The Case for Global Small Cap

Learn about the benefits of an active manager allocation and see how momentum exposure in global small cap can boost long-term returns

Global small cap stocks have typically outperformed large and mid cap stocks over the long-term. Looking at rolling 10-year periods, the MSCI ACWI Small Cap Index has outperformed the MSCI ACWI Index (mid & large cap) 80% of the time, and by an average of +229 basis points annually (reference analysis on page 2). While the return premium from investing in small cap is compelling, we believe the strongest case for global small caps stems from active managers' proven ability to generate consistent alpha.

That said, the economic backdrop has led investors to shy away from economically sensitive areas of the market like small caps, in favor of the perceived safety of large cap stocks. Our analysis finds that small cap stocks typically lag in market corrections but then go on to add significant value in the subsequent recovery periods. If history is any guide, now may be an opportune time to introduce or increase an allocation to small cap stocks.

In this analysis, we explore the benefits of a dedicated allocation to an actively managed global small cap strategy. We demonstrate small caps' outperformance over time and discuss why active managers have been able to consistently add alpha. We discuss the sheer size of the opportunity set as well as how it offers a differentiated source of returns and exposures that is complementary to large cap. Finally, we look at what factor exposures have worked best in the global small cap universe.

February 2024

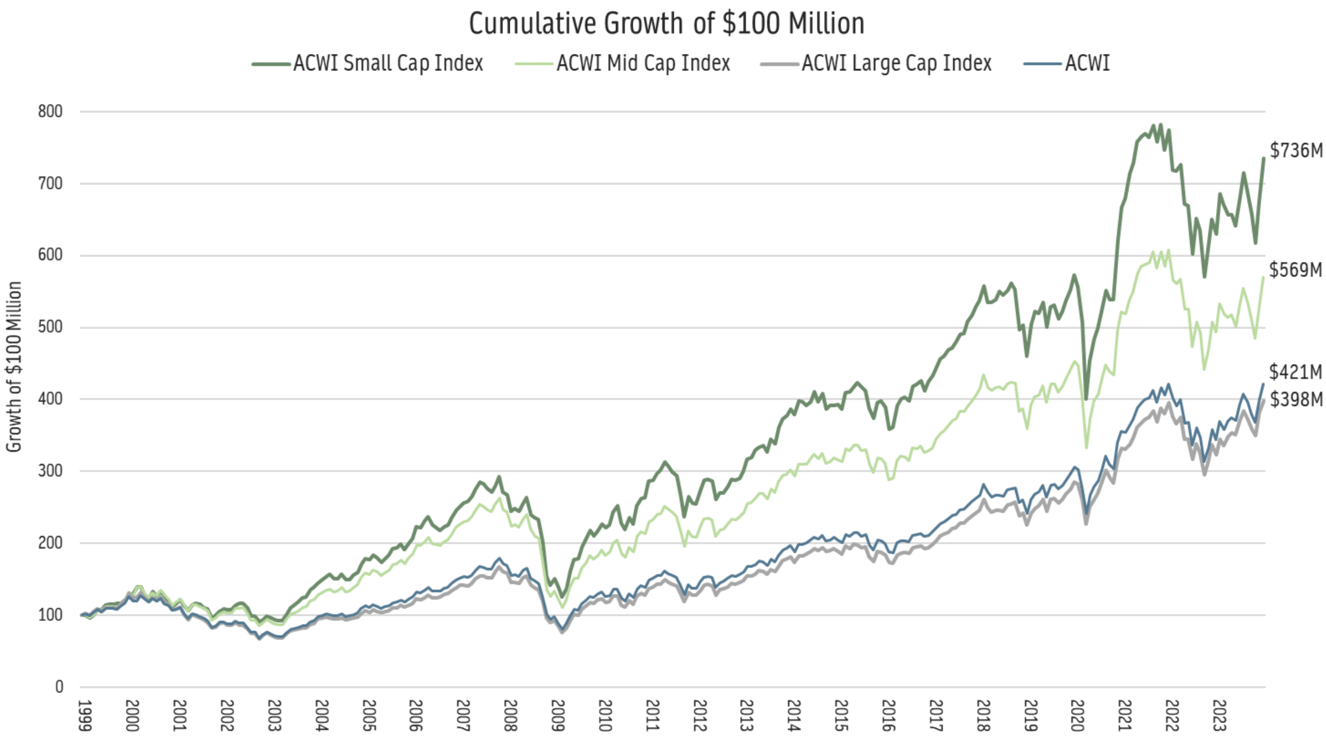
Evidence of the Small Cap Premium

Academic researchers have found that small cap equities have higher risk-adjusted returns than their large cap peers. Theories as to why the small cap premium exists can be divided into two general camps: 1) the market misprices small cap stocks, and 2) small cap stocks are inherently riskier and therefore should earn commensurate return. The truth is likely some combination of the two theories.

