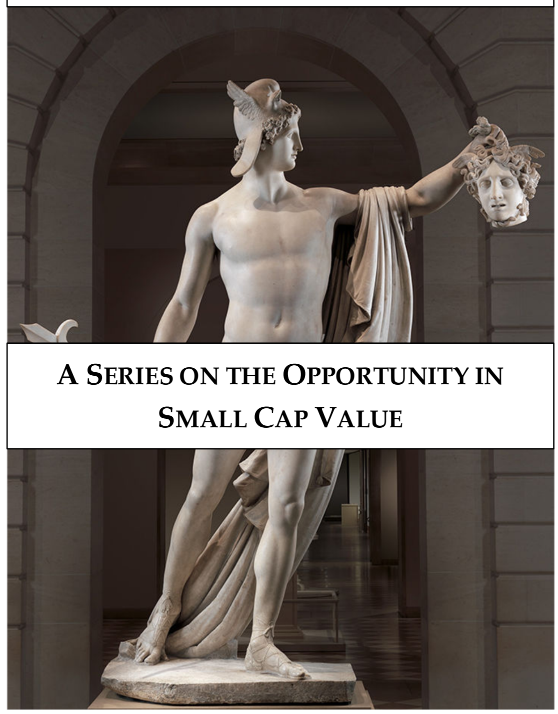
Overview of the Great Opportunity in US Small Cap Value

We see a unique opportunity given the current environment to invest in the North American Small Cap Value universe. We will walk through some of the highlights below, but we intend to articulate key tenets of small caps over the coming months.

The significant opportunity is built upon a host of factors, but the core principals of those factors are principally based upon four points:

- Small Cap Value is a high-returning and highly attractive equity category over time and versus other categories.
- Passive investing does not work in Small Cap; the average small cap manager outperforms the index.
- A host of related factors that have impeded the category are now likely to help or at least no longer hurt the category.
- Macro and political trends appear to be in position to support the category disproportionately.

STRENGTH IN AN ADAPTING WORLD



A SERIES ON THE OPPORTUNITY IN SMALL CAP VALUE

Perseus with the Head of Gorgon Medusa.
Metropolitan Museum of Art, New York

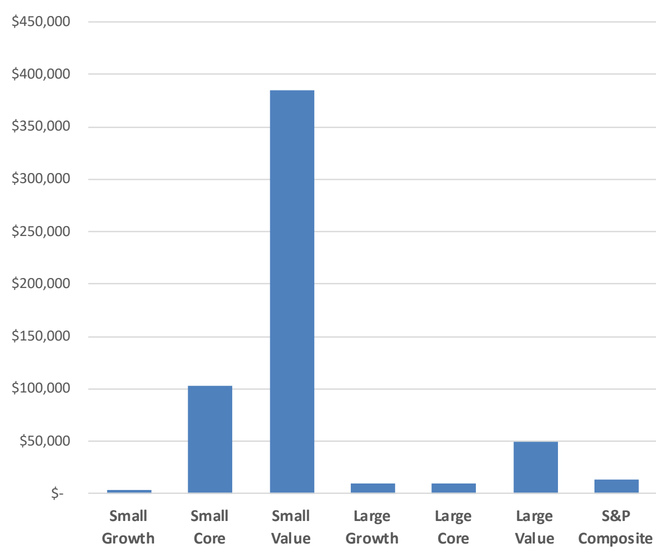
Like the Greek hero Perseus, small caps have endured a long trial with multiple challenges in recent years – all in the pursuit of great reward. The headwinds faced by small caps have produced a scenario that appears to be attractive on both an absolute and on a relative basis versus history and versus other areas of the Equity market. This series explores several of those areas and provides some of the insights that we have gathered and uncovered in both Orchard and external research.

Key Context

Our clients will find this area familiar as it is a key long-term tenet of the opportunity in Small Cap Value: US Small Value is a consistent outperformer versus other styles within the US equity market (Figure 1) and has returned multiples more than the nearest style over the long term.

