

THE SMALL CAP VALUE OPPORTUNITY

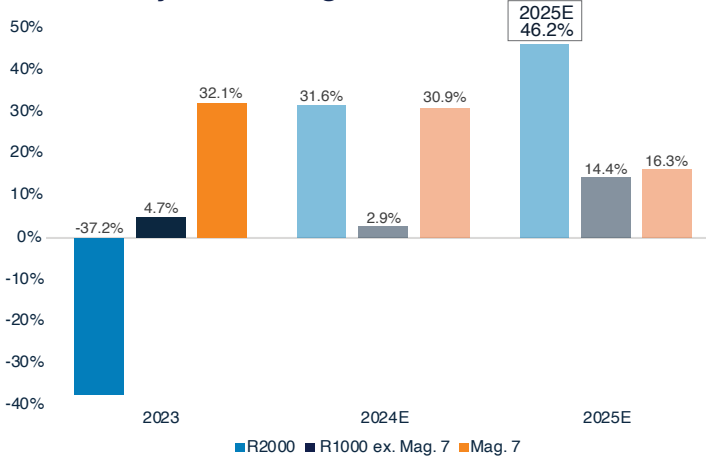
US small caps are trading at their cheapest valuations relative to large caps in nearly twenty-four years, resulting in what we believe is an attractive opportunity for investors to boost exposure to financially stable, small cap value stocks, that are projected to grow earnings at a faster rate than their large cap peers.

In 1992, academics Eugene Fama and Kenneth French unveiled their renowned three-factor stock return model, which included as one of the key variables the small-cap effect – specifically, that shares of smaller companies should outperform those of larger companies over the long term. Since the Global Financial Crisis (GFC), small caps have underperformed large caps by 285 basis points per annum¹; however, we do not consider today's performance disparity to be the new normal. We believe alpha-seeking investors should look to structurally profitable, cash-generating small-cap value stocks, with higher expected earnings growth and far cheaper valuations than overbought large caps.

THE FUNDAMENTAL CASE

We believe small caps are more attractive from an income statement and balance sheet perspective than the market is acknowledging. The so-called Magnificent 7, and consequently the S&P 500®, had nothing short of a magnificent run, but we believe the type of earnings growth that propelled them higher is moderating, whereas small caps' earnings are spring-loaded.

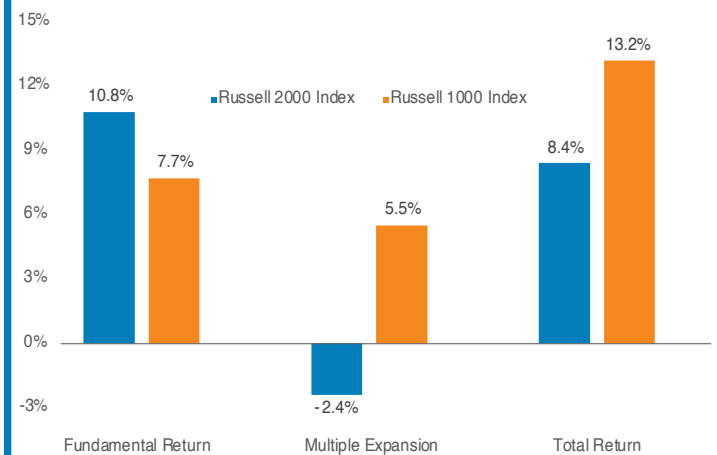
Year-over-year Earnings Growth



FactSet, Pzena analysis; year-over-year change in aggregate net income for index constituents

Valuation multiples fluctuate in the short term, but over time, stock prices tend to track earnings growth. Interestingly, since 2011, Russell 2000® Index companies have delivered faster free cash flow (FCF) growth than their Russell 1000® Index peers, yet their multiples have contracted. We don't believe this is sustainable over the long run; we believe it's a matter of when, not if, small-cap stocks will regain leadership.

Small vs. Large Performance Drivers Based on FCF Since Start of Latest US Large Cap Cycle (Mar 2011 - June 2024)



FactSet, Pzena analysis, from start of latest US Large Cap Cycle (Mar 2011 - Jun 2024)
Fundamental Return = dividend return + free cash flow growth. Analysis uses LTM free cash flow data. Free cash flow was chosen instead of the more commonly used GAAP EPS because write-downs and unusual expenses for small cap stocks are commonplace. All data annualized in US dollars as of June 30, 2024. Past performance is not indicative of future returns.

