RADIANT ESG

WHY SMALL CAP NOW?

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SUMMARY

US smaller companies offer a specific long-run advantage in terms of their positioning as the drivers of innovation at the heart of the transformation of the US economy. Pair this with the increased inefficiency linked to ESG and the increased possibility of 'soft landing', and the time starts to feel right to consider small cap stocks.

WHY INVEST IN US SMALLER STOCKS NOW?

We see a unique investment case for US smaller stocks now. The classical arguments about inefficiency are a legitimate starting point, but we see even greater opportunity for active management being introduced by ESG and Impact. And, while the US economy is most definitely still working through the dual effects of inflation and interest rate increases, the time seems to be right to prepare for 'what's next?'. Finally – and most importantly – we believe that there is an excellent long-run case for investing in companies that sit at the nexus of the transformation of the US' infrastructure, power supply, transport, and healthcare.

EXTENDING THE CLASSIC INEFFICIENCY ARGUMENT

Traditional arguments around inefficiency only grow stronger when ESG enters the picture.

The classic small cap inefficiency argument goes as follows: the average number of analysts covering stocks in the Russell 2000 is 4.8 compared to an average of 13.5 analysts covering stocks in the large cap Russell 1000 Index[1]. While the Large and Mega Cap names represent a greater percentage of market cap, there are far more small stocks by count. Fewer eyes spread across more stocks translates to greater alpha opportunity for those with 'informed breadth'.

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[1] Source: S&P Capital IQ as of 31 Dec 2022. And it should be noted that 7.7% of the Russell 2000 Index has 1 or no analyst coverage.

Now add the requirement that ESG be considered, and the inefficiency argument only grows stronger. Most major data providers now boast ESG ratings for the bulk of smaller US stocks[2], but as has been well documented, there can be significant disagreement across vendors when it comes to company-level ESG bona fides. To be clear, we see nothing wrong with this. This disagreement should be welcomed in the same way we welcome lack of uniformity on the definition of 'value', or dispersion across GDP growth assumptions. But it is important to recognize that the disagreement itself only adds to the aggregate inefficiency in the market. Additionally, because we believe that we can do a better job uncovering opportunity via a more nuanced, multi-dimensional approach to ESG and impact analysis, we believe we are uniquely positioned to take advantage of yet another source of inefficiency stemming from the one-dimensionality of most ESG 'scores'. As active managers who believe that the information sitting under the ESG banner is a necessary complement to traditional financial statement data, we seek a more robust understanding of where a company is headed with respect to its ESG journey, not just where it sits today. This is especially important for smaller, growing companies that may be at the beginning of their ESG evolution. We need to understand how competitive these companies are and how they are preparing for a future that will likely look very different than the past by examining the effectiveness of their Boards, shareholder protections, labor relations, how much water a company uses, supply chain risks, whether the company is using more or less energy or is polluting more this year than last year… all of these things help us gauge the true set of threats and opportunities facing companies. In our view, management that is committed to a positive path of ESG travel will have a distinct advantage relative to peers[3]. To identify these companies, we have developed a proprietary ESG and impact model that leverages a nimble data infrastructure specifically designed to harness the power of a variety of data sources that are notoriously difficult to work with.

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[2] While we appreciate the drive on the part of large data vendors to increase their coverage to small and smid caps, we estimate that a little over 20% of the Russell 2500 Index does not have the threshold amount of data that we need to form what we believe to be a robust view of the true set of ESG risks and opportunities faced by companies.

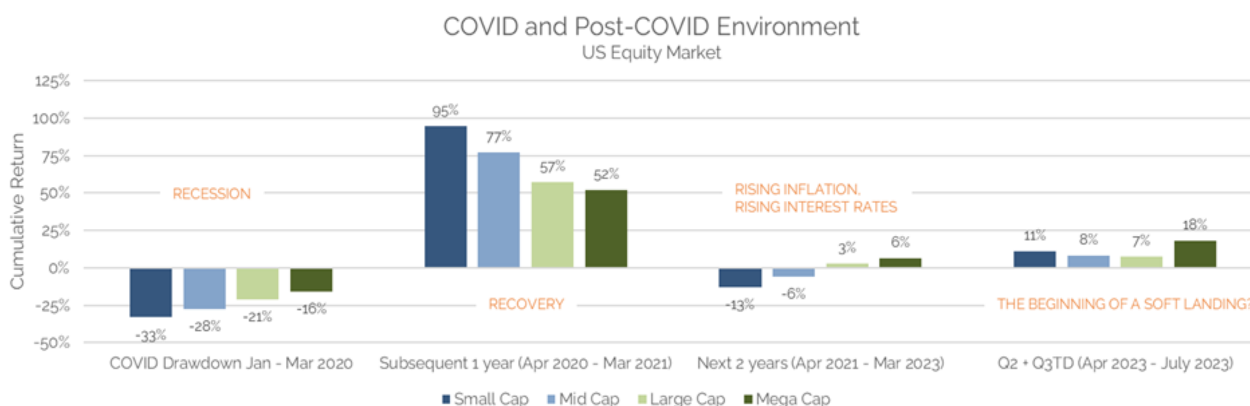
[3] It is our opinion the companies with stronger ESG and impact characteristics, ceteris paribus, will experience stronger risk adjusted returns over time and may even prove to be more attractive as acquisition targets.

All told, the combination of fewer traditional analysts covering a name, the disagreement in ESG ratings across the major data vendors, and the challenges of truly robust, forward looking ESG analysis leads to greater inefficiency in the small cap end of the market… which can translate into alpha opportunity for those willing to roll up their sleeves, instead of just throwing up their hands.