An analysis of long-term returns finds that the additional risk associated with small cap stocks is well-compensated over the long term. While performance of any asset class may fall out of favor occasionally, our analysis shows that if you have a longer time horizon, small caps outperform most of the time. Since inception of the MSCI ACWI Index (large/mid cap stocks) in January 1999, the MSCI ACWI Small Cap Index has outperformed in 80% of rolling 10-year periods, and by 229 basis points annualized. For the same period, the global small cap index returned 8.31% annualized through December 31, 2023, outperforming the MSCI ACWI Index by 239 basis points annualized over that time. Said another way, if you invested $100 Million in small cap in January 1999, you would have $736 Million compared to $421 Million invested in large/mid cap.

Smaller market cap stocks have historically outperformed mid and large cap

	Rolling 3-Year Periods	Rolling 5-Year Periods	Rolling 10-Year Periods
% of the time small cap has outperformed ACWI	72%	75%	80%
Average annualized basis points outperformance	258	239	229



Source: MSCI Net Index returns from inception of the MSCI ACWI Index in January 1999 through December 2023. The analysis of rolling periods is calculated using a monthly series of 3-, -5, and 10-year annualized returns for the MSCI ACWI Small Cap Index compared to the MSCI ACWI Index. All data is in USD terms.

As with all asset classes, small cap leadership comes in cycles. Typically, small cap stocks tend to underperform during market downturns, but they often experience significant outperformance during recovery periods. We identified seven drawdown periods when the MSCI ACWI Small Cap Index fell more than 20% and analyzed performance compared to the MSCI ACWI Index in both the drawdown and recovery periods. This analysis shows that in six of the seven correction periods, small cap led on the downside, while in five of the seven recovery periods, small cap outperformed.

Small cap typically underperforms in market corrections, and leads significantly in the recoveries

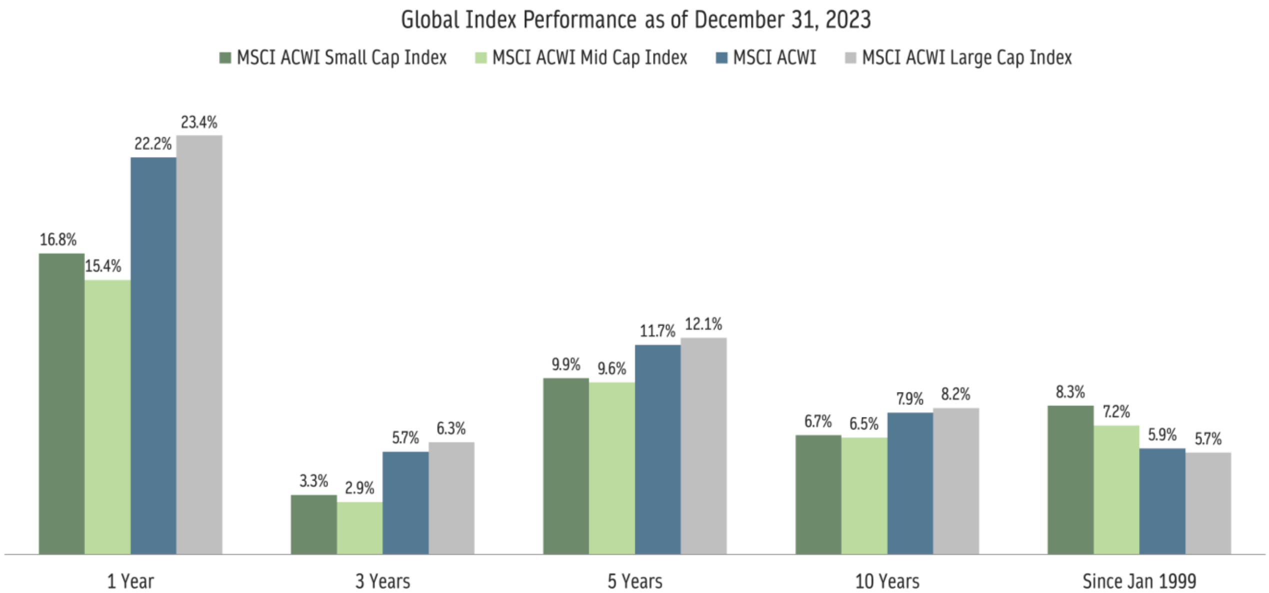
Drawdown Periods		Duration (~# of months)	MSCI ACWI Small Cap Index	MSCI ACWI Index
Feb 2, 2001	Oct 9, 2002	20	-31.4%	-41.8%
Jul 16, 2007	Mar 9, 2009	20	-60.8%	-58.4%
May 2, 2011	Oct 3, 2011	5	-27.0%	-22.6%
Jun 24, 2015	Feb 11, 2016	8	-21.4%	-18.4%
Jan 29, 2018	Dec 25, 2018	11	-22.7%	-19.3%
Jan 21, 2020	Mar 23, 2020	2	-40.9%	-33.5%
Nov 9, 2021	Sep 26, 2022	11	-29.8%	-25.0%
Average Drawdown		**11**	**-33.4%**	**-31.3%**

