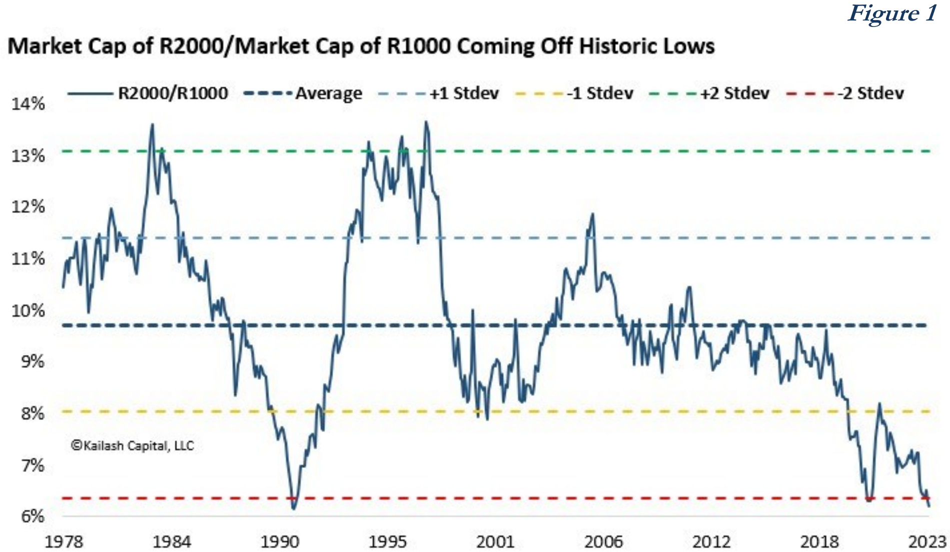
MAGNIFICENT…SMALL CAPS?

WHY NOW AND WHY CONFLUENCE

Why Small Caps?

Small capitalization stocks have spent the better part of 10 years in the shadows of their larger cap brethren but now currently provide an attractive opportunity, in our estimation. The divergence has been driven primarily by the narrow focus on a select few mega-cap technology-oriented businesses. This has led the Russell 2000 Index to trade at two standard deviations below its average relative to the Russell 1000 Index (see *Figure 1*), which was last reached during the Savings and Loan (S&L) Crisis of the late 1980s/early 1990s.

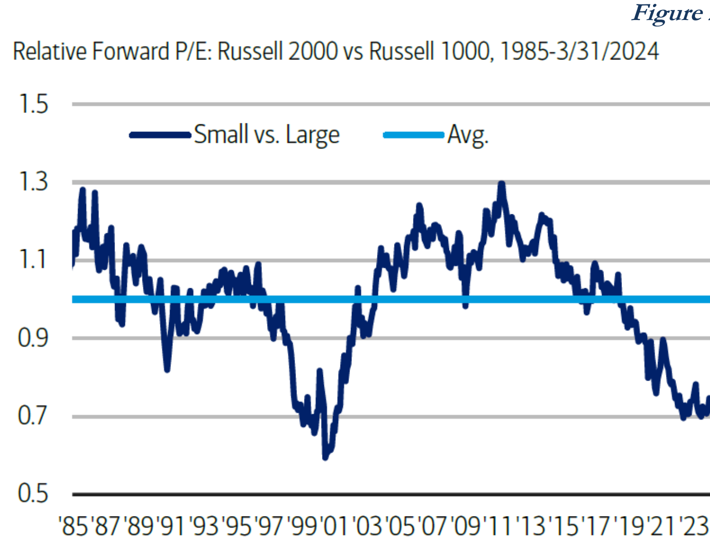
Figure 1



(Source: Kailash Capital)

Additionally, the divergence has placed the relative valuation of the Russell 2000 at levels last witnessed toward the end of the dot-com boom of the late 1990s/ early 2000s (see *Figure 2*). This has some investors questioning the vitality of small caps. However, we view the relative underperformance as cyclical, driven by the prolonged accommodative monetary policy that followed the Great Financial Crisis of 2008-2009, which seems to have encouraged a more aggressive allocation of capital toward tech and unprofitable small caps.

Figure 2



The heart of the discussion of whether small caps will reclaim their historical performance advantage revolves around the thinking that bigger is better, with large technology-oriented companies being the secular winners. As we stated in our *Value Equity Insights* report, "Is It Different This Time?," it can be tempting to extrapolate a trend into a permanent shift (especially the longer its duration); however, it is prudent to view each trend within the historical context. While no two environments will ever be exactly the same, there are parallels that can be drawn as the economy is bound by the principles of capitalism and human nature. As our economy evolved from an agrarian base to an industrial base, and then to one founded on intellectual property and services, we experienced periods of excess exuberance. From the buildout of the railroads, to the Roaring 1920s and the growth of radio, to the Nifty Fifty of the 1970s, to the dot-com craze at the turn of the century, and through the housing bubble of the 2000s, investors were wise to adhere to an investment discipline despite the temptation to jump on the popular trend of the moment. And if the past is prologue to the future, we believe small caps should stand to benefit relative to large caps.

As Howard Marks, legendary investor, once said:

> "I think it's essential to remember that just about everything is cyclical. There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future."

Why Confluence?

It has been a trying time for small cap investors, and especially so for fundamental investors, due to the excess liquidity that was injected into the system, which has aided the survival of a larger number of smaller, unprofitable businesses as well as creating various pockets of speculation.

