

Four Reasons We Believe Small Caps Are Compelling

We believe...

1. *Small caps should be part of every balanced portfolio*
2. *Investing successfully in small caps requires being selective*
3. *It's a good time right now with attractive valuations even for high quality businesses*
4. *Small caps typically outperform large caps in a declining interest rate environment*

We believe we are living in an era of unprecedented stock market narrowness. Seven stocks have dominated market performance for nearly one year. These companies have been endlessly debated and scrutinized and follow a storied tradition of a select few companies driving investors' imaginations. Wall Street has even had nicknames and acronyms for these groups, such as Nifty Fifty, FAANG, and most recently, Magnificent 7.

From our perspective, this attention is a function of broader investor uncertainty on the direction of the economy, as well as unease with several conflicts around the world. The Magnificent 7 have offered investors clear growth drivers, while earnings in the rest of the economy have been more challenged by higher inflation and interest costs.

That said, we believe there are compelling investment opportunities outside the largest, and most well-known companies. We believe that small capitalization companies can be important drivers of investment outperformance over market cycles.

SMALL CAP STOCKS DEFINED

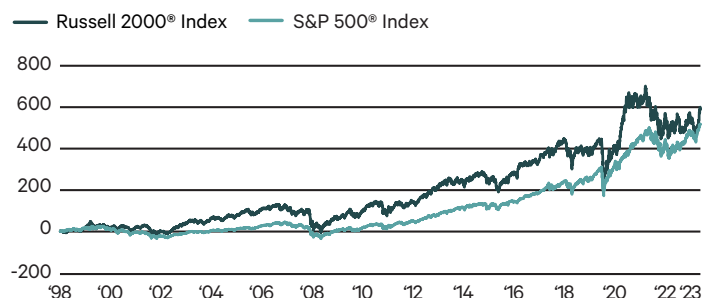
Small capitalization stocks are defined by their market capitalization (total market value). Market capitalization is determined by multiplying the number of shares outstanding by the current price per share. While there is no universal definition, an accepted range of capitalization for small cap stocks is typically between \$250 million to \$5 billion. By contrast, large cap stocks have market capitalizations of \$40 billion or higher.

1. WE BELIEVE SMALL CAPS SHOULD ALWAYS BE A PART OF A BALANCED PORTFOLIO... BUT NOT ALL SMALL CAPS ARE THE SAME

Over extended periods of time, smaller cap stocks have historically produced higher returns than their larger peers (Figure 1). In our experience, this is typically the result of better earnings growth through an economic cycle. Smaller businesses are earlier in their maturation relative to large cap companies and often have more opportunities for earnings growth.

FIGURE 1: CUMULATIVE RETURNS

25 Years Ending December 31, 2023



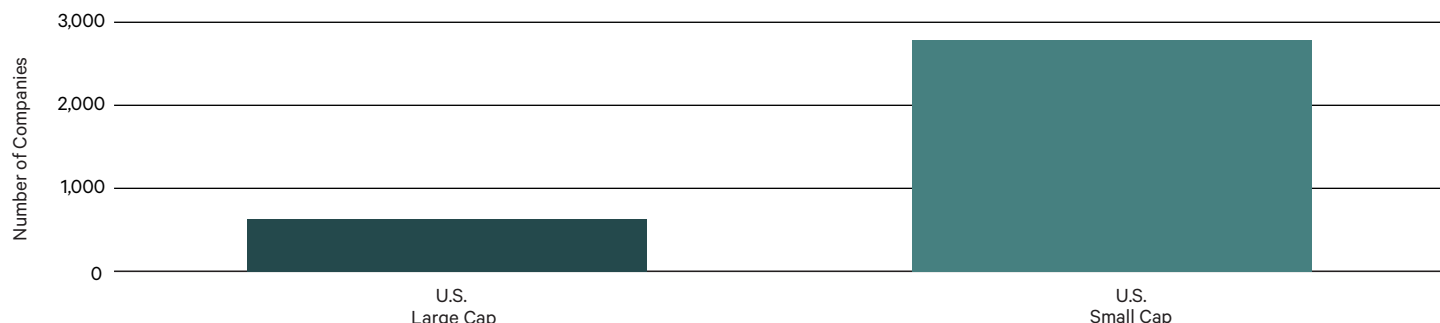
Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. Please see the end of this paper for important information regarding the indexes. **Past performance is no guarantee of future results.**

That said, small caps are much less homogenous in terms of quality than larger capitalization companies. Forty percent of the stocks in the Russell 2000 Index were unprofitable as of December 31, 2023. The small company universe is both a large and diverse group and is comprised of companies that are economically sensitive and cyclical as well as ones with

more durable earnings. Some have pristine balance sheets, others are highly levered. Those with high leverage are particularly vulnerable to economic swings because they typically have less access to the capital markets than larger, more well-established companies.