Figure 1: Growth of $1 invested since 1926

Style Returns for US Fama/French Styles 1926-Sept 2023



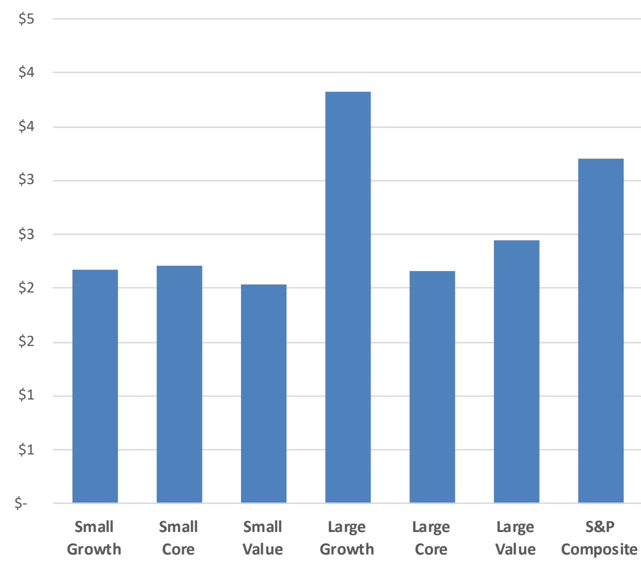
Note: Source: CRSP, Fama-French growth/value series, Case-Shiller, Orchard Analysis, Dartmouth, Yale

However, returns of small caps and small value have not outperformed larger growth companies in the last decade (Figure 2). Why?

The answer is simple. The valuations of large and growth companies have expanded versus smaller value companies. Today the PE of small value companies are 40% BELOW their 20-year average while the PE of large growth companies are 40% ABOVE their 20-year average. (Figure 3). Large is historically expensive versus Small and Growth is historically expensive versus Value.

Figure 2: Growth of $1 invested over the last 10 Yrs

Style Returns for US Fama/French Styles Sep 2003-Sep 2023



Note: Source: CRSP, Fama-French growth/value series, Case-Shiller, Orchard Analysis, Dartmouth, Yale

This valuation gap has persisted despite strong earnings growth in small caps. The strong performance of Large Growth has been extensively covered and discussed, and yes during the current economic cycle (since 2010) there has been an impressive 8.4% annualized earnings growth in the S&P500. Less noted is that the Russell 2000 has had a similar 8.2% annualized growth rate over the same period. During this bull run the valuation multiples of the S&P500 have expanded to historical extremes while the multiples for small caps actually shrank, with small cap value shrinking the most. The gap in returns in the last decade is a story of a gap in multiples, not in underlying fundamentals.

Why has this gap occurred and (when) will it change?

While we don't know the timing of a transition, we see helpful signs that lean in the camp of "this will help small caps" or at least "this will no longer hurt small caps."

- Relative valuations are at or near historical extremes – Valuations for Large versus Small and for Value versus Growth are both near the statistical edges and call for some form of mean reversion (See Figure 3 and Figure 4). Even in the case where reversion does not occur, the likelihood of further expansion of relative multiples is low given the current environment.
- Small value appears to have already priced in a recession – the Russell 2000 value is currently in the 7th largest drawdown in 50 years. Typically, drawdowns lead to rebounds of 60-70% over the following 3 years. We also believe that the drawdown is partly the market's recession fears embedded in our category. Should we get a recession, it is already "priced into" the stocks. Should we see a soft landing, it should substantially lift the expectations (and prices) of our category.
- Rate peaks predict strong returns – in keeping with the end of rate rises, Small cap value stocks typically outperform after rates stop rising.
- Inflation and higher rates have brought back value in cash and in assets – we expect that even as rates ease or stop rising, that the period where growth companies faced zero costs of capital is over. We are observing a shift where heavily-penalized, asset intensive industries are enjoying closing discounts on now difficult-to-replace assets. Profits and asset prices should rise in this more "balanced" regime (more on this in a future write-up).

- Small Value earns more and has fewer "negative earners" – The Russell 2000 Value has a lower percentage of "non-earning" or negative EPS companies than its Blend and Growth indexes. A thoughtful active manager can find quality companies everywhere, but we have the benefit of a universe with more of them. Despite this fact, the small value universe has underperformed the other small cap universes in the last decade. Neither value nor this version of quality (i.e. actual earnings) has worked, but we are seeing signs of a change. For this reason, we believe that the active manager in small caps should have a distinct advantage in an environment where avoiding non-earners or difficult balance sheets is a premium.

