Punch

A BOUTIQUE INVESTMENT ADVISORY

Reasons to Own Small Cap Stocks Today

September 2022

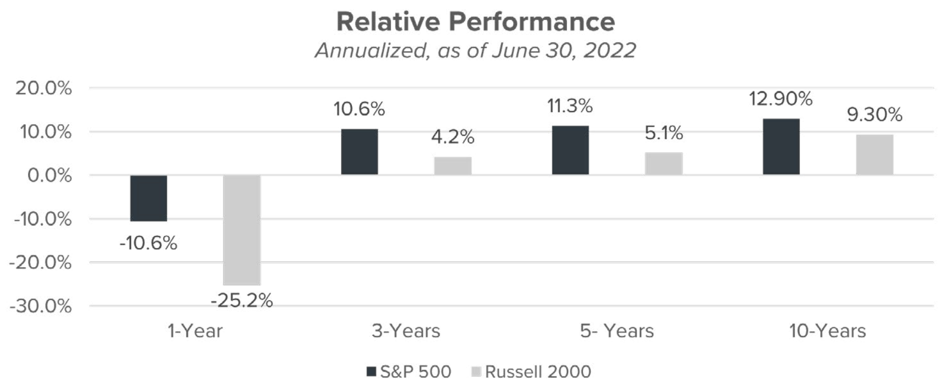
Summary

1. Small Cap stocks have under-performed large cap stocks over the past decade , despite a long-term track record of higher returns driven by structural inefficiencies.
2. Valuations for the asset class are the lowest in over 20 years and are at a point where forward returns have historically been positive on both an absolute and relative basis.
3. Relative earnings for small cap companies have improved this year, an indication that many are well-prepared for a potential recession.

Performance

The past decade has been difficult for small cap stocks as an asset class. Since June 30, 2012, the Russell 2000 Index has returned 9.3% annually, underperforming the S&P 500 by 3.6% per year. Over the past three- and five-years, small caps have fallen short of large caps by over 600 basis points per year.

While the reasons for longer-term trends are debatable, there are several obvious explanations for recent underperformance, including cyclical recession fears, wider credit spreads, a stronger dollar, and an aggressive Fed tightening cycle. Often perceived as a riskier asset class, small caps have not fared well in this risk-off environment.



Source: Bloomberg LP and Punch & Associates. Data as of 6/30/2022.

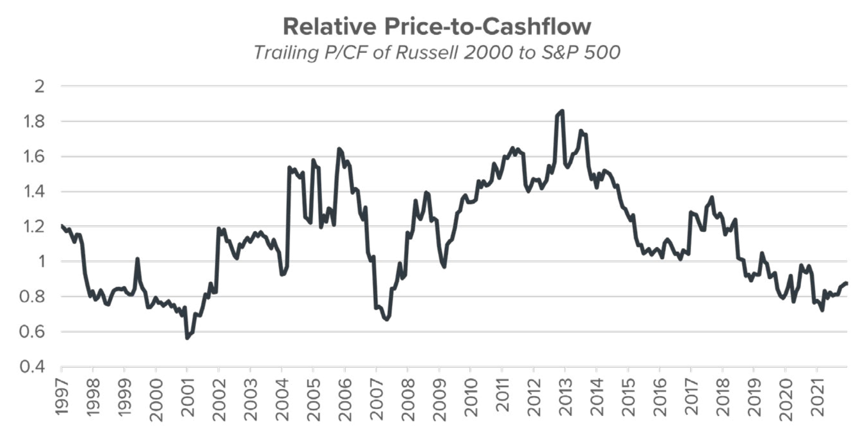
The long-term track record of performance by smaller companies remains intact, however, and since 1926 the smallest decile of public companies has returned 11.7% annually compared to 9.9% for the largest decile. As small cap specialists, we believe this incremental return is a result of the persistent and structural inefficiencies, such as fewer sell-side analyst recommendations, lower public share float, and a mid-cap bias among institutional shareholders, that are inherent in small cap investing.

Valuation

Unsurprisingly, valuations for small cap companies have compressed substantially during this period of underperformance, and now reflect a significant—and we believe excessive—amount of pessimism. **Relative valuations for the asset class have not been this cheap since late 2001.** Historically, small cap stocks traded at a P/E premium to large cap stocks; today they trade at a 45% discount. Other valuation metrics suggest similar levels of undervaluation.