Because the small cap universe is both large and very diverse in quality, we believe active management is critical to investment outperformance as well as risk management (Figure 2). We do not think investing in an index is the way to reduce risk in small cap investing. When owning an index, there’s not only exposure to profitable companies, but also all the unprofitable companies. As mentioned above, these unprofitable companies alone make up 40% of the index. This means owning all the balance sheet risk of higher leveraged companies, and owning less of the high quality names.

FIGURE 2: INVESTABLE UNIVERSE



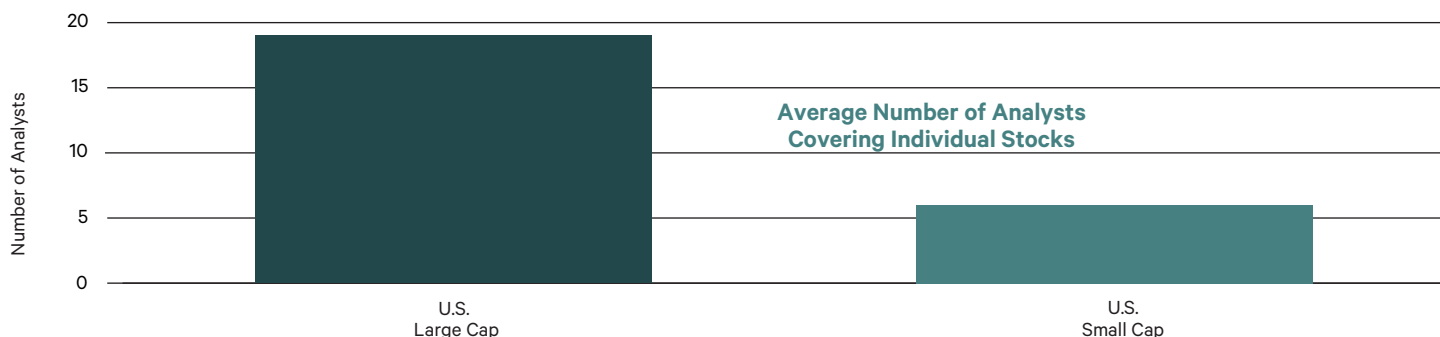
Data is as of December 31, 2023. Data is obtained from FactSet Research Systems and is assumed to be reliable. U.S. Large Caps are represented by companies greater than \$10 billion; U.S. Small Caps are represented by companies between \$100 million to \$5 billion. Returns could be reduced, or losses incurred, due to currency fluctuations. **Past performance is no guarantee of future results.**

We think the way to manage risk in investing in small cap is to do so at the individual business level where you can seek to avoid unprofitable companies with high leverage or highly cyclical earnings. In our view, this allows the portfolio to focus on strong businesses that are typically reliable in good economic times and bad, and reduce the risk added to a portfolio of the weakest links in the index.

2. WE BELIEVE THE KEY TO INVESTING IN SMALL CAPS IS BEING SELECTIVE

Kayne Anderson Rudnick (KAR) has focused investing in the small cap universe because we believe it suits our focus on deep fundamental research. Unlike the well-known large cap names, small caps are often businesses the average person has never heard of. In addition to very little media coverage, they have very little Wall Street analyst coverage (see Figure 3). These companies, which tend to have little to no leverage, are typically not big clients of Wall Street investment banks, so they may not be invited to industry conferences or events.

FIGURE 3: ANALYST COVERAGE



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As such, they are often overlooked for the larger companies with plenty of available information. Because KAR focuses on the qualitative aspects of the companies in which we invest (e.g., durability of a company's sustainable competitive advantage and management quality) rather than the pure quantitative outputs (e.g., specific targets for earnings or revenue), we believe we are better able to identify high quality companies with true competitive protections that will endure through a business cycle.

A great example of this would be our long-standing investment in a software vendor which serves small and mid-sized banks with a mission critical core offering. As long as your bank is open, you're paying this company to keep the core business operating. This is evidenced by the company's continued growth during the Global Financial Crisis (GFC) where its financial statements remained strong despite its customers facing their darkest days on record.

Finding these types of resilient businesses with structural competitive protections is the focus of everything we do at KAR. There is not an endless supply of these companies in the small cap universe, but we believe our approach of deeply understanding a company's business yields robust outperformance, particularly in challenging periods such as the GFC.