From a balance sheet perspective, smaller companies are generally more indebted than mega-cap corporations. But, as always, the devil is in the details. Excluding financial companies, which have inherently leveraged business models, nearly 50% of the Russell 2000 Index's \$863bn in net debt is concentrated in just 74 companies (none of which we currently own), representing 7.6% of the index's non-financial market cap².

Small caps also have relatively more floating rate debt, and their interest coverage ratios have therefore fallen in recent quarters amid the Fed's rate hikes. However, as rates eventually moderate, that relative headwind will start to become a tailwind. Indeed, the Russell 2000 Index's interest coverage ratio³ was 2.6x in 2Q22, just before the Fed began raising rates; today, that coverage has declined to 1.7x⁴. Our portfolio's non-financial interest coverage ratio is approximately 3x today and is expected to rise to 5.6x by 2025⁵, as earnings grow while interest costs normalize.

UNEARTHING SMALL CAPS' RETURNS

Small-cap skeptics often note that the Russell 2000 Index is full of unprofitable companies – and they are not wrong. Approximately 43% of Russell 2000 constituents posted negative net income over the past year, compared to just 13% of Russell 1000 companies. But nearly a quarter of the Russell 2000 loss-making names are biotech companies, which are not necessarily expected to be profitable⁶.

² FactSet, Pzena analysis

³ Operating profit / interest expense

⁴ FactSet

⁵ FactSet, Pzena analysis of median interest coverage ratios

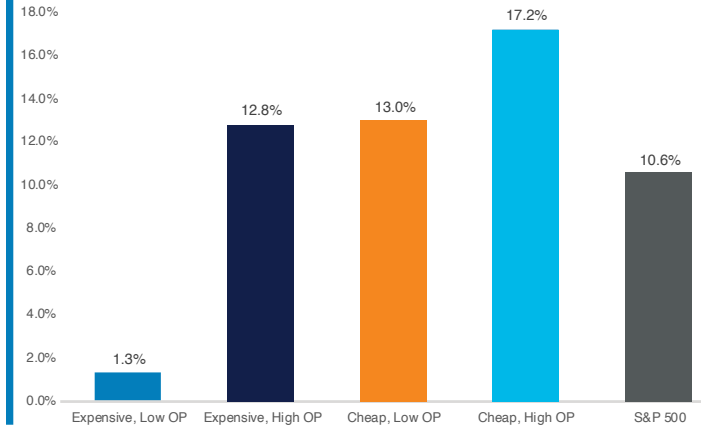
⁶ FactSet, Pzena analysis

¹ Kenneth R. French cap-weighted monthly data, Feb. 2009 – June 2024; small caps = smallest 30% of companies, large caps = largest 30% of companies

THE SMALL CAP VALUE OPPORTUNITY CONT.

Interestingly, the 2025 FCF yields of the two indices are currently identical at 4.5%¹. Still, it pays to be selective with small caps – to pick the most attractively valued names with high structural profitability.

Annualized Small Cap Returns by Valuation & Operating Profit (1963 – 2024)



Kenneth R. French cap-weighted monthly data, July 1963 – June 2024; small cap = smallest 50% of companies; cheap = first quartile of price/book; expensive = fourth quartile of price/book; high OP = fourth quartile of operating profit; low OP = first quartile of operating profit; OP is operating profits (sales – cost of goods sold – selling general and administrative expenses - interest expense) divided by book at the last fiscal year end of the prior calendar year. S&P 500 return sourced from Bernstein.

We believe the highest long-term returns are available to investors who sift through the small-cap universe and buy the cheapest names with the best fundamentals. The caveat is that these companies aren't necessarily in plain sight. A skilled active manager must uncover these names before their solid financial metrics are reflected in their valuations.