IMPLICATIONS OF A 'SOFT LANDING'

There may be a specific opportunity right now for a good small cap entry point as investor consensus has shifted toward a 'soft landing' (or at least a less terrible landing than many expected)

Smaller stocks have traditionally done well as the market transitions out of a recessionary phase into a recovery rally, as investors pivot from a risk-off to a risk-on footing. The returns of US equities during the recent Covid and Post Covid periods are consistent with historical patterns – during the COVID sell off in the first quarter of 2020, smaller names lost more value than large caps, but in the subsequent recovery rally, they outperformed significantly. It was during the next two years (Apr 2021 – Mar 2023) that inflation, initially deemed 'transitory' by the Fed, became a more sticky and menacing threat. As the market first anticipated rising rates, then the Fed formally acted on a promise to bring inflation down to 2%, equity returns flatlined, with investor preference turning back toward large cap companies as it typically does in 'risk off' scenarios.



Source: RadiantESG Global Investors. Mega Cap stocks are defined as companies in the top 40% of market cap, Large Cap are the next 35%, Mid Cap are the next 15%, and Small Cap are the next 9.5%. Micro Cap – not shown here – represent the bottom 0.5% of the US stock market.

Fast forward to the summer of 2023: increasing evidence to support the 'soft landing' scenario has mounted, causing most market pundits to downward-revise their probability of recession[4]. While we are likely not out of the woods yet with respect to macro challenges, the coming environment is looking less like doom-and-gloom, and more like positive, but subdued growth. There is good reason to believe that an *avoided* recession, marked by inflation continuing to cool and the labor market remaining resilient, may spark the kind of rally that is typically good for smaller stocks. With the important caveats that 1) precise asset class timing is folly, and 2) we are wise not to assume that the risk of recession has disappeared completely[5], it is undeniable that there are better and worse entry points for smaller capitalization investing as we move through the earnings cycle. This indeed may be one of the better ones.

LONG RUN TAIL WINDS

Perhaps most importantly, there is an excellent long-run case for smaller stocks, especially small cap growth

Information Technology, Industrials, and Healthcare dominate the smaller end of the capitalization spectrum. The good news is that this is where innovation lives. Many smaller companies are poised to help transform our nation's infrastructure, our energy grid, our methods of transportation and the way we manage health. Smaller companies are typically either pure-play or limited in the number of business lines in which they operate, and by and large, they are deeply connected to, and dependent on, the local economy. Many are primarily suppliers to larger companies and are specialized in their product offering in a way that has allowed them to pass along the increased costs of the recent inflationary environment to their customers.

Current massive government spending initiatives are pushing money toward parts of the economy that will depend on the type of innovative products and services being produced by smaller companies in the US. In conjunction with the Infrastructure Investment & Jobs Act and the CHIPS Act, the Inflation Reduction Act

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[4] See Goldman Cuts US Recession Chances to 15% With Cooling Inflation - Bloomberg and 'Imagine no recession, it's easy if you try,' BofA says | Fortune
[5] Soft Landing Optimism Is Everywhere. That's Happened Before. - The New York Times (nytimes.com)

(IRA) implies that the US federal government is set to triple its average annual spending on climate and clean energy this decade compared to the 2010s[6]. Of the approximately $400B in the IRA, tax incentives to corporations represent the biggest slice with most going toward incentivizing clean electricity and manufacturing, with transport and cross-industry technologies (like carbon capture) also getting sizeable chunks. Many of the companies in the US smid- and small-cap space create products that are critical components of electric vehicles, solar inverters, smart metering, and green building materials, for example, and are responsible for early-stage scaling of potentially revolutionary technologies like bioplastics and green hydrogen. They are poised to benefit directly from these incentives or benefit indirectly by virtue of being niche suppliers to larger firms.

When it comes to Healthcare, the US is currently undergoing a radical transformation in terms of the way we deliver care (as sparked by the COVID crisis, extending through to the current nursing shortage), the technologies at the forefront of disease detection, treatments used to fight chronic conditions like diabetes, cancer, and heart disease with novel infusion drugs or biologics, and even advancements in wearable devices for condition management. There is a flourishing of opportunity within US Healthcare now, and much of it resides within smaller, nimble firms.

But not all innovative companies will meet with financial success. We believe that identifying the winners of tomorrow means evaluating these opportunities through both traditional financial models contextualized to find opportunity within smaller stocks, as well as through a sustainability lens which includes an emphasis on impact as well as ESG. This leads to investments that sit at the intersection of strong fundamentals and compelling ESG/impact profiles, ultimately capitalizing on the long run case for smaller company investments.

LOOKING FORWARD

In sum, smaller companies are at the heart of innovation, in large part because of the critical role they play as specialized suppliers to bigger firms. Small cap stocks

[6] US Inflation Reduction Act: A catalyst for climate action (credit-suisse.com)

allow investors to access opportunity in this space, but we believe it is critical to invest only in companies that are both gaining financial traction and those with compelling ESG or impact stories – taken together, we believe these features point us toward the likely winners of the future, with ESG and impact information acting not as an expression of *'values'* rather an arbiter of future 'value' in the face of a changing competitive landscape. With the probability of recession decreasing, we see now as an excellent time to contemplate adding to a small cap allocation.

At RadiantESG, we are committed to investing at the intersection of strong fundamentals and compelling ESG to build portfolios that will help our clients meet their investment goals.

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