Recovery Periods		Duration (~# of months)	MSCI ACWI Small Cap Index	MSCI ACWI Index
Oct 10, 2002	Jul 13, 2007	58	250.0%	166.4%
Mar 10, 2009	Apr 29, 2011	26	172.1%	116.5%
Oct 4, 2011	Jun 23, 2015	45	88.2%	73.5%
Feb 12, 2016	Jan 26, 2018	24	68.0%	61.9%
Dec 26, 2018	Jan 20, 2020	13	32.4%	35.7%
Mar 24, 2020	Nov 8, 2021	20	136.1%	102.8%
Sep 27, 2022	Dec 31, 2023	15	26.0%	33.3%
Average Recovery		**29**	**110.4%**	**84.3%**

Source: Daily returns as far back as available for the MSCI ACWI Index (Net) and MSCI ACWI Small Cap Index (Net), January 2001 through December 2023.

One exception is the most recent recovery period, where mega cap companies have soared. In the MSCI ACWI Index, the largest companies by market cap (>US$450 Billion) climbed 43% in 2023, while smaller cap companies failed to keep pace. We saw such divergence in the early months of the pandemic as well, as investors gravitated to the perceived safety of large cap. As demonstrated, having a longer-term perspective can avoid missing out on significant gains as leadership changes tend to cycle. As such, this recent dislocation of small cap underperformance may represent a timely opportunity for investors wishing to either introduce an exposure to small caps or increase existing exposure.

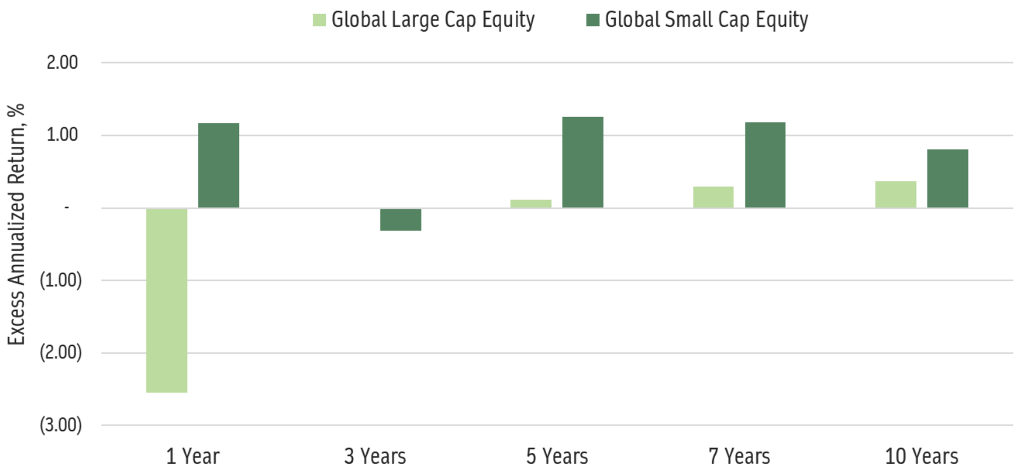
Recent dislocation between large and small cap may be an opportunity



Fertile Ground for Active Managers

The return premium from investing in small cap is compelling, but we believe the strongest case for global small caps stems from the opportunity for active managers. Dynamics inherent in the asset class have resulted in a large, less efficient market where the potential for overlooked and mispriced securities is greater than in large caps. As such, skilled active managers have historically exploited these conditions to generate consistent excess returns beyond what might be expected in a large cap strategy. Indeed, eVestment median manager performance shows that global small cap managers have added more alpha than their large cap peers over longer periods of time.

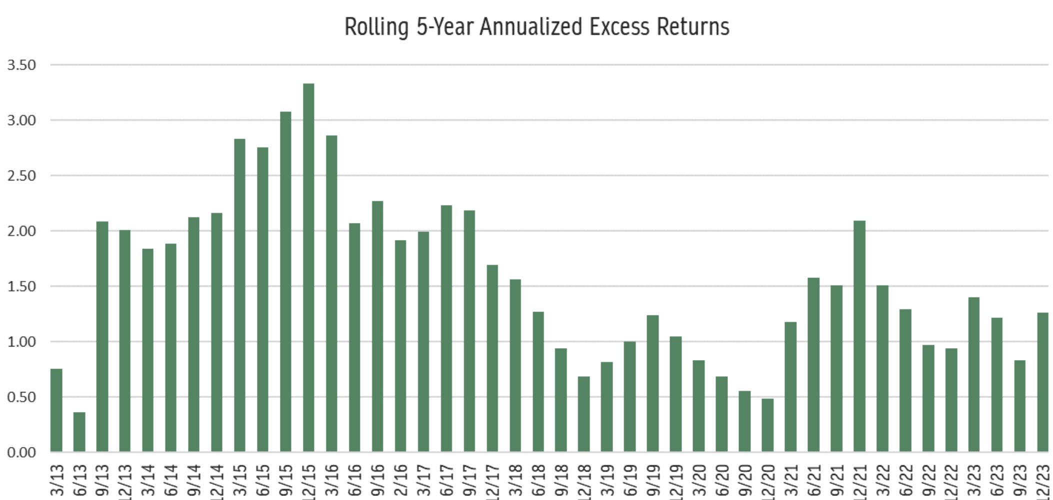
Global small cap active managers have had higher excess returns than their larger cap peers



Source: eVestment data as of December 31, 2023. Excess return of the median manager, gross of fees, within each respective peer group is shown. Calculated using the MSCI ACWI Small Cap Index benchmark for Global Small Cap, and MSCI ACWI Large Cap Index benchmark for Global Large Cap.