Our research process requires patient gathering of all publicly available information to understand why a business is differentiated and why its competitive position is protected. We meet with management teams to understand their long-term vision for the company and what they are doing today to nurture their competitive advantage. We evaluate management incentives to see if they align with our long-term focus.

And only once we are confident that we understand the qualitative business characteristics do we focus on the more quantitative outputs that we believe will drive the investment outcomes.

3. WE BELIEVE SMALL CAP VALUATIONS ARE PARTICULARLY ATTRACTIVE RIGHT NOW

From our perspective, small cap stocks are attractively priced relative to their larger peers as well as their own historical averages. The Russell 2000 Index of small capitalization stocks is trading at about 13.9 times forward earnings, well below its 10-year average of 16.8 times. What's more, the valuation spread between the Russell 2000 and the large cap-focused Russell 1000 Index is the widest it's been since the tech bubble burst in the early 2000s.

FIGURE 4: SMALL CAPS ARE TRADING AT DISCOUNT RELATIVE TO LARGE CAPS

Relative Forward P/E Ratio, Russell 2000 Index/Russell 1000 Index, Last 30 Years

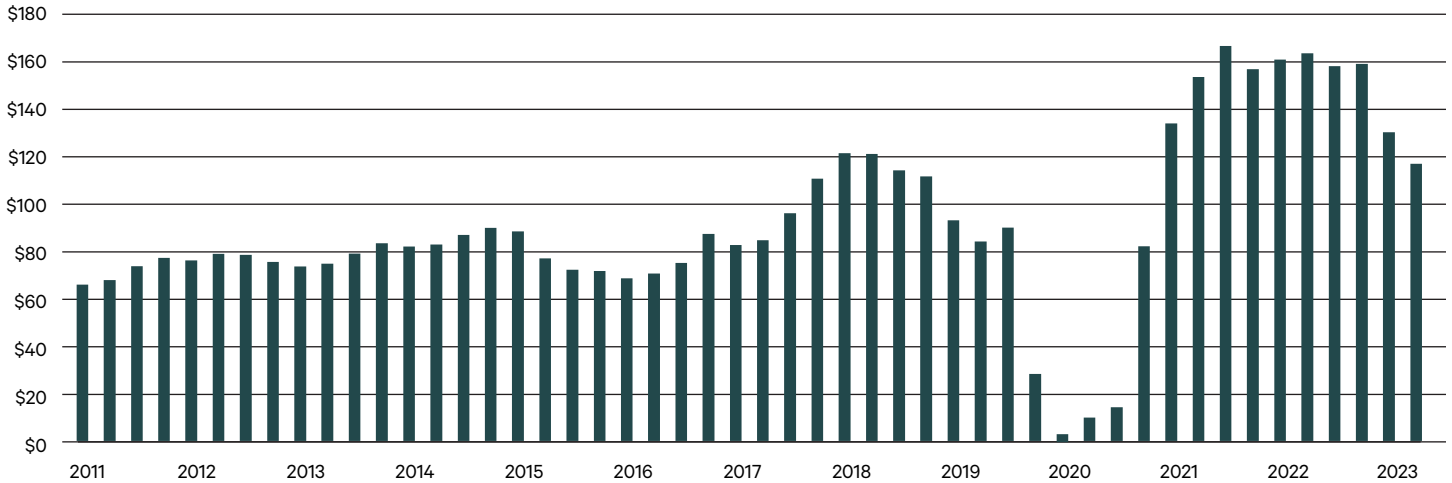


Data is as of December 31, 2023. Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. Please see the end of this paper for important information regarding the indexes. **Past performance is no guarantee of future results.**

We believe this is a reflection of investor uncertainty on the direction of the global economy. Small caps as a group are often more economically sensitive to the macroeconomic environment. They also typically have more leverage with less ability to access capital markets for liquidity.

Small cap earnings remain in a multi-quarter recession (Figure 5). While topline growth has been mostly positive, smaller businesses are grappling with supply chain challenges, heavy burden of goods, and wage inflation as well as higher interest burdens. As inflation continues to soften and borrowing costs also ease, we would expect this to be a positive tailwind that is felt more forcefully for small caps over larger companies. We believe this should improve earnings growth for small caps, which should also support valuations (Figure 6).

