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Pragmatic Perspectives

Are we missing the point with Small-Cap?

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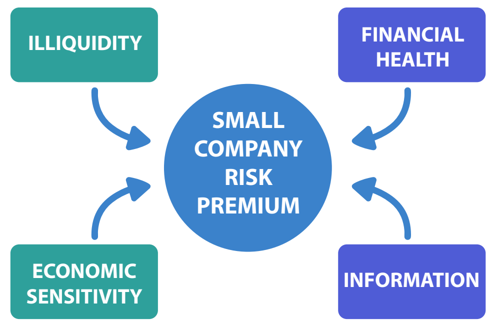
Small-cap stocks are a compelling asset class within equity markets and included by many investors in their diversified portfolios. In the traditional asset pricing model, the Fama-French Three-Factor model, size, in this case small-cap, is considered a risk factor that can reward investors. The rationale for this risk premium stems from two key points:

1. Small-cap stocks are riskier as they have less access to capital, lower liquidity, and naturally higher business volatility.
2. For incurring this higher level of risk, investors demand to be compensated through higher expected returns.

We believe that these two key points, and the associated risk premium for small-caps, remain true today. However, the small-cap market has undoubtedly continued to evolve over the past several decades. Looking back at the 1990s and early 2000s, small-cap companies were often under-researched, creating fertile ground for alpha generation through fundamental analysis. Asymmetry of information, limited buy-side and sell-side analysts, and the lack of transparent financial reporting created a widespread structural inefficiency in the small-cap market. Given the limited public data available, traditional quantitative approaches were less effective, and investors employed dedicated teams of fundamental research analysts to comb through balance sheets and reporting, seeking valuable data. Today, data availability has vastly improved, and the market has become more efficient, meaning more accurate pricing and less opportunities for alpha generation through identifying mispriced securities. This has changed the landscape for active managers and their ability to add significant alpha as consistently as they had in the past.

This leads us to a key question… ***are we missing the point with small cap?***

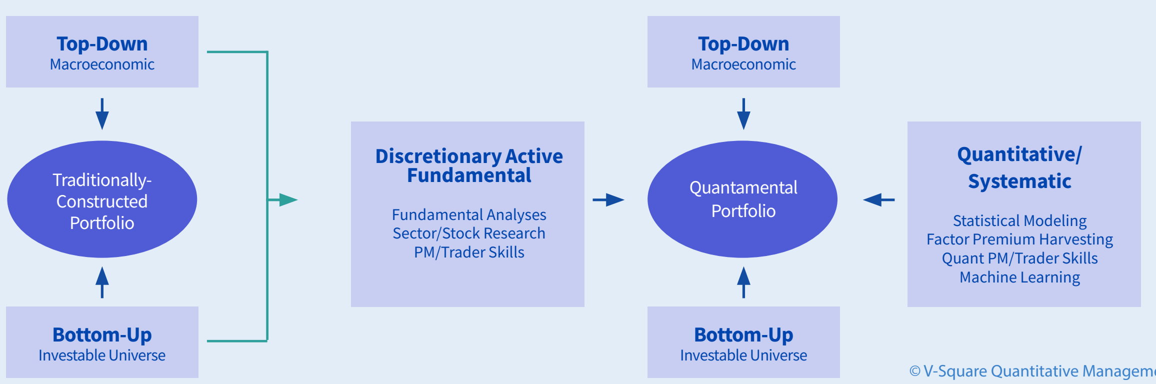


Illustrative purposes only

At V-Square, we aim to balance our data-driven, systematic investment approach with relevant fundamental metrics where appropriate, leading to a hybrid quantamental approach.

As a quantamental manager, our goal is not to stoke the fire between the two approaches to generating outperformance: fundamental vs. quantitative. Quantitative investment approaches leverage data and algorithms, can identify opportunities across a wider range of stocks and can potentially capture inefficiencies in the market; however, they typically place less emphasis on qualitative items that impact long-term performance. Conversely, fundamental analysis focuses on in-depth company research and may offer a deeper understanding of individual companies; however, this approach is more time-consuming and less scalable. We conclude that for small-cap equities, given the increased data availability, a hybrid quantamental approach of both quantitative and fundamental analysis allows managers more opportunity to capture alpha over the long term.

Quantamental Broadens the Scope - Making a 2-dimensional process, 4-dimensional



The Evolving Small Cap Universe

Looking at the small-cap universe 20-30 years ago, data aggregation was limited, corporate governance was often opaque, and access to management teams could dramatically tilt the playing field. Teams of skilled analysts could uncover hidden value or, conversely, avoid pitfalls that the average investor might miss. Today however, the small-cap market has greater transparency and efficiency through advances in technology, the increased availability of financial data, and the compressing of bid/ask spreads.