Further, looking at rolling periods of median active manager excess returns shows the consistency of this outperformance. Over the last decade, the median global small cap active manager has added +152 basis points of excess return on average over rolling 3-year periods and +158 basis points annualized on average over rolling 5-year periods.

Active managers have consistently added value in global small cap

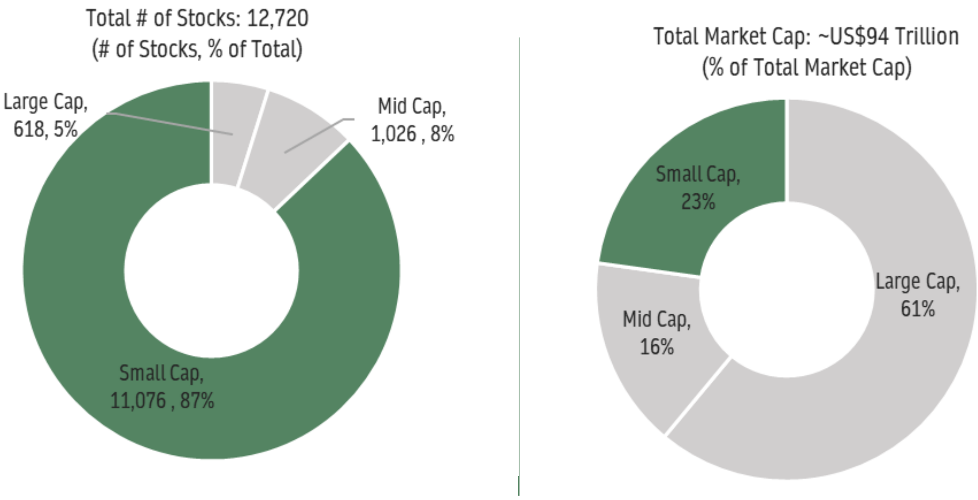


A Vast, Yet Overlooked Opportunity

Characteristics of the global small cap universe, including a broad universe of stocks, low research coverage, and high cross-sectional volatility, have likely contributed to active managers' consistent success.

Global small cap's defining characteristic is the breadth of the universe. Spread across 47 countries in both developed and emerging markets, the global small cap equity universe presents a broad and diverse opportunity set of over 12,000 public companies, or 87% of the total equity market universe. By number of constituents, the global small cap universe is seven times larger than mid and large cap combined.

Most publicly listed stocks are small cap

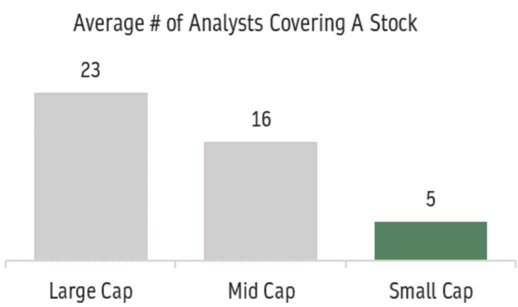


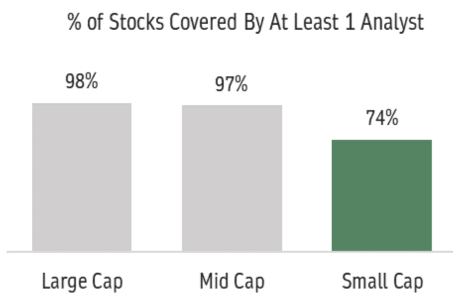
Source: FactSet universe as of December 31, 2023. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

Despite this impressive breadth, the number of investment strategies dedicated to global small cap equities remains relatively limited. According to eVestment, just 6% of all actively managed global equity products fall under the Global Small Cap classification. Investors may choose to own an All Cap strategy, believing it provides sufficient exposure to full market range of the global universe. However, most Global All Cap managers have a benchmark of the MSCI ACWI, which represents only mid and large cap stocks, with just 8% in stocks less than $10 Billion in market cap. This discrepancy results in a natural large-cap bias in most all-cap strategies, therefore missing out on what we believe is the most vibrant segment of the market.

Among these companies, 26% of them are completely uncovered by sell-side research analysts. On average, global small cap stocks are covered by 5 analysts relative to large cap at 23 analysts. The result is information inefficiencies that create opportunities for managers to exploit mispricing.

