VALUE CREATION THROUGH CONSTRUCTIVE ACTIVISM

A Case for Small Caps in 2023

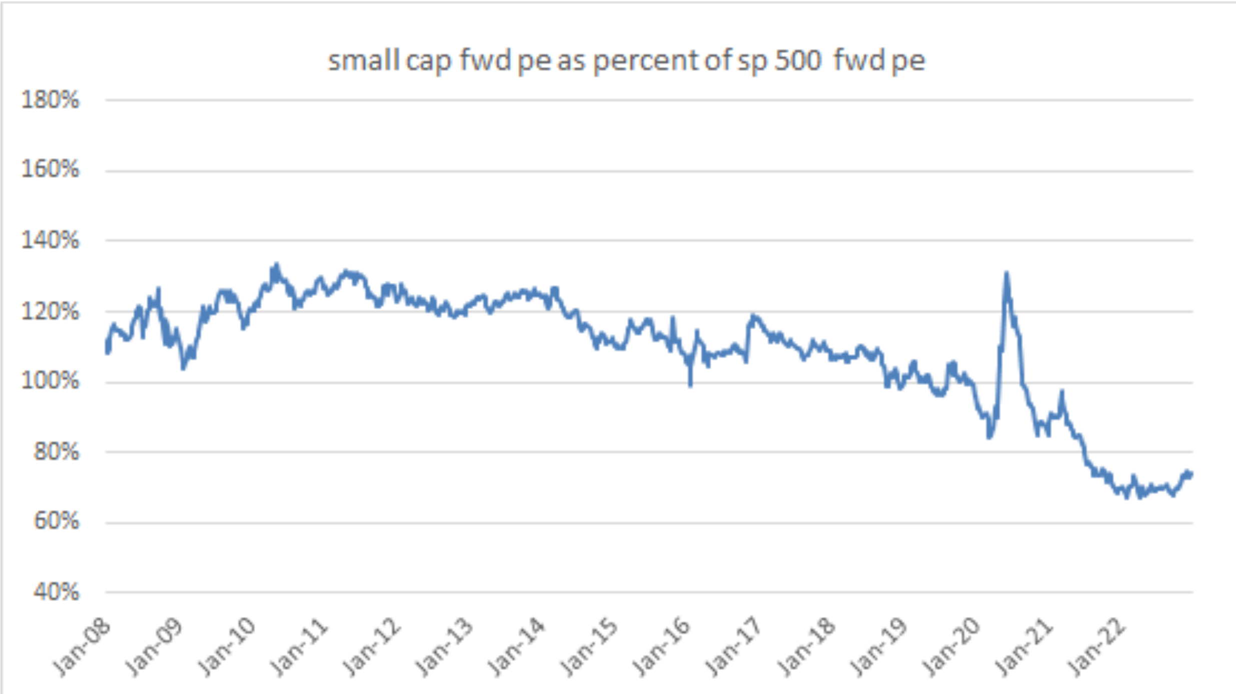
2022 was clearly a rough year for the stock market; all of the major indices were down significantly. The S&P 500 Index was down 18.1%, the NASDAQ Composite Index dropped a whopping 32.5% and the Russell 2000 Index was off 20.5%.