We intend to elaborate on many of these points in coming pieces. The list of future tailwinds is long. Some have persisted and some are new. In addition, some remain natural advantages for the investor in US Small Caps and in Value (most of which we either exploit or intend to benefit from).

Figure 3: Valuations by Style and vs 20 Year Avg.

Style P/E for Russell Indexes, June 2003-June 2023

Current P/E vs Long Term Average

	Value	Blend	Growth
Large	16.0 (15.5)	22.0 (18.5)	32.6 (22.7)
Small	**8.5** (15.0)	11.5 (17.6)	19.6 (21.8)

P/E (historic)

	Value	Blend	Growth
Large	103%	119%	144%
Small	57%	65%	90%

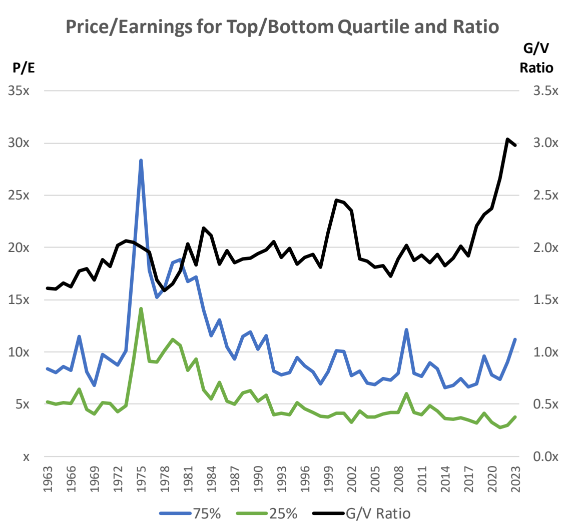
PE % of historic

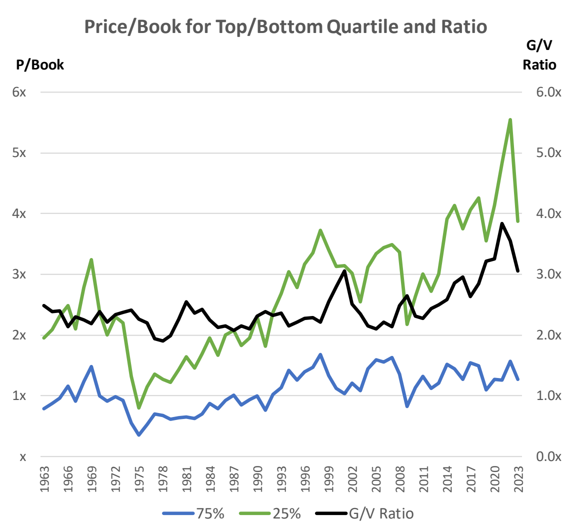
June 2003 – 2023

Source: Morningstar Direct for the Russell US Style Indexes

Figure 4: Top and Bottom Quartiles of US Stock Valuations are Near Historical and Relative Extremes

Valuation of Price/Book and Price/Earnings for Universe of US Stocks





Source: CRSP and Fama/French database, Orchard Analysis, Dartmouth University

Will Small Cap Value Outperform?

In our view: Yes. The long-term evidence and our observation of the current situation points to the Small Cap Value category as benefiting from either a more "normal" or higher inflation environment with a slowing of rate increases. Whether transitory or extended, Value multiples are in much better position than Growth multiples. Large growth is especially sensitive to absolute inflation now given its historically high multiple and the reality of significant relative rises in long term inflation (even from 1% to 3%). Small Cap Value Stocks also have a range of industries with significant sensitivity to inflation and benefit disproportionately from the reshoring and domestication of GDP. Some will be greater or lesser beneficiaries of inflation given their ability to pass on costs, but it provides fertile ground for fundamental stock pickers.

We look forward to your continued support and engagement,

The Team at Orchard Capital Management

Next up: The embedded advantage of active investing in small caps