Lower research coverage compared to larger market cap segments

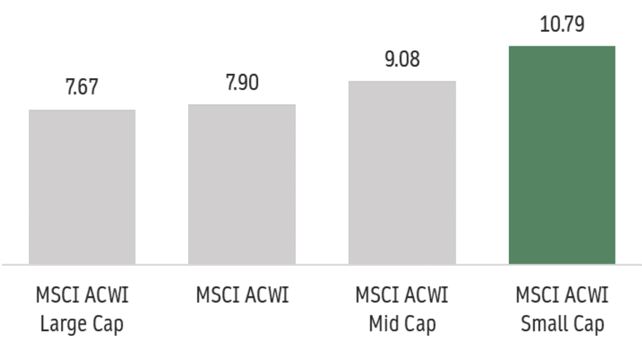




Source: FactSet universe as of December 31, 2023. Small Cap is defined as those stocks with market cap $500M-10B, Mid Cap $10-30B, Large Cap >$30B.

Additionally, the asset class has a consistently higher degree of cross-sectional volatility compared to other equity asset classes, which is to say, these stocks tend to act very differently from one another. Small cap companies typically address specific markets and sell a narrow set of products and services. Their success or failure is more often driven by company-specific factors, and the result is a wide range of outcomes. The higher level of cross-sectional volatility in small cap highlights a rich environment for active managers to identify companies that are positioned to outperform.

The higher level of cross-sectional volatility highlights the active management opportunity



Source: Calculated using monthly data from FactSet for the last 5 years ending December 30, 2023.

Manager Selection: What Style Exposures Work Best in Global Small Cap

We have shown that an allocation to global small cap provides a compelling, complementary exposure for allocators that either have a large cap bias or are looking for additional alpha opportunity. When selecting a global small cap strategy, it is important to keep in mind that the investment approach matters.

First, the sheer size and rapidly changing dynamic of the small cap universe can make it difficult for many managers to research each and every stock thoroughly. Thus, we believe the incorporation of a systematic investment process is paramount in helping managers identify and capitalize on those opportunities with the most potential in a timely fashion.

Additionally, while the universe of stocks may be fertile ground for active managers, style and factor biases can significantly impact results.

We conducted a study using historical Fama-French data to analyze factor performance and risk within the global small cap equity universe over time. For the available data set from July 1992 through August 2023, our findings show momentum as the best performing factor in global small caps. Additionally, momentum wins on a risk-adjusted basis with the highest Sharpe ratio and information ratio among each of the factors tested. This suggests that selecting a manager with the added tailwind of persistent momentum exposure may prove beneficial over time.

Momentum is the best performing factor in global small cap on an absolute and risk-adjusted basis

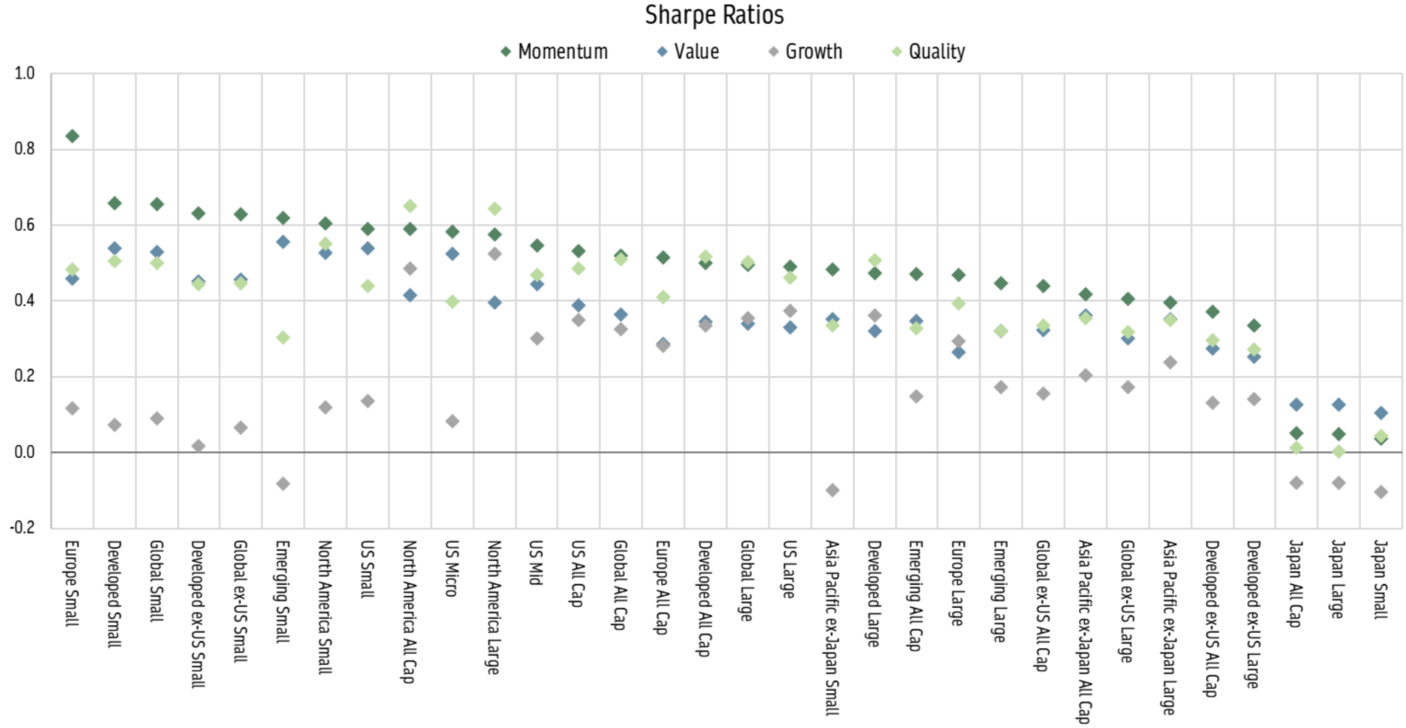
	Momentum	Value	Growth	Quality	Market
Return (Annualized)	**13.58%**	10.64%	4.02%	10.53%	7.46%
Volatility (Annualized)	**17.09%**	15.61%	18.61%	16.37%	16.48%
Tracking Error (to Market)	**5.13%**	4.40%	4.58%	2.80%	--
Sharpe Ratio	**0.66**	0.53	0.09	0.50	0.31
Information Ratio (to Market)	**1.19**	0.72	-0.75	1.10	--
T-Stat (Excess Returns)	**6.29**	3.59	-3.56	5.72	--
Batting Average (Excess Returns)	**68%**	58%	42%	65%	--

