THE HISTORIC OPPORTUNITY IN SMALL-CAP VALUE

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Last week we hosted Chris Meredith, Director of Research, Co-Chief Investment Officer and a portfolio manager at O'Shaughnessy Asset Management (OSAM), on our "Behind the Markets" podcast. OSAM is a systematic factor investor that manages about $5 billion in quantitative strategies. Meredith joined OSAM in 2005 and is co-responsible for research, investing and trading at the firm.

At a time when growth has dominated value as an investment style, causing many to question their devotion to value disciplines, Meredith shared his work on what contributed to value's underperformance.

Why Does Value *Usually* Work?

Meredith highlighted his paper "Factors from Scratch" that shows how value stock pricing is often too pessimistic on future earnings trends, where earnings are lower than they are for most other firms but not as low as would be justified by their prices. The average discount is about 17%, but that valuation gap closes over the subsequent three years.

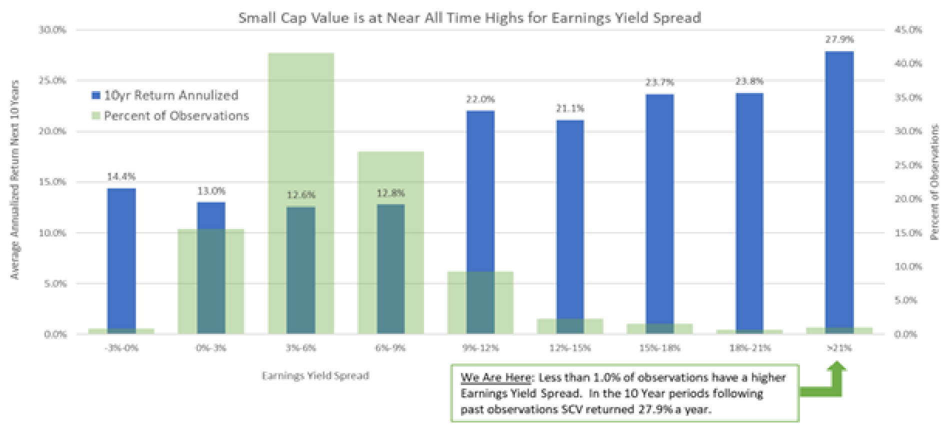
Most often, growth areas of the market are priced at such premium multiples that when those companies grow earnings at premium rates, the prices started so high that future growth rates inevitably disappoint. In other words, faster growth is already priced in, and it is difficult to live up to those elevated expectations. Yet over the last 12 to 13 years, the growth rates have nevertheless surpassed high expectations. Meredith thinks that will be a tough trend to uphold.

Historic Opportunity

There are a few different charts below that we discussed on the podcast and which illustrate how OSAM sees the current situation as unique for small-cap value investors, from a piece they published in April 2020.

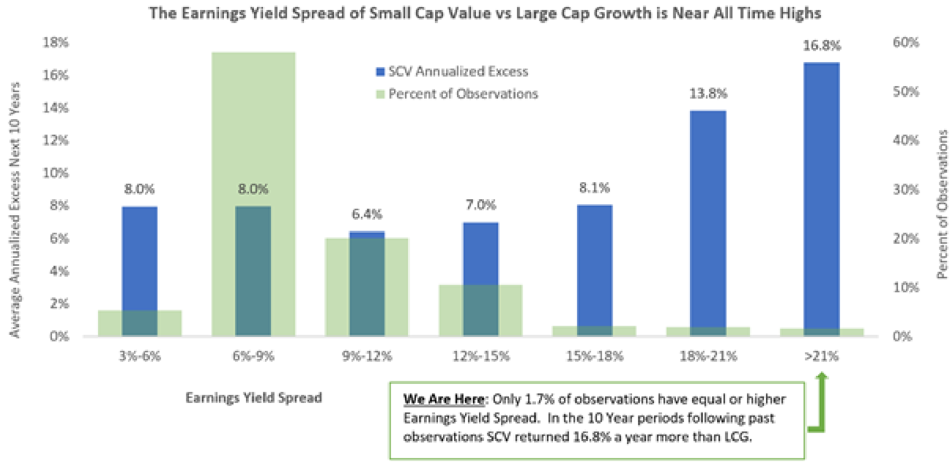
First, when measuring small-cap value earnings yields versus Treasury yields, historical spreads as wide as the current ones have occurred less than 1% of the time.

The 10-year forward-looking returns from various earnings yield spreads is also graphed, and they were dramatically higher the more the earnings yield spread over Treasuries widened.



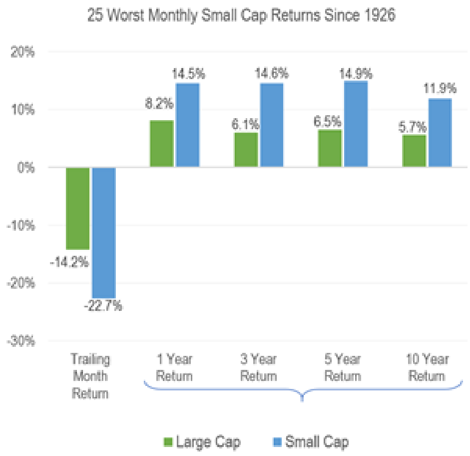
Source: O'Shaughnessy Asset Management, as of April 2020. Past performance is not indicative of futut results. You cannot invest directly in an index.

There was a similar relationship that held if one compared small-cap value earnings yields versus large-cap growth earnings yields, where yield spreads were this wide less than 2% of the time.



Source: O'Shaughnessy Asset Management, as of April 2020. Past performance is not indicative of future reuslts.

While the future is never exactly like the past, if one does not believe the [valuation](#) argument, past return patterns of underperformance similar to first quarter underperformance led to higher returns consistently one, three, five and ten years into the future.



Source: Ibbotson Associates, as of April 2020. Past performance is not indicative of future results.

We also talked about Canvas, a new investing platform the OSAM team is developing to help advisors manage their business and offer trading capabilities built on OSAM's separate account infrastructure. Canvas is still relatively early in its rollout, but the team is seeing strong engagement from their test clients on the platform.

This was a great discussion, and you can listen to the full conversation below.

Behind the Markets on Wharton Business Radio · Behind the Markets Podcast: Chris Meredith

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.