Orchard Capital Management

Active Management's Unfair Advantage in Small Cap Value

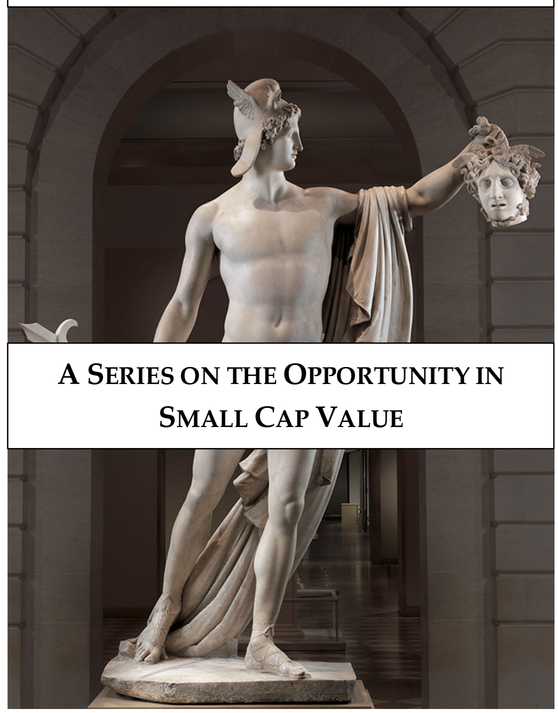
US Small Cap Value (SCV) investors have long enjoyed important advantages: over the long term the SCV index has outperformed other styles, and the average SCV manager regularly outperforms the index.

In figures 1 and 2 you will see that the Median and Average manager regularly beats the index over multiple periods. This runs in contrast to many categories. A study by Canterbury Consulting indicated that over 80% of small cap managers beat their respective index over time (15 years in their study), while the majority of large and mid cap managers underperform their indexes. Active small cap management tends to beat the index over time and well in excess of fees, rewarding investors for picking an active manager.

There are several fundamental reasons for Active outperformance, but they all relate to the fact that fundamental research still rewards disciplined managers in this category and the active managers have a very large universe from which to draw.

STRENGTH IN AN ADAPTING WORLD

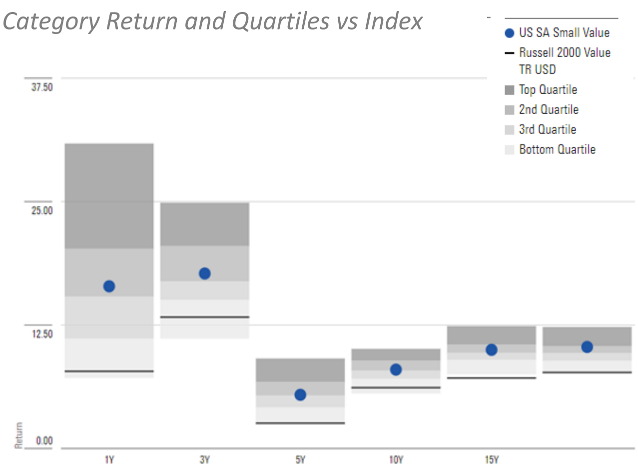
A SERIES ON THE OPPORTUNITY IN SMALL CAP VALUE



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

Figure 1: Small Cap Value Strategies vs the Russell 2000 Value Total Return

Category Return and Quartiles vs Index

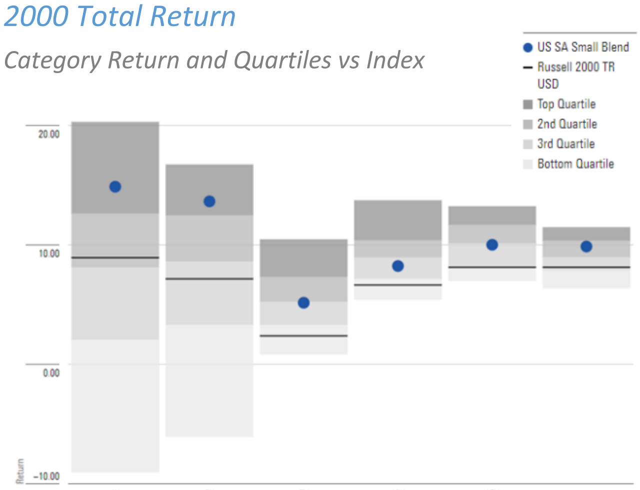


Name	1Y	3Y	5Y	10Y	15Y	20Y
1 US SA Small Value	16.44	17.73	5.46	8.01	10.01	[illegible]
2 Russell 2000 Value TR USD	7.84	13.32	2.59	6.19	7.16	7.73

Source: Morningstar Direct, As of Q3 2023

Figure 2: Small Cap Blend Strategies vs the Russell 2000 Total Return

Category Return and Quartiles vs Index



Name	1Y	3Y	5Y	10Y	15Y	20Y
1 US SA Small Blend	14.86	13.64	5.16	8.23	10.01	[illegible]
2 Russell 2000 TR USD	8.93	7.16	2.40	6.65	8.13	8.13

