A Systematic Advantage in Small & Micro Caps

H&W Small Cap Diversified Value

2019

"Right now I'm having amnesia and déjà vu at the same time…I think I've forgotten this before."
-Steven Wright, Comedian

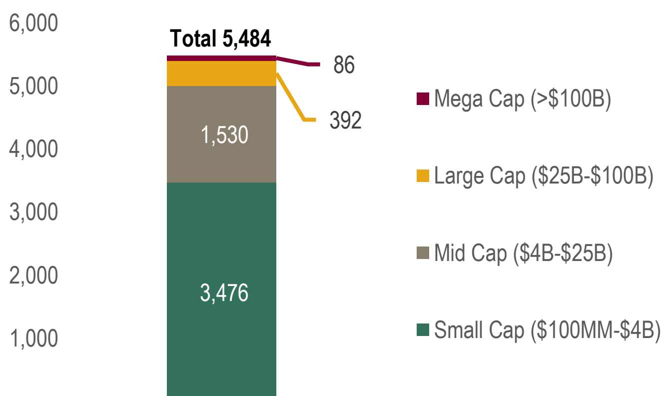
The objective of this paper is to revisit important concepts that have likely been learned in the past, but perhaps have faded from memory. Many of us have been taught that the small cap equity market is less efficient (i.e. less followed) than the large cap equity market. The opportunities for able-minded, diligent investors, therefore, should be more pervasive in small caps. As intuitive as this notion may be, however, it fails to provide tangible support for simple questions like…

– *Why is the small cap market less efficient than the large cap market, and how much less efficient is it?*
– *Is there a systematic way to take advantage of small cap inefficiencies?*

Why is the small cap market less efficient than the large cap market, and how less efficient is it?

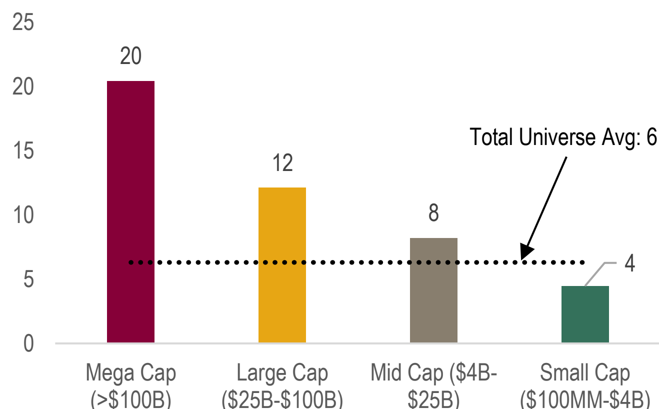
Measured by total market value, the large cap market is significantly larger than the small cap market. Measured by total number of opportunities, however, the small cap market dwarfs the large cap market. In fact, nearly two-thirds of publicly traded US stocks are small cap, as highlighted in Chart 1.

Chart 1: Number of Publicly Traded Equities in the US
As of December 2018



We estimate there are approximately 2,700 sell side analysts covering the US equity market[1]. Most cover multiple securities across their particular area of expertise, typically an industry or sub-industry. The coverage area varies from one analyst to another, depending on the complexity of the companies followed and differences in individual bandwidth. For the 5,484 stocks in Chart 1, there are 34,588 formal analyst ratings (i.e. buy/sell/hold), which implies that the average analyst provides about 13 ratings and the average company has six analysts covering it[2]. Facebook has 53 official ratings, while scores of companies have none. The relationship between the level of sell side coverage and a company's market cap is summarized in Chart 2.

Chart 2: Average Number of Sell Side Ratings by Market Cap
As of December 2018



Outperformance in the large cap equity market can be achieved by interpreting available information in a different way than consensus, and then being correct about that interpretation. This is best accomplished by implementing an economically sound and consistent investment approach. Adding value in the small cap equity market can be achieved this same way, but can also be achieved by uncovering information that has simply been overlooked by the market. Naturally, these informational inefficiencies are rare for a company with an army of analysts covering it actively.

[1] Source: Bloomberg (2,671 unique analysts).

[2] This likely overstated as many of the ratings are dated (i.e. not active), and also include ratings by quantitative firms that deduce ratings formulaically.

Past performance is not a guarantee or a reliable indicator of future results.

Another important consideration is the quality of coverage. It seems logical that the best and/or most experienced sell side analysts cover stocks that would command the most attention—those with large asset bases. Naturally, these are large cap companies. Conversely, an obscure small cap company is more likely to be covered by a freshly-minted graduate, if it is covered at all. Consequently, the vast difference between the sell side coverage of large caps and small caps from Chart 2 is actually *understated*.

Chart 3 dissects the small cap market further. It replicates Chart 1, but isolates just the 3,476 small cap companies. Similar to the overall equity market, the number of stocks, i.e. opportunities, is significantly greater farther down the cap spectrum—nearly 60% of small cap stocks have a market cap below $1 billion.