In another signpost of undervaluation, Morningstar recently reported that small cap value stocks are the cheapest relative to their firm's estimate of fair value of any of their nine style boxes—a 39% discount. According to Furey Research, if every small cap company traded at its sell-side consensus price target, the asset class would be 40% higher than its current level.

The last time small caps were this cheap on a relative basis was the fourth quarter of 2001, at a time when small cap stocks were coming off a decade of underperforming large caps by over 3% annually for the previous decade. The subsequent performance of the asset class from that point was strong on both an absolute and a relative basis:



Source of Charts: Bloomberg LP and Punch & Associates. Data as of 8/31/2022.

	FORWARD RETURNS FROM SEPTEMBER 30, 2001 *(Cumulative)*			
	1-Year	**3-Year**	**5-Year**	**10-Year**
Russell 2000	-9.3%	47.0%	90.5%	131.2%
S&P 500	-20.5%	12.6%	40.0%	53.3%

Earnings

Despite weak relative returns, small cap companies' earnings growth has been stronger than large cap companies since mid-2020, and that growth has accelerated this year. Many small companies appear to be well-positioned for economic weakness.

Source: Bloomberg LP and Punch & Associates. Data as of 9/13/2022.

In the Punch Small Cap Strategy, our focus is on uncovering smaller public companies with consistent growth and profitability before they are discovered by other investors. The fundamental performance of many of our portfolio companies today is healthy, in contrast to much of the macroeconomic concern broadly, and the average Punch company grew revenues by 30% and produced an 11.5% operating margin in the past twelve months. The median number of sell-side analysts covering these companies is only five.

Conclusion

While the recent relative performance of small cap stocks as an asset class has been weak, we believe that valuations have compressed to an extreme level and one which historically has heralded strong forward returns. Of course, it is difficult to predict the timing of any renewal in small cap outperformance, and the risk of prolonged inflation, a continued Fed tightening cycle, or significant economic weakness could hamper small cap returns.

At Punch, we focus our research on identifying promising individual companies that offer attractive opportunities over a three-to-five-year horizon. We believe fundamentals for many small companies are strong and improving, and valuations are unusually attractive, which should augur well for the coming years.

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*Up & Down Capture: A statistical measure of an investment adviser's overall performance in up or down markets. The up-market capture ratio is used to evaluate how well an investment adviser performed relative to an index during periods when that index has risen while down-capture ratio applies during periods when the market has fallen. The ratio is calculated by dividing the investment adviser's net of fee returns by the returns of the index during the respective up-market or down market months, and multiplying that factor by 100.

Any benchmark indices shown are for illustrative and/or comparative purposes and have only been included to show the general trend in the markets in the periods indicated. Such indices have limitations when used for comparison or other purposes because they may have volatility, credit, or other material characteristics (such as number and types of securities or instruments represented) that are different from those of the Composite and/or any client account, and they do not reflect the Composite investment strategy or any other investment strategies generally employed by Punch & Associates. For example, the Composite for a particular client investment portfolio will generally hold substantially fewer securities than are contained in a particular index.

The performance information contained herein represents the unaudited and approximated composite performance of Punch & Associates clients' accounts managed pursuant to the mandate described herein (the "Composite"). Punch & Associates calculated performance information based upon certain assumptions, and performance is shown net of all actual investment advisory fees paid by the client accounts included within the Composite through 12/31/2020 and net of model fees beginning 12/31/2020. For more information about Punch's process for calculating performance net of model fees, please contact us. Certain clients in the Composite direct Punch & Associates to reinvest income and dividends, while other clients direct Punch & Associates to not reinvest those earnings. As a result, performance data shown for the Composite includes or excludes the reinvestment of income and dividends as appropriate, depending on whether the client directed Punch & Associates to reinvest income and dividends. Actual client accounts may incur other fees and expenses such as brokerage commissions, custodial costs, and other expenses. Accordingly, these other fees and expenses reduce an account's actual performance results. Punch & Associates' investment advice, and the timing for implementing the advice, varies across clients. Consequently, some of Punch & Associates' clients experienced returns that were higher than those included in the Composite, while others experienced returns that were lower.

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