

Small Caps Today: A Favorable Entry Point

Transcript of a video recorded on August 23, 2019

Behan: There are many headwinds facing investors today. Can you give us an overview of the U.S. small cap space?

Nelson: It's a fantastic environment, actually, for small caps right now. They're a bit of a safe haven in that we all know there are global economic struggles right now, partly due to natural macroeconomic cyclical forces, and there's also a lot of noise about tariffs.

Small caps are somewhat insulated from that. They're not completely insulated, but it's a relatively safe place to be, so I think it's a favorable time for that reason. Small caps also happen to be very inexpensive versus large caps relative to history. So, that's another factor that makes the asset class of small caps overall very interesting.

Behan: In general, when you've seen small caps have this valuation disparity with large caps, what causes that and how does that reverse its way out?

Nelson: There can be a lot of different reasons for why it's happening. I think, today, the reason it's most disconnected or most inexpensive relative to the large caps is that there's been a lot of "safe haven" money going toward large caps from a lot of international locations. The S&P 500 is a very liquid market, and that tends to attract a lot of outside money. When the U.S. is a relatively better place to be versus other international markets, large caps tend to get that first look from outside money.

Small caps are a safe haven, but that is more of a fundamental safe haven. I think large caps tend to be a liquidity safe haven and tend to get a premium because of that.

Also, the U.S. is in a really strong position. The economy is strong and the markets are transparent and very liquid. That, in and of itself, attracts assets on an ongoing basis. But, it's a bit of a disconnect right now relative to history and history shows that this disconnect probably won't last forever. When you get a spread this big on a go-forward basis, the gap is most likely



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going to close, either because small caps rally or because the large caps pull back or maybe some combination of both. So, the point is it's a favorable entry point for small caps relative to large caps right now.

We are coming off a recent earnings period and I've studied how we've performed during this earnings season. It turns out that even with all the crazy headlines about tariffs and other macro concerns, I saw a real pattern where stocks that were fundamentally underperforming got punished materially, but importantly, companies that showed fundamental upside were getting disproportionately rewarded.

And, if we're good at sniffing out that fundamental upside, then we should be a great place to have active management in your portfolio.

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