Chart 3: Number of Publicly Traded Equities in the US
As of December 2018, small caps only

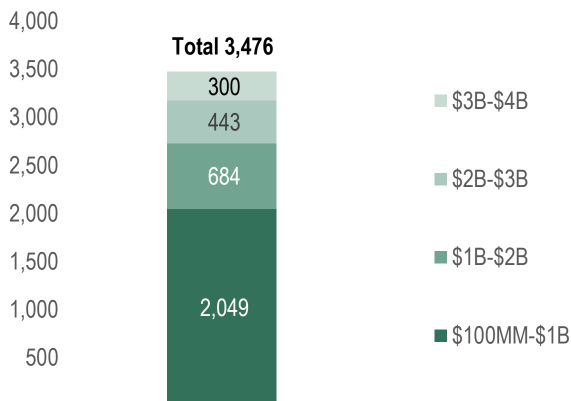


Chart 4 highlights the sell side coverage of the different market cap ranges within small cap, essentially replicating Chart 2 but isolating just the small cap market. The average sell side coverage is between 6 and 7 for the 1,427 small caps stocks with a market cap above $1 billion. The average sell side coverage is 3 for the 2,049 stocks with a market cap below $1 billion.

Chart 4: Average Number of Sell Side Ratings by Market Cap
As of December 2018, small caps only

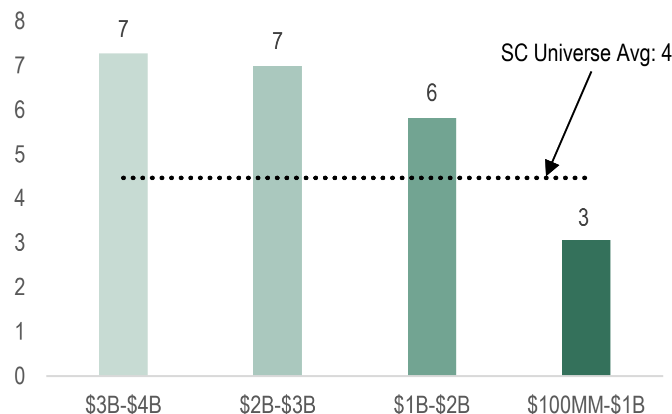
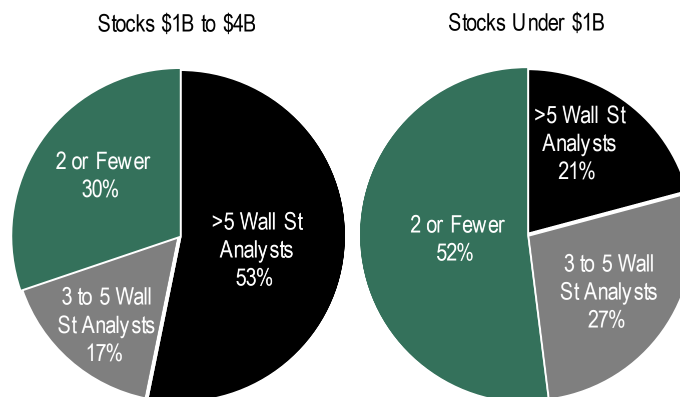


Chart 5 shows small cap stocks above $1 billion in market cap on the left, and small cap stocks below $1 billion on the right. More than half of the stocks above $1 billion have at least 5 sell side analysts covering the stock; more than half of the stocks below $1 billion, however, have 2, 1, or zero analysts covering the stock.

Chart 5: Small Cap Sell Side Coverage
As of December 2018



Buy side analysts, or research analysts of money managers that invest client assets, appear to be similarly biased toward larger cap coverage, presumably for similar reasons. Buy side data is less easy to come by, but active small cap managers demonstrate a clear bias toward the larger stocks within small cap. eVestment provides data on more than 300 active small cap strategies as of December 31, 2018. More than 75% of these managers had a weighted average market cap that

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exceeded the Russell 2000 Index, averaging 36% higher than the index. On an asset weighted basis, these managers had a weighted average market that was 72% higher than the index, indicating that the larger the manager, the larger the market cap bias.

At the end of the day, it is difficult to support a small cap strategy that satisfies the following criteria:

- Stays true to its original mandate without taking excessive liquidity risk
- Has sufficient resources but is financially tenable for the sponsoring firm

All too often, small cap managers that develop a successful track record early on, stray from the original process that generated that success if/when the asset base grows. Worse still would be staying true to the original mandate but assuming excessive liquidity risk. Unfortunately, both of these occur as the temptation of near term revenue too often trumps the long-term benefit of clients. In reality, what is best for the client long-term is also best for the manager long-term. Failed strategies produce no revenue. We gave a lot of thought to these difficult questions, and designed our Small Cap Diversified Value ("SCDV") strategy to disentangle these problems while taking advantage of the small cap market's inefficiencies.