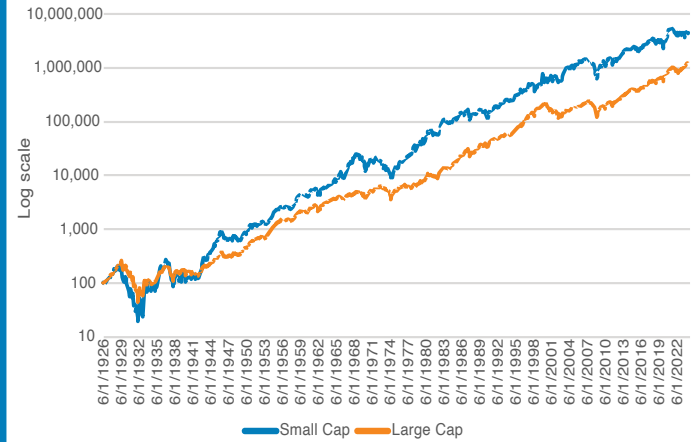
Below, we highlight a few of the Pzena Small Cap Focused Value portfolio metrics:

- Ninety-six percent of our portfolio companies were profitable on a net income basis over the latest fiscal year, with only two names expected to be loss-making for FY24¹.
- The portfolio's median forward earnings multiple is 13.7x; this compares to 15.0x for the Russell 2000 Value Index, 16.9x for the broad Russell 2000, and 20.3x for the S&P 500¹.
- Since its 1996 inception, the strategy has outperformed the S&P 500 by 206 basis points per annum, as well as its Russell 2000 Value benchmark by 265 basis points per annum, both net of fees. (See Exhibit A on page 3)

BREAKING DOWN SMALL CAPS' LOST DECADE

While far from spectacular, small caps' 6.7% annual return over the past decade is hardly a disaster, and only looks deficient when compared to large caps' stellar 13.2% print. None of the various explanations for the performance delta make a convincing case that smaller, higher beta, less informationally efficient stocks are somehow less attractive today than they have been throughout history. And that historical performance advantage is material: 142 basis points per annum over the past 98 years.

98 Years of Small Cap Outperformance



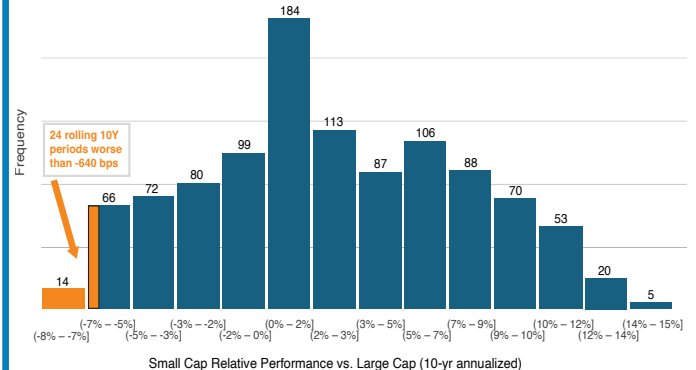
Kenneth R. French cap-weighted monthly data, July 1926 – June 2024; small cap = smallest 30% of companies, large cap = largest 30% of companies

The initial post-GFC recovery was characterized by slow growth and ultracheap financing – an environment conducive to venture capital and public growth investing. Nonetheless, cheap, small-cap stocks held their own, benefitting from the domestic economic recovery and 2016 post-election reflation trade.

The US economy continued to expand into 2017/18, but the volatile period was largely mired in global trade wars, rising interest rates, and recession concerns. This uncertainty led investors to perceived safety stocks – namely, expensive growth companies expected to deliver steady earnings regardless of the economic backdrop. From there, the valuation gap exploded. Following their historic drawdown in 2022, mega-cap growth stocks regained the ascendancy on enthusiasm over AI, while higher-for-longer rates benefitted the biggest companies, given their huge piles of cash and mostly fixed-rate debt.

Although the performance of small and large caps really started to diverge around 2018, market pundits have primarily focused on the last decade of activity. Small-cap bears have plenty of ammunition; the large cap performance advantage is 640 basis points per annum over the past 10 years. That's clearly material, but how does it compare to history? Though rare, rolling 10-year periods (monthly intervals) of large cap dominance have occurred before, and we've witnessed worse periods – 24 of them, between 1926 and 2024, to be precise.