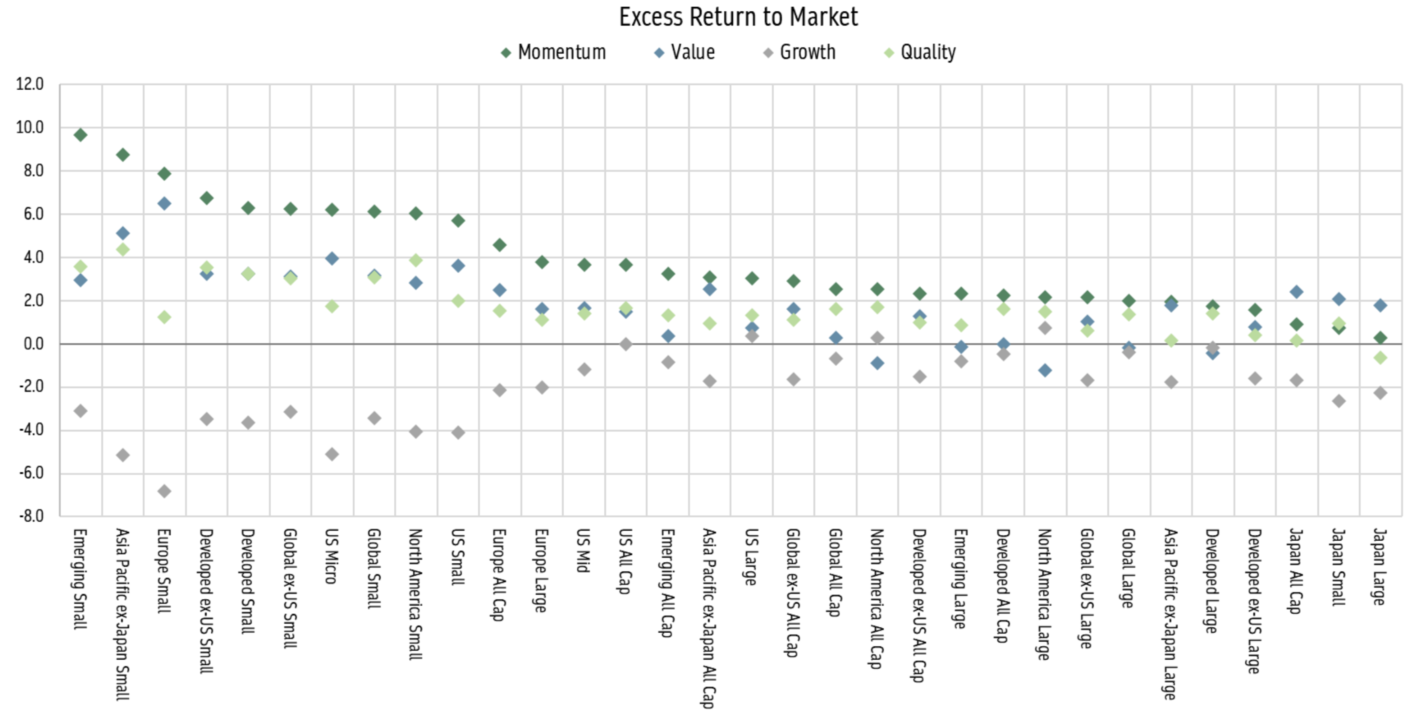
https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Analysis is for the period July 1992 – August 2023. To calculate Market returns for the Global Small equity universe, we construct monthly returns series assuming an 88% weight for developed markets and 12% weight for emerging markets. For the developed portion: small cap represents the bottom three market cap quintiles. The emerging markets portion includes the full universe of securities. The factors displayed are referenced by Ken French as follows: Value (High Book/Market), Momentum (High Prior Return), Growth (Low Book/Market), and Quality (High Operating Profitability).