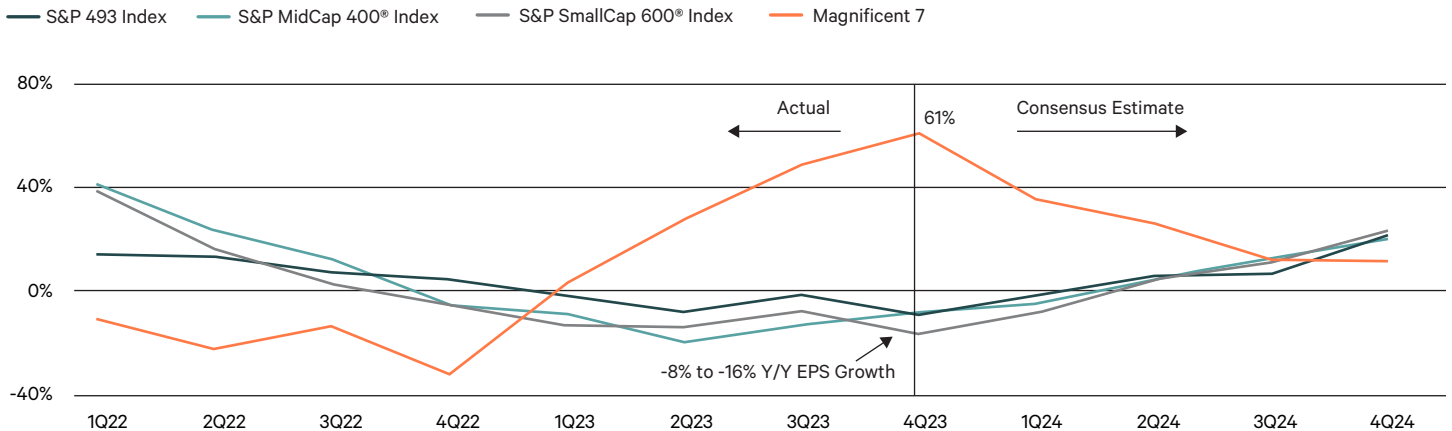
FIGURE 5: RUSSELL 2000® INDEX EARNINGS PER SHARE



Data is as of December 31, 2023. Data is obtained from FactSet and Strategas is assumed to be reliable. The index is not actively managed and does not reflect the deduction of any investment management or other fees and expenses. Please see the end of this paper for important information regarding the indexes. **Past performance is no guarantee of future results.**

FIGURE 6: CONSENSUS QUARTERLY YEAR-OVER-YEAR EARNINGS PER SHARE GROWTH

Large, Mid, Small and Magnificent 7



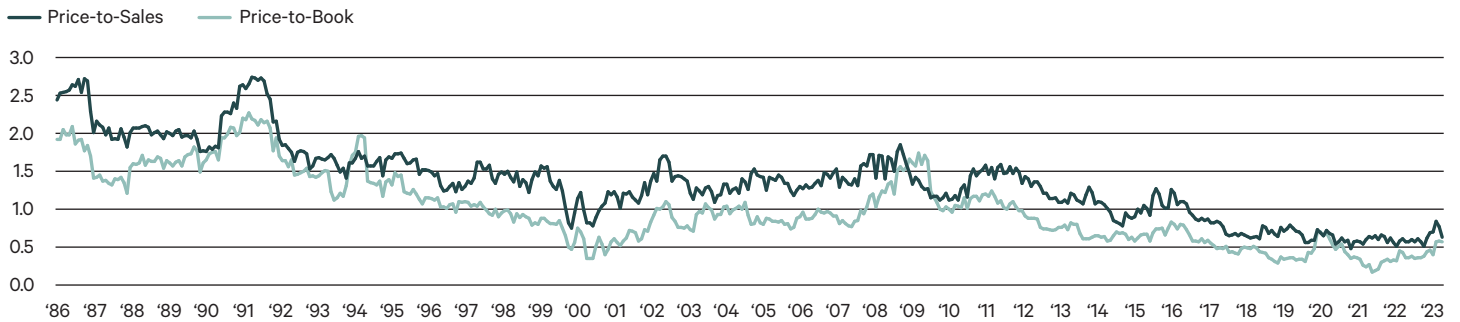
Data is as of December 31, 2023. Data is obtained from Raymond James and is assumed to be reliable. The S&P 493 represents the The S&P 500® Index without the Magnificent 7. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. Please see the end of this paper for important information regarding the indexes. The Magnificent Seven stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. **Past performance is no guarantee of future results.**

We saw an early appetite for this change in leadership at the end of 2023, when small caps outperformed their larger-cap peers. This has reversed somewhat recently as concerns over inflation returning put some doubt in investor minds that small caps would outperform in 2024.

We believe however that this valuation discount to large caps is unlikely to be sustained over the long-term. What is even more compelling for KAR specifically is that typically when buying higher quality names, you have to pay a quality premium. Currently, investors do not have to pay the typical quality premium in small caps, which in our view represents an even better bargain for long-term investors who want exposure to the asset class, with typically more downside protection through a cycle (Figure 7).