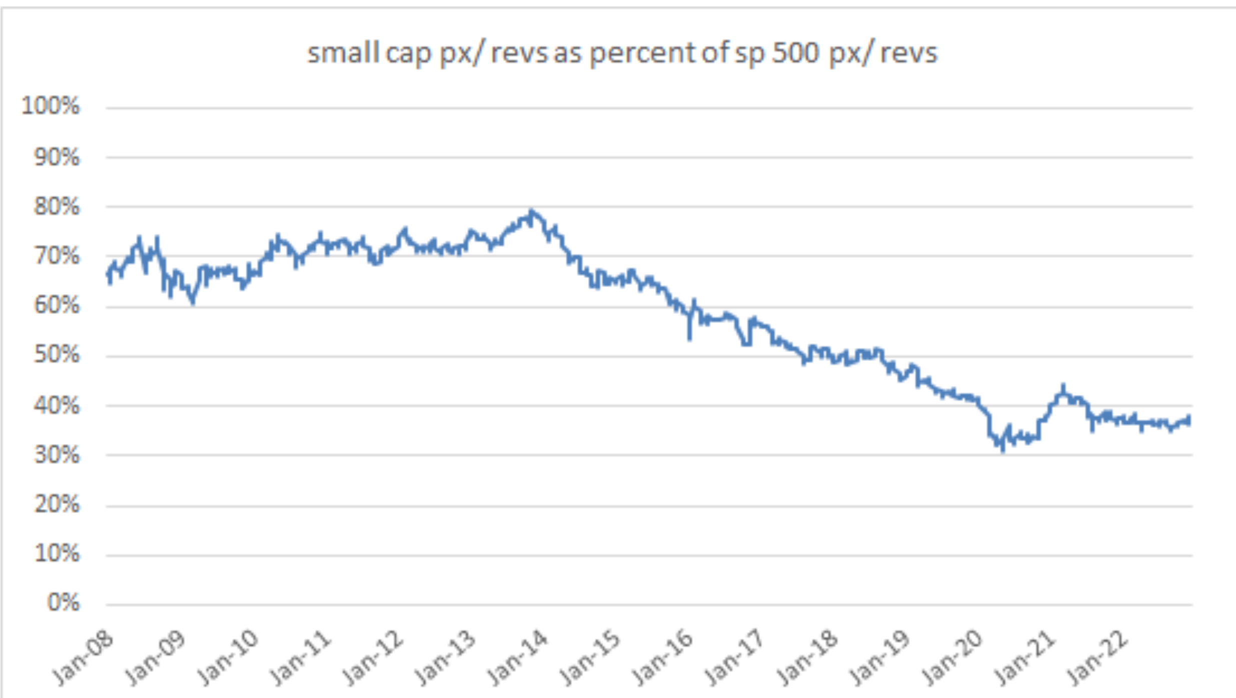
Assigning blame for this sharp fall off is not difficult and can be laid almost exclusively at the feet of a number of macroeconomic events that occurred during the year. This list includes on-going high inflation and the corresponding Fed rate hikes used in an attempt to bring inflation back to its target of 2%; the seemingly never ending COVID crisis; the recession that we are either already in or expect to be in soon, and, of course, the on-going war in Ukraine. Combined, these events are clearly linked and presented a toxic brew for the market in 2022.

As a small/microcap manager, it's worth examining where that market currently sits in comparison to the rest of the market. While small caps began the 2022 year undervalued relative to large caps, they actually managed to decline further in both relative and absolute value. As the charts below illustrate, small caps currently trade at multi-decade lows in terms of relative valuations versus large caps.

This first chart shows the relative valuations of the Russell 2000 vs the Russell 1000 LTM EV/EBIT (excluding negative EBIT companies).

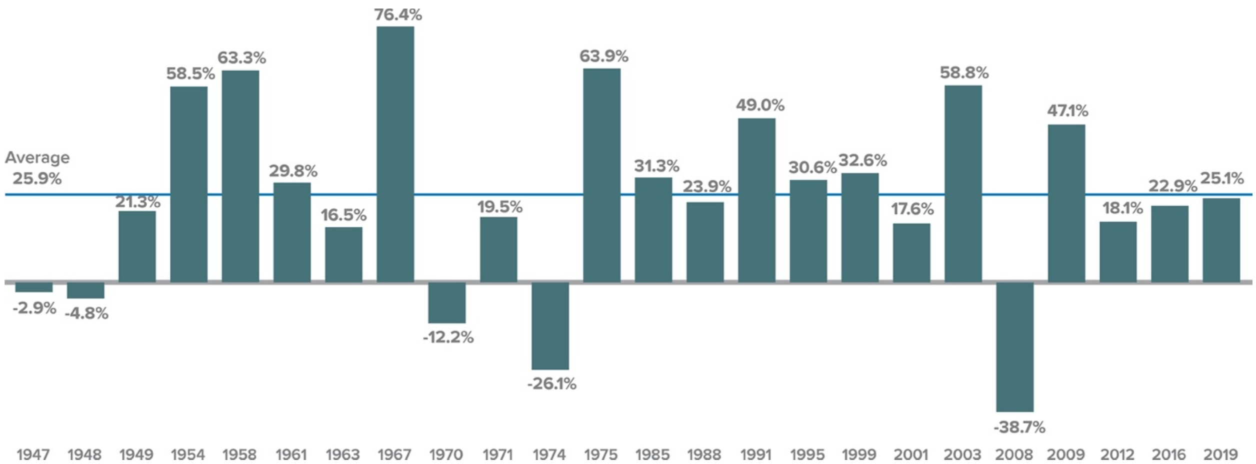
The next two charts compare the small cap forward price to earnings ratio (PE) as a percentage of the S&P 500 forward PE and the small cap price to revenue ratio as a percentage of that for the S&P 500. Both charts again demonstrate the current attractiveness of the small cap market relative to the large cap market.