More broadly, we looked at factor performance across 32 distinct global equity markets. Notably, momentum demonstrated exceptional performance, surpassing the respective market return in 100% of the samples. Furthermore, momentum consistently yielded the highest excess returns, outperforming other factors in 91% of the samples. Impressively, it also exhibited superior risk-adjusted returns (Sharpe ratio) in 75% of the samples, emphasizing its ability to generate favorable returns with lower associated risk. Additionally, when assessing significance at the 90% level, momentum displayed statistically significant excess returns in 72% of the samples, surpassing all other factors tested in this regard. These findings collectively underscore the robust and reliable performance of momentum as a factor across various market geographies and capitalizations.

The outperformance of momentum is pervasive across markets, but most prominent in small cap



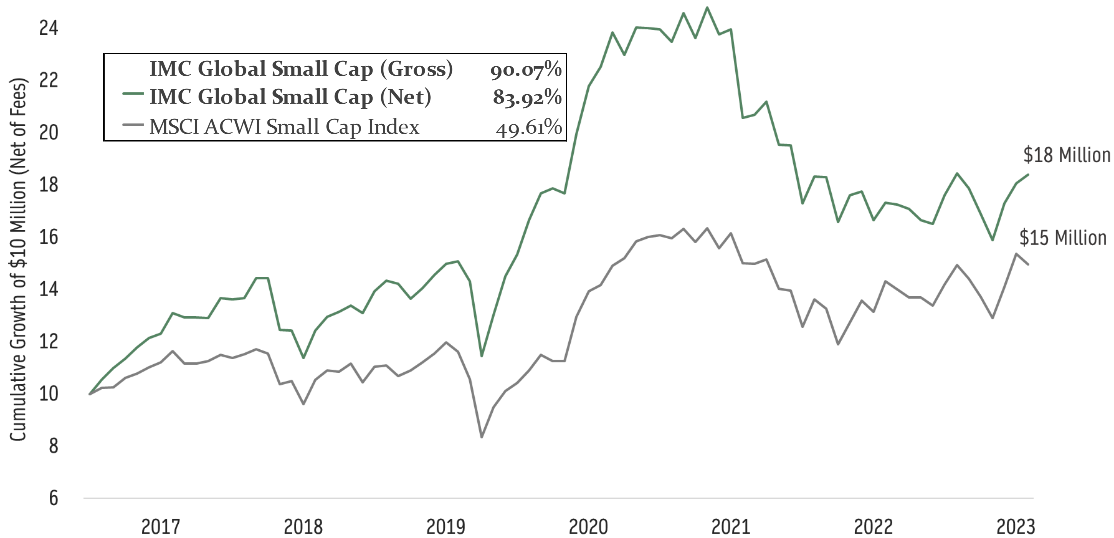


IMC's Expertise

IMC has been able to navigate the large selection universe of global small cap stocks by utilizing a systematic approach designed to deliver consistent and predictable return streams. Our Informed Momentum® approach combines momentum with stock selection, tailored risk management, and efficient implementation to deliver alpha for clients. This approach is the foundation of our firm and has been applied consistently across all strategies since inception in 2007 (formerly EAM Investors*).

Strong inception-to-date alpha	Benchmark-like volatility with beta at or below 1.0	Favorable upside and downside capture ratios	Excess return correlations complement traditional styles	Consistent exposure to stock-specific risk and momentum

IMC Global Small Cap** Composite Performance as of January 31, 2024



	Jan	1 Year	3 Year	5 Year	ITD
IMC Global Small Cap (Gross)	1.84%	6.66%	-6.06%	8.70%	10.25%
IMC Global Small Cap (Net)	1.80%	6.13%	-6.53%	8.16%	9.70%
MSCI ACWI Small Cap Index	-2.62%	4.52%	1.80%	7.25%	6.31%
MSCI ACWI Small Cap Growth Index	-2.85%	5.17%	-2.33%	7.48%	7.01%
MSCI ACWI Small Cap Value Index	-2.40%	3.85%	5.75%	6.55%	5.25%

Performance is for the period since inception July 1, 2017 – January 31, 2024. See important disclosures at the end of this document.

*As of February 4, 2025, EAM Investors, LLC (EAM), has officially changed its name to the Informed Momentum Company (IMC). This name change does not impact the integrity or content of the research, reports, or any materials previously published under the old name. All references to "EAM" in past publications or reports now refer to "IMC."

** The EAM Global Opportunities Strategy is now called the IMC Global Small Cap Strategy. This name change aligns with the firm's rebranding to IMC and more accurately reflects the strategy's investment focus. Please note, the investment approach, objectives, and the team managing the strategy remain unchanged.

