific risk and momentum

Composite Performance as of 6/30/2023

	Q2	YTD	1 Year	3 Year	5 Year	ITD*
EAM Global Opportunities (Gross)	3.10%	5.89%	2.26%	5.22%	5.78%	10.43%
EAM Global Opportunities (Net)	2.91%	5.50%	1.50%	4.43%	4.99%	9.61%
MSCI ACWI Small Cap Index	3.62%	8.02%	13.02%	10.83%	4.53%	6.02%
MSCI ACWI Small Cap Growth Index	4.50%	11.55%	15.81%	7.45%	5.15%	7.18%
MSCI ACWI Small Cap Value Index	2.72%	4.59%	10.25%	13.95%	3.46%	4.49%

*ITD performance is for the period since inception July 1, 2017 – June 30, 2023. See important disclosures at the end of this document.

Risk Statistics

	EAM Global Opportunities	MSCI ACWI Small Cap Index
Annualized Return (Gross)	10.43%	6.02%
Annualized Return (Net)	9.61%	6.02%
Alpha	4.70%	-
Tracking Error	8.76%	-
Standard Deviation	20.6%	19.6%
Information Ratio	0.50	-
Sharpe Ratio	0.43	0.23
Beta	0.96	1.00
R-Squared	0.82	1.00
Up Market Capture	107.4%	-
Down Market Capture	91.5%	-

Risk statistics are for the period since inception July 1, 2017 – June 30, 2023, relative to the MSCI ACWI Small Cap Index, calculated gross of fees.
Please see important disclosures at the end of this document.

About EAM

EAM Investors is solely focused on delivering alpha for clients in global equity markets. Our approach to investing leverages our collective insight within a systematic process designed to deliver consistent and predictable outcomes. As of 6/30/2023, we manage $2.2 Billion on behalf of our clients.

Contributors

Nicholas Dame, CFA

Director, Portfolio Manager/Analyst for Global Strategies

- Prior experience: Victory Capital Management; Nakoma Capital Management; American Century Investment Management
- 18 years of investment experience
- MBA from the University of Wisconsin

Travis Prentice

Founder, CEO and Chief Investment Officer
Portfolio Manager/Analyst for US and Global Strategies

- Prior experience: Nicholas-Applegate Capital Management
- 25 years of investment experience
- MBA from San Diego State University

Adam Rubin, CFA

Director, Portfolio Manager/Analyst for Global Strategies

- Prior experience: Rice Hall James & Associates; Paramo Capital Partners; Brandes Investment Partners
- 16 years of investment experience
- MBA from the University of California, Los Angeles

David Wroblewski, PhD

Director of Applied Research

- Prior experience: Denali Advisors; Nicholas-Applegate Capital Management
- 15 years of investment experience
- PhD from the University of California, San Diego

Michele Rodrigues

Director of Communications, ESG Lead

- Prior experience: Fidelity Investments
- 19 years of investment experience
- MBA from Northeastern University

Important Disclosures

Past performance does not ensure future results, and there is no assurance that the portfolios will achieve their investment objectives.

The inception date for the EAM Global Opportunities composite is July 1, 2017. Net returns are net of the maximum annual management fee of 0.75% for the EAM Global Opportunities Strategy. The MSCI ACWI Small Cap Index captures small cap representation across 23 Developed Markets (DM) countries and 25 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 MSCI ACWI Small Cap Growth Index captures small-cap securities exhibiting overall growth style characteristics across 23 DM countries and 25 EM countries. The MSCI ACWI Small Cap Value Index captures small cap securities exhibiting overall value style characteristics across 23 DM countries and 25 EM countries. The MSCI All Country World Index includes large and mid cap representation across 23 Developed Markets and 24 Emerging Markets countries. The MSCI ACWI Small Cap Value Index, MSCI ACWI Small Cap Growth Index, and MSCI ACWI Index are being presented for informational purposes only.

Gross and net composite 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. All periods greater than one year are annualized.

Risk statistics for the EAM Global Opportunities portfolio are calculated for the period beginning July 1, 2017 through June 30, 2023.

The portfolio(s) 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 portfolio(s) 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.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.