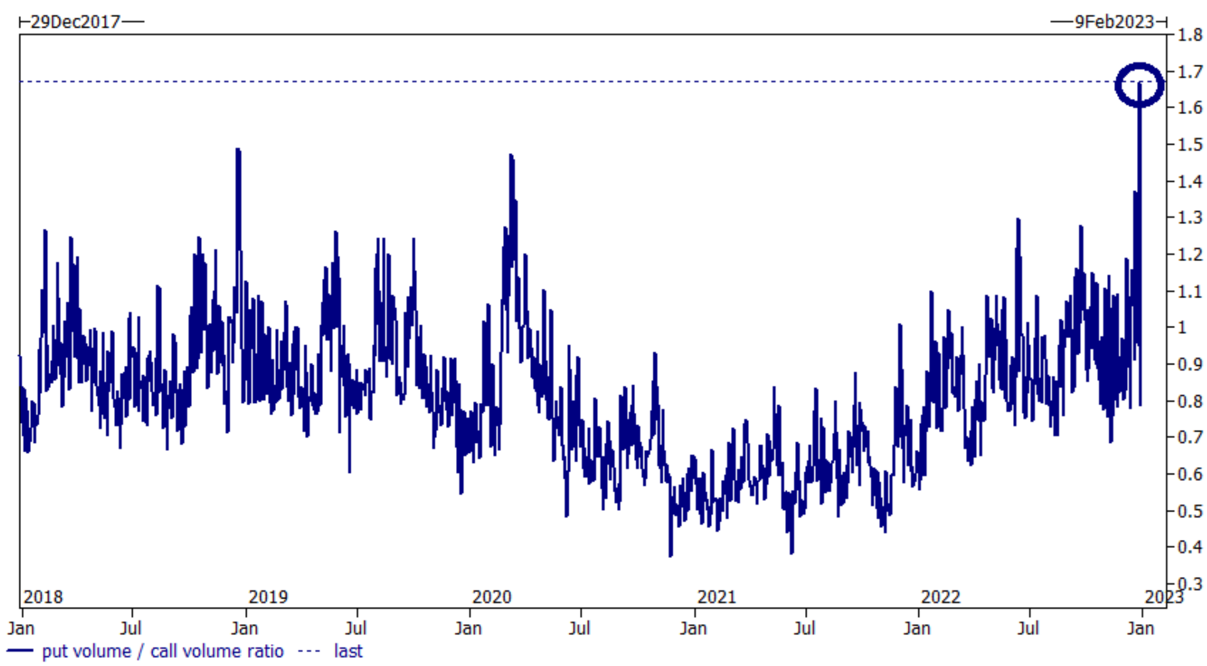


Having closed the proverbial door on 2022, what can one expect for the small cap market for 2023? Predictions are tricky especially given that many of the macro conditions that dragged the market down in 2022 remain relevant. That said, there are indications that those issues will create less of a drag going forward. Inflation, for example, seems to have peaked which in turn means that the Fed's rate hiking is likely nearing an end. Also, many economists actually increased their projections for GDP for the coming quarters.

Without these factors acting as a headwind, we believe that the small cap market is well positioned for a strong run over the coming year. Some of this optimism is based on historic returns of the small cap market following down years; 79% of the time when small caps experienced a negative return during a calendar year, the following year was positive.



Another indicator we consider interesting is the current put/call ratio for all US listed options. This ratio is as high as it has ever been. Historically, this ratio has been a strong contra-indicator, particularly when it reaches extreme levels.



Source: Goldman Sachs global markets and banking // Bloomberg data as of 28dec22

The dollar's rapid appreciation against a basket of major currencies throughout most of 2022 may also bode well for small caps in the near term. Given smaller companies derive, on balance, proportionally less of their sales overseas versus larger organizations, we believe it is not likely that the small and micro cap universe of stocks we invest in will see the same level of currency headwinds as higher capitalization stocks could face.

Index characteristics

	Russell 1000	Russell 2000
Weighted Avg Market Cap ($B)	587.5	3.6
Non-US Revenue (%)	39.2	17.9

Source: FTSE Russell as of March 31, 2022

The final and, perhaps, most salient point we would make is more subjective, but we believe is still worth noting. Throughout 2022 most of the small cap and microcap companies that we are invested in were able to produce solid financial results despite the many macro factors we listed earlier. Additionally, many have raised guidance for the coming quarters as well. We have remarked repeatedly during 2022 that stocks were selling off regardless of performance, particularly in the small/microcap world. While we believe that the small/microcap market is likely to rise generally in the coming year, we think it likely that companies that have seen their share prices beaten down the most despite strong results have the potential to significantly outperform the general market over the next 1-3 years.

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