Performance & Risk Statistics Since Inception

	IMC Global Opportunities	MSCI ACWI Small Cap Index
Annualized Return (Gross)	10.25%	6.31%
Annualized Return (Net)	9.70%	6.31%
Alpha	4.28%	-
Tracking Error	8.73%	-
Standard Deviation	20.43%	19.71%
Information Ratio	0.45	-
Sharpe Ratio	0.41	0.22
Beta	0.94	1.00
R-Squared	0.82	1.00
Up Market Capture	105.7%	-
Down Market Capture	92.5%	-

Risk statistics are for the period since inception July 1, 2017 – January 31, 2024, relative to the MSCI ACWI Small Cap Index, calculated gross of fees.
Please see important disclosures at the end of this document.

About IMC

IMC is solely focused on helping clients build better portfolios through our Informed Momentum® investment approach. This approach has been applied consistently across all strategies since the inception of the firm in 2007 (formerly EAM Investors*). The daily application of our systematic process is designed to deliver consistent and predictable results. Since our entire company works for a single objective, it only makes sense to align the name of our brand with exactly what we do every day.

We are the **Informed Momentum Company.**

About the Authors

TRAVIS PRENTICE

Travis is the chief investment officer, responsible for oversight of all of IMC's strategies, as well as a portfolio manager for IMC's US and Global strategies. Travis co-founded The Informed Momentum Company, formerly EAM Investors, in 2007. Prior to that, Travis was a partner, managing director and portfolio manager with Nicholas-Applegate Capital Management where he had lead portfolio management responsibilities for their Micro and Ultra Micro Cap investment strategies and a senior role in the firm's US Micro/Emerging Growth team. He has 27 years of institutional investment experience specializing in momentum-based strategies. He holds an MBA from San Diego State University and a BA in Economics and a BA in Psychology from the University of Arizona.

DAVID WROBLEWSKI, PHD

David is the director of applied research at IMC. Prior to joining the company in 2021, David was director of research at Denali Advisors, an institutional equity manager with US and Non-US strategies. He has additional experience in research and risk management from Nicholas-Applegate Capital Management. David also serves as an adjunct instructor in the Department of Mathematics at San Diego City College. He has 15 years of investment experience. David received a Ph.D. in Mathematics at the University of California, San Diego, a Master of Science in Applied Mathematics and a Bachelor of Science in Applied Mathematics from San Diego State University. David has published papers in the Journal of Investment Management, Financial Analyst Journal, and Applied Economics, among other financial publications. He has been awarded the "Harry M. Markowitz, Special Distinction Award" from The Journal of Investment Management.

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Important Disclosures

Past performance does not ensure future results, and there is no assurance that the portfolios will achieve their investment objectives.

Effective 2/4/2025, the EAM Global Opportunities strategy changed its name to IMC Global Small Cap. This name change aligns with the firm's rebranding from EAM Investors to the Informed Momentum Company (IMC) and more accurately reflects the strategy's investment focus. Please note, the investment approach, objectives, and the team managing the strategy remain unchanged.

The inception date for the IMC Global Small Cap composite is July 1, 2017. Net returns are net of the maximum annual management fee of 0.50% for the IMC Global Small Cap Strategy. The MSCI ACWI Small Cap Index captures small cap representation across 23 Developed Markets (DM) countries and 25 Emerging Markets (EM) countries. The index is designed to measure small cap equity market performance in the global developed and emerging markets. The MSCI ACWI Small Cap Index has been chosen as a benchmark to the IMC Global Small Cap strategy because the Advisor believes that it is the most appropriate broad-based securities index available to be used for comparative purposes given the investment strategy of the portfolios. The MSCI ACWI Small Cap Growth Index captures small-cap securities exhibiting overall growth style characteristics across 23 DM countries and 25 EM countries. The MSCI ACWI Small Cap Value Index captures small cap securities exhibiting overall value style characteristics across 23 DM countries and 25 EM countries. The MSCI ACWI Small Cap Value Index and the MSCI ACWI Small Cap Growth Index are being presented for informational purposes only.

Gross and net composite returns are presented net of brokerage commissions and include income from interest and dividends as well as capital gains less applicable withholdings. The returns do not reflect the deduction of other taxes a typical investor may accrue or custodial fees. The U.S Dollar is the currency used to express performance. All periods greater than one year are annualized.

Risk statistics are calculated for the period beginning July 1, 2017 through January 31, 2024.

The portfolio(s) are actively managed and holdings are subject to change. We believe the information presented is reliable, but we do not guarantee its accuracy. The opinions expressed will evolve as future events unfold. The investment risk of the portfolio(s) may be increased by the portfolios' ability to invest in smaller company stocks, and IPOs. Investing in growth stocks involves certain risks, in part, because the value of securities is based upon future expectations that may or may not be met. Small company stocks are generally riskier than large company stocks due to greater volatility and less liquidity.