FIGURE 7: RUSSELL 2000® INDEX QUALITY VALUATIONS

Relative Valuations: Quintile 1 (Highest) Return on Equity vs. Quintile 5 (Lowest) Return on Equity



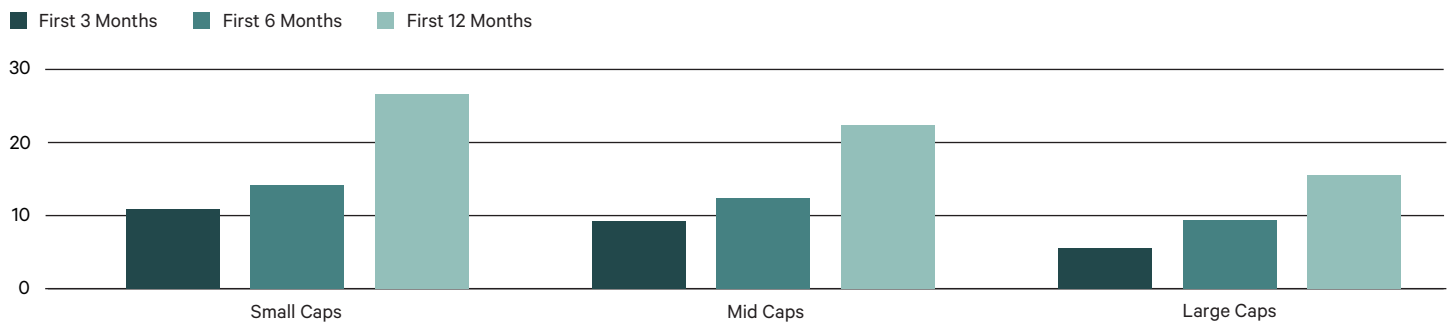
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4. SMALL CAPS TEND TO OUTPERFORM LARGE CAP STOCKS IN A DECLINING INTEREST RATE ENVIRONMENT

While we do not advocate market timing in investing, we do recognize that as an asset class, small caps have historically outperformed larger peers when interest rates are declining (Figure 8).

FIGURE 8: RATE CUTS HAVE TENDED TO GIVE THE BIGGEST BOOST TO SMALL CAPS

Performance After First Fed Rate Cut



Data is as of December 31, 2023. Data is obtained from Jefferies using Federal Reserve Board, Haver Analytics, Center for Research in Securities Prices (CRSP®), and the University of Chicago Booth School of Business and is assumed to be reliable. Note: used fed funds rate from 1954 until 1963, then used the discount rate from 1963 until 1994 and the fed funds rate thereafter. Market caps defined by CRSP based on placing market caps into deciles. Deciles 1 and 2 are large and 6 through 8 are small. **Past performance is no guarantee of future results.**

There are two reasons for this. The first is that lower borrowing costs are more meaningful to smaller companies than larger businesses as discussed above. The second is that lower financing costs also make it easier for acquirers, such as larger companies or private equity, to acquire these smaller businesses and earn an adequate return. The M&A environment has been particularly weak as rate increases have taken effect.

While we do not know when the Federal Reserve will begin to reverse course and cut rates, we do believe the federal funds rate has likely peaked with rate cuts expected in 2024. While past performance does not guarantee future results, small cap stocks have tended to perform well relative to large and mid-cap stocks following the first interest rate cut.

CONCLUSION

As long-term investors, we do not believe in trying to predict the macro-economic environment or time the market. But we do believe small caps should be a part of every investment portfolio and that their current valuation makes for a compelling opportunity to invest now. Additionally, we believe investors can upgrade the quality in their portfolios without having to pay the usual premium to do so.

GLOSSARY

The price-to-earnings (P/E) ratio measures a company's share price relative to its earnings per share (EPS). Forward price-to-earnings (forward P/E) is a version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation. Earnings per share (EPS) is a company's net profit divided by the number of common shares it has outstanding. The price-to-sales (P/S) ratio is a valuation ratio that compares a company's stock price to its revenues. The price-to-book ratio is the company's current stock price per share divided by its book value per share (BVPS).

INDEX DEFINITIONS

The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The S&P 500® Index is a market capitalization-weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the US market. The Russell 1000® Index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are included. The S&P Mid Cap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The S&P SmallCap 600® seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The indices are calculated on a total return basis with dividends reinvested. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

This report is based on the assumptions and analysis made and believed to be reasonable by Kayne Anderson Rudnick ("KAR"). However, no assurance can be given that KAR's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. **Past performance is no guarantee of future results.**