Frequency of Rolling 10-year Relative Returns



Kenneth R. French cap-weighted monthly data, July 1926 – June 2024; small cap = smallest 30% of companies, large cap = largest 30% of companies

¹ FactSet as of July 2024

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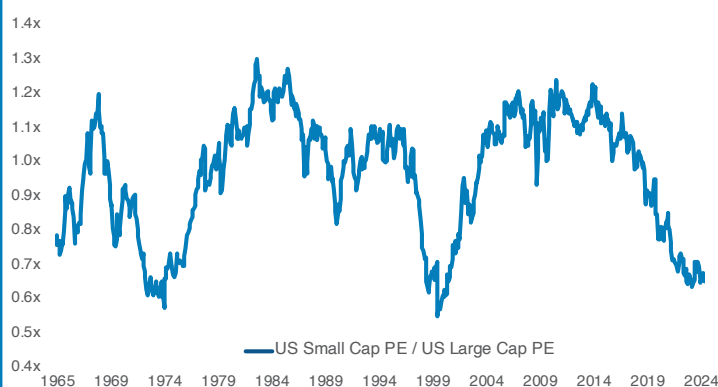
Each of these 24 periods occurred in the 1990s, when the “small cap is dead” calls were as ubiquitous as they are today. That was immediately before the Russell 2000 Index outpaced the 1000 series by 42 percentage points over the decade following the dot-com peak¹.

The key takeaway is not when and by how much small caps have underperformed historically, but how the cohort performed following these rare periods. Of the 232² rolling 10-year periods between 1926 and 2014, in which small caps underperformed their large caps peers, their fortunes reversed 86% of the time over the subsequent decade, and the average small cap outperformance for all 232 periods was 420 basis points per annum.

CONCLUSION

The multi-year, extreme multiple expansion of US large caps has manifested in a small-cap relative valuation discount approaching the 1974 Nifty Fifty trough level, which occurred just before small caps trounced large caps by nearly 13 percentage points³ per year over the subsequent decade.

US Small Cap & Large Cap Relative P/E Ratio



Empirical Research Partners, Pzena analysis. Large Cap = Largest 1000 US stock universe. Small Cap = Next 2000 largest stock universe. Trailing price/earnings data from January 31, 1965 – June 30, 2024.

We believe the conditions exist for US small caps to experience a powerful and sustained rotation, and our concentrated portfolio of structurally profitable businesses, trading at a discount of over 30% to the market, with higher expected earnings growth, is poised to disproportionately benefit from a changing of the guard. ■

¹ Russell 2000 vs. 1000, TR August 2000 – August 2010

² July 1926 – June 2014 (the limit of 10-year forward return calculations)

³ Kenneth R. French cap-weighted monthly data, Dec. 1974 – Dec. 1984; small cap = smallest 30% of companies, large cap = largest 30% of companies

EXHIBIT A

Annualized Returns

Returns in USD	July 2024	Year to date	One Year	Five Year	Ten Year	Since Inception 1/1/1996
Pzena Small Cap Focused Value Composite—Net*	11.9%	10.6%	20.6%	13.0%	10.3%	12.1%
Russell 2000® Value Index	12.2%	11.2%	15.7%	9.5%	8.1%	9.4%
S&P 500® Index	1.2%	16.7%	22.1%	15.0%	13.2%	10.0%

Returns through July 31, 2024

Past Performance is not indicative of future results.

Net Returns are derived using a model fee applied monthly to Gross returns. Pzena uses the highest tier fee schedule, excluding performance fees, to illustrate the impact of fees on performance returns. As product fees change, the current highest tier schedule will be in effect.

CALENDAR YEAR RETURNS

	2019	2020	2021	2022	2023
Small Cap Focused Value - Gross	26.7%	1.4%	30.5%	-5.8%	26.7%
Small Cap Focused Value - Net	25.5%	0.3%	29.2%	-6.8%	25.5%
Russell 2000® Value Index	22.4%	4.6%	28.3%	-14.5%	14.6%
S&P 500® Index	31.5%	18.4%	28.7%	-18.1%	26.3%

Returns could be impacted, positively or negatively, by currency fluctuations, where applicable.

Gross rates of return are presented gross of investment management fees and net of the deduction of transaction costs. An investor's actual return will be reduced by investment management fees. Net Returns are derived using a model fee applied monthly to Gross returns. Pzena uses the highest tier fee schedule, excluding performance fees, to illustrate the impact of fees on performance returns. As product fees change, the current highest tier schedule will be in effect.

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The Russell 2000® Value Index measures the performance of small-cap value segment of the US equity universe. It includes those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The S&P 500® Index seeks to track the performance of an index composed of 500 large-cap U.S. companies. These indices cannot be invested in directly.

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