Source: Morningstar Direct, As of Q3 2023

Long-term drivers of active outperformance

Active small-cap managers can add meaningful alpha by exploiting a universe that rewards their experience, their deep research, and their investment discipline. Small cap opportunities to outperform for active managers exist for:

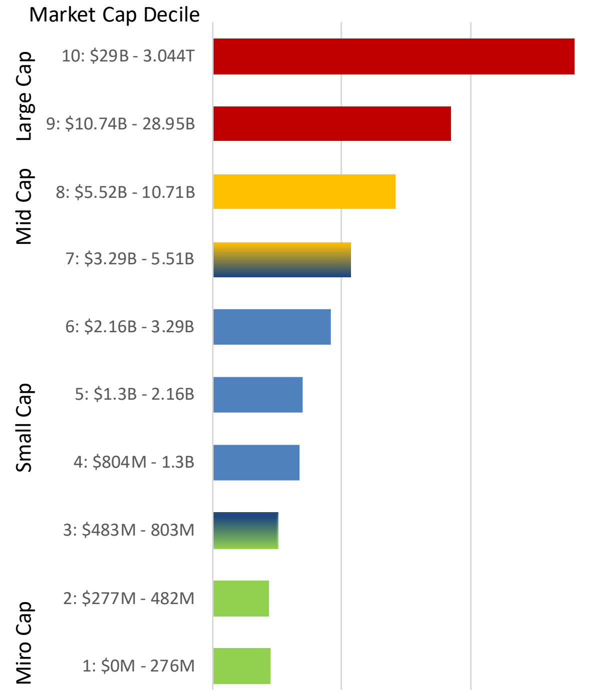
- ***Inefficiency*** – the small-cap universe is typically far less researched than large-caps as illustrated in Figures 3 & 4. The relative lack of analyst coverage can contribute to mispricing that creates potential opportunities – that is, without experts actively evaluating a stock, shares can diverge from their fair value.
- ***Stock picking in a large universe*** – with over 2,500 companies to choose from in the US alone, active managers can dig deep to identify promising growth stories or undervalued opportunities that may be overlooked by the broader market.
- ***Domain expertise*** – managers and research teams who focus on this area develop the expertise needed to uncover specific industries or geographic niches or patterns that may be under-represented in small-cap indexes. For example, an analyst might specialize in banks or biotechs or a team may be able to uncover activity from prior successes that translate into another industry. This can help identify promising opportunities that others may overlook or misunderstand.

Active Managers and Inflection Points

We have seen the persistence of active management pay off over time. However, as passive management flows have driven momentum in index names and as large cap asset flows have dominated the equity markets, small caps have not enjoyed the benefits of momentum. This may, in part, be an explanation for some of the historically wide gap in valuations between large and small and between value and growth. We do know that small value and active managers tend to do better during economic regimes undergoing change and when absolute interest rates are higher. This tends to be because indexes cannot account for large scale changes in technology or critical industries as rapidly.

Figure 3: Fewer Analysts, Less Research for Smaller Companies …

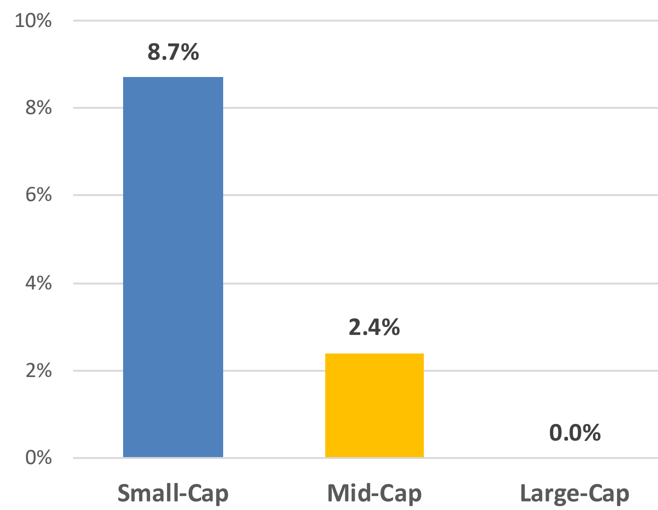
Average # of Analyst Recommendations per Company by



Source: Bloomberg, Orchard Analysis

… and more companies with NO research coverage

Percentage of companies with no research coverage



Source: Furey Research

Additionally, the indexes tend not to price changing values of earnings quality or changes in the importance or risk of debt as comprehensively. In these cases, thoughtful, active managers can steer their portfolios to opportunity and away from difficulty. In an inefficient market, prices will reflect those changes less accurately or more slowly – and small caps provide that inefficiency for active managers like Orchard Capital Management to take advantage of mispricings in the market.

Thank you for your continued engagement,

The Team at Orchard Capital Management

Up next: The growing list of future tailwinds for the Small Cap Value category