The improved efficiency in the small-cap market has undeniably changed the landscape for active managers over the last 20 years. While there is still a subset of fundamental and quantitative managers that have shown an ability to generate alpha in recent years, investing in small-caps has become more challenging. This challenging investment environment is also reflected in manager performance as a significant proportion of active small-cap equity managers have underperformed their respective benchmarks over the past ten years. The S&P Dow Jones 2024 SPIVA U.S. Scorecard[1] highlights the percentage of active fund managers that have underperformed their benchmarks on both an absolute and risk-adjusted basis. These numbers are disappointing, with the majority of active managers underperforming the benchmark, over the trailing 3-year, 5-year, 10-year, and 15-year periods.

Over the trailing 10 years, 82% of active small-cap funds underperformed the benchmark's total return after fees[1].

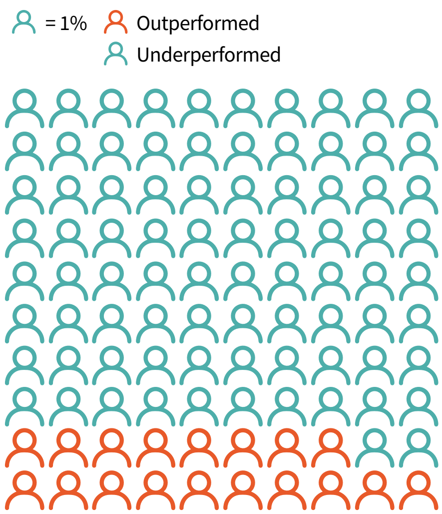
Key Challenges for Small-Cap Managers

We point to three key drivers of underperformance for small-cap managers:

- **Challenging Alpha Generation** – Outperforming the market is challenging, and many managers simply have not proven an ability to outperform before fees. As the small-cap equity universe has become more efficient over the past several decades, and pricing has become more accurate, opportunities for alpha generation have reduced.
- **Fee Drag** – With median fees ranging from 95bps - 108bps for actively managed small-cap funds across blend, value, and growth[2], the resulting fee drag leads to a significant underperformance with the majority of managers failing to outperform on a net-of-fee basis.

Challenged Performance in Small-Cap

Majority of Active Small-Cap Managers Underperformed over the trailing 10 years



Source: 1. S&P Global - SPIVA U.S. Scorecard 2024

- **Scalability** – Scalability remains a key challenge for all small-cap managers, given the inherent size of the companies they invest in. Challenges associated with research at scale is perhaps most acute for fundamental managers seeking to deploy larger amounts of capital without diluting their highest conviction ideas, notwithstanding liquidity constraints.

Overcoming these challenges may require investors to revisit their approach to generating alpha in small-cap equities. At V-Square, we believe our quantamental approach presents a more efficient and pragmatic approach to investing in small-caps. Leveraging data and algorithms, we aim to capture market inefficiencies at scale, while integrating relevant fundamental data, to enable alpha generation without the need for a large team of fundamental analysts.

The Systematic Opportunity in Small Caps

While traditional bottom-up analysis still has its place, we believe investors can benefit from a quantamental approach. Systematic signals and factor exposures identified through a quantamental approach provide opportunity for outperformance: rewarding investors for risks incurred.

A well-designed quantamental approach can systematically take advantage of market inefficiencies to provide compelling returns to investors. Importantly, inefficiencies and risk premiums can be harvested without the costs associated with a large team of fundamental analysts often associated with active managers. When looking across an incredibly wide universe of securities, specific factor exposures can be measured and deliberately targeted, while still maintaining significant diversification and avoiding undesired idiosyncratic risks.

Time for a New Approach?

At V-Square, we believe a quantamental approach, utilizing relevant fundamental data and a rules-based approach, enables investors to better capture size and other factor exposures consistently over time.

This approach does so while avoiding the pitfalls of discretionary stock picking (e.g., bias/style drift) often associated with active management and allowing for precise control of a portfolio's risk exposures. This quantamental approach is also designed to be more cost-efficient and scalable than alternative approaches.

As the small-cap landscape has continued to evolve, our approach to alpha generation must evolve.

Instead of solely asking, "Where can we find alpha in small-caps?", perhaps we should ask, "Are we seeking alpha in small-caps in the most efficient way?"

1. *S&P Global - SPIVA® U.S. Scorecard 2024: The S&P Indices Versus Active (SPIVA) U.S. Scorecard compares the performance of actively managed funds against their respective benchmarks. The scorecard primarily focuses on whether active managers can consistently outperform the market. The scorecard metrics are all as at 12/31/2024 and utilizes data from the Center for Research in Security Prices' Survivor-Bias-Free US Mutual Fund Database. This database includes historical information for more than 33,000 active managers.*

2. *Morningstar 2024 US Fund Fee Study: Morningstar's US Fund Fee Study displays fee levels for funds across asset classes, styles, and geographies. Data is as at 12/31/2024. The Study utilizes data from Morningstar Direct and includes a wide range of mutual funds and ETFs.*

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