Is there a systematic way to take advantage of small cap inefficiencies?

The breadth and thinly-followed nature of the small cap market has one large benefit and one large drawback. The benefit is that there are overlooked opportunities available. The drawback is that the large universe makes these opportunities difficult to find. Our solution: proprietary models designed to narrow the universe to a more attractive and more manageable subset.

Our models are not simply screens that score companies based on current metrics like P/E, EPS growth, etc. Instead, they are designed to replicate what one of our analysts would do during the normal course of our research process. The myriad of adjustments that our models make fall into two categories: accounting and normalizing. Accounting adjustments are designed to better capture true cash flows, and also to allow for an apples-to-apples comparison between companies. Our normalizing adjustments are designed to estimate a company's valuation by reverting current margins and returns on capital, to normal or mid-cycle levels.

The objective of the models is NOT to make an investment decision, but rather to prioritize the research effort for our research team. As well designed as we believe our models to be, we acknowledge their imperfections—appropriately adjusting for fundamental changes is difficult to automate. Our 21 analysts, with average industry experience of more than 2 decades, then review the output of the models with disproportionate attention paid to its weaknesses. The analyst can either 1) endorse the model results; 2) make an adjustment to any element of the model, or; 3) eliminate the name from consideration.

After a portfolio level risk evaluation on the back end, we have a rank order of securities starting from most attractive, and we construct a roughly 400 stock portfolio:

- Top 100 ideas: 0.4% weight
- Next 100: 0.3%
- Next 100: 0.2%
- Next 100: 0.1%

Our models work well in the small cap market due to its information inefficiencies. They work disproportionately well further down the market cap spectrum. As a result, the portfolio typically exhibits outsized exposure to stocks with a market cap of less than $1 billion, averaging about double the benchmark weight historically (~41% vs. ~23% as of January 2019). The diversification of the strategy combined with our inclination to limit strategies to responsible asset levels allows us to remain true to our core competency, without taking excessive liquidity risk. It also permits a financially tenable strategy for the firm, and the structure of our team/firm ensures sufficient resources.

So has this design worked in a repeatable way? We believe so. While stock selection in this market cap cohort has not been the sole driver of outperformance for the fund, it has been a substantial and fairly consistent contributor. This provides us with reassurance that what we created is systematically advantaged, and we see no reason why that advantage shouldn't persist in the future.

(The H&W Small Cap Diversified Value Fund Fact Sheet contains standardized performance and expense ratios. The performance shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month-end, access our website at www.hwcm.com.)

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Wrap Up

The small cap market's breadth creates both opportunities and challenges for active investors. It results in a less efficient market containing many overlooked opportunities, but locating the opportunities can be an arduous task. The Hotchkis & Wiley Small Cap Diversified Value strategy was designed with these challenges in mind. The purposefully constructed models solve the problem of an overbearing universe size, while both the models and the experienced analyst review take advantage of the market's numerous overlooked opportunities.

Investing in smaller and/or newer companies involves greater risks than those associated with investing in larger companies, such as business risk, significant stock price fluctuations and illiquidity. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.

Data sources: Chart 1-5: Bloomberg. **Diversification does not assure a profit or protect against loss in a declining market.**

The Russell 2000® Index, an unmanaged index, measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The index does not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. The Fund's value disciplines may prevent or restrict investment in major stocks in the benchmark index. It is not possible to invest directly in an index. The Fund's returns may not correlate with the returns of their benchmark index.

Market capitalization of a company is calculated by multiplying the number of outstanding shares by the current market price of a share. Price-to-Earnings (P/E) is calculated by dividing the current price of a stock by the company's trailing 12 months' earnings per share. Return on capital measures how effectively a company uses the money (borrowed or owned) invested in its operations. EPS growth (earnings per share growth) illustrates the growth of earnings per share over time. Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g., depreciation) and interest expense to pretax income.

Top ten holdings as of 6/30/19 as a % of the Fund's net assets: Commercial Vehicle Grp Inc. 0.5%, Wabash National Corp. 0.4%, Adient PLC 0.4%, Cooper-Standard Hldg Inc. 0.4%, Methode Electronics Inc. 0.4%, First BanCorp (Puerto Rico) 0.4%, Magellan Health Inc. 0.4%, Boston Private Financial Hldgs Inc. 0.4%, Diodes Inc. 0.4% and Group 1 Automotive Inc. 0.4%. Fund holdings are subject to change and should not be considered a recommendation to buy or sell any security.

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. This and other important information is contained in the Funds' summary prospectus and prospectus, which can be obtained by calling 1-800-796-5606 or visiting our website at www.hwcm.com. Read carefully before you invest.

Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods. Impact of interest rates on equity markets are subject to uncertainty and may change based on varying factors (market, sector-level, economic, political and etc.). Large cap companies as a group could fall out of favor with the market, causing them to underperform small or mid-cap companies. Small- and medium-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies.

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