These so-called zombie businesses increased from a low of 20% in the Russell 2000 to mid-40% (see *Figure 3*) and diverted investor capital as well as presented challenges for competitors who sought profits and returns on capital. This extended era of accommodative monetary policy following the Great Recession in 2008-2009 has benefited financial engineering over operating acumen. We experienced similar misallocations in the late 1990s, yet we successfully navigated through that challenging period by staying disciplined. With the recent return to positive real interest rates, businesses and investors will likely be sharpening their focus on the real cost of capital, which will require greater discernment in risk analysis.

Figure 3

(Source: J.P. Morgan Asset Management; Guide to the Markets®, U.S. 1Q 2024, as of December 31, 2023)

Fortunately, the team at Confluence has been managing small cap stocks since 1994, having consistently applied a philosophy focused on managing risk, where risk is defined as ***the probability of a permanent loss of capital***. More specifically, our process is centered on fundamental analysis that emphasizes owning competitively advantaged, quality businesses trading at attractive valuations with a long-term investment horizon. Over nearly 30 years, our investment process has consistently delivered solid downside protection and reduced volatility (see *Figures 4* and *5* on next page) by seeking businesses with sustainable competitive advantages, strong financial foundations, and trustworthy management teams. Confluence is well-positioned to navigate through the market cycles and capitalize on the opportunities presented, which are more plentiful in the current environment.

As investors contemplate small caps, their primary concern generally centers around the risk, as small caps have historically provided more upside but their smaller size, and often shorter tenure, heightens volatility and downside risk. Our philosophy of focusing on quality businesses trading at attractive valuations has a long history of dampening these concerns, allowing investors with the appropriate risk appetite to enjoy the benefits of small caps.

Confluence Small Cap Value vs. Small Capitalization Indexes

Figure 4

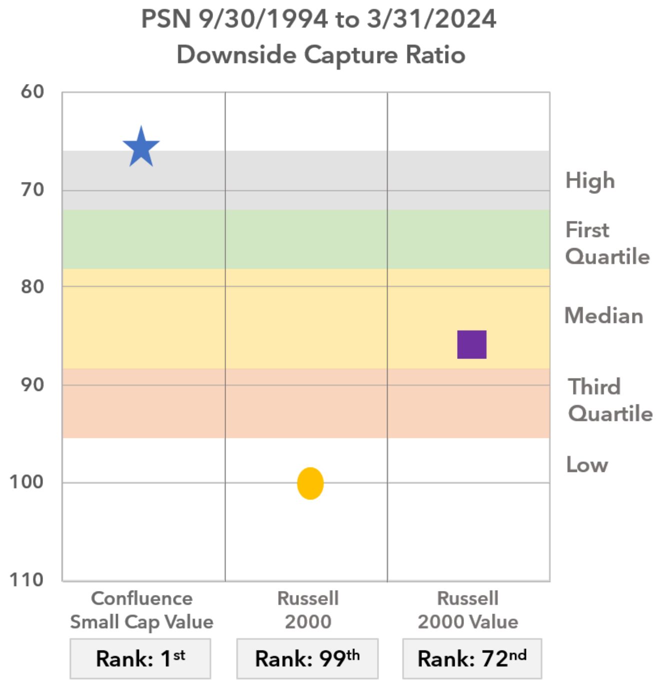
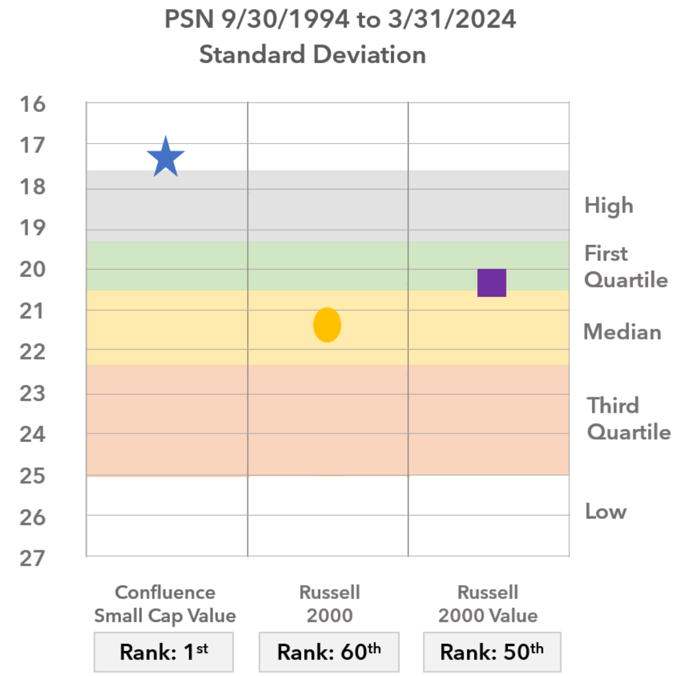


Figure 5



(Sources: Confluence, PSN)

Confluence Value Equities Investment Committee

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Figures 4 and 5: Data sourced from Zephyr's PSN SMA Database ("PSN"). This information is not intended to forecast or predict future performance. Past performance is not indicative of future results. Statistics and ratings are objective, based entirely on a mathematical evaluation of past performance, and based on gross-of-fee returns which do not reflect advisory, custody, financial intermediary, brokerage, commissions, or other fees the client will incur. Net performance information is available on the Confluence website. This content is provided for informational purposes and is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Downside Capture Ratio: Measures performance in down markets relative to index (down market: any quarter where the market return is less than zero); lower Downside Capture Ratio indicates manager protected capital better during a market decline. Standard Deviation: Measures price variability (risk) over a period of time. Ratings based on 32 'valid count' constituents in the PSN Small Cap Value universe for the time frame of 9/30/94-3/31/24. Confluence provides compensation to Zephyr PSN for use of their analytics systems/database as well as for permission to publish these ratings.

Indexes: The Russell 2000 and Russell 2000 Value are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

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