Small-cap Value Stocks: An Overlooked Opportunity

by Westwood's U.S. Value Team

May 15, 2015

Strong long-term performance has historically driven robust investor demand for the U.S. small-capitalization (cap) value asset class. While 2014 performance was not as strong as in recent years, we believe the asset class, and small-cap value in particular, is set to continue its long-term trend of outperformance relative to larger-cap stocks.

Why Small-cap Value Stocks?

We see two prime advantages for small-cap value stocks:

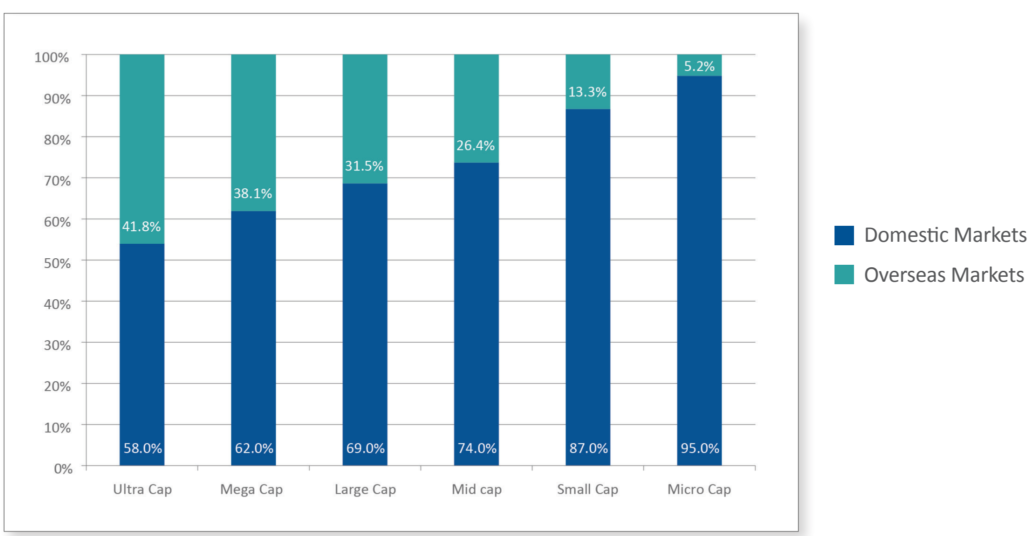
1. Due in large part to their significant growth potential, small-cap stocks tend to outperform large-cap stocks over time.
2. Value stocks can, in the right circumstances, generate competitive returns compared to their growth stock counterparts due to more favorable valuation characteristics that create attractive upside potential.

The Opportunity for Small-cap Value Investors Today

Small-cap stocks may be in a position to benefit from a notable trend that has been occurring since mid-2014 – the strengthening of the U.S. dollar in comparison to other currencies. Additionally, the stronger dollar reduces net earnings from sales made in overseas markets, often with a negative impact on the bottom line of companies doing business in foreign markets. As Figure 1 shows, larger-company stocks, with a notable percentage of sales from overseas markets, may be particularly vulnerable to the impact of an improving dollar. As a result, earnings for large-cap stocks may suffer, while smaller companies should be better positioned to withstand the currency environment given the modest contribution of foreign sales to their bottom lines.

Percent of Sales in Domestic and Overseas Markets

[Figure 1]



Source: Cornerstone Macro, 4th Quarter 2014.

When considering earnings growth expectations for this year, small-cap companies are poised for growth, especially compared to large-cap. Projected earnings growth for S&P 500 stocks are expected to drop from 6.8% in 2014 to 2.8% in 2015. Meanwhile, small-cap company profits are anticipated to grow faster in the coming year. Earnings in the Russell 2000 Index are projected to increase by more than 10% in 2015, compared to approximately 8% in 2014*.

What Happens to Small-cap Value Stocks as Interest Rates Move Higher?

Small-cap companies, with performance tied closely to the prosperity of the U.S. economy, should see business improve as the economy accelerates, which is a likely prerequisite for higher interest rates. The markets have historically favored small-caps in a flat-to-rising interest rate environment, as Figure 2 illustrates.

1-Year Relative Return vs. Fed Funds Rate

[Figure 2]

Source: Fundstrat Global Advisors, July 1, 1993 to May 8, 2015.

Another more recent example is the "taper tantrum" that took place in 2013. It was created by expectations that the Federal Reserve (Fed) would scale back, or "taper," its quantitative easing (QE) program and increase rates. With that expectation, small-cap and value stocks proved to be favorably positioned compared to the rest of the equity market, as shown in Figure 3. A similar pattern could occur if rates begin to creep up, leaving small-cap and value stocks well positioned relative to other equity asset classes.

Returns During 2013 "Taper Tantrum"

[Figure 3]

Index	Return
S&P SmallCap 600	**10.4%**
S&P 500 Pure Value	10.4%
Russell 2000	9.5%
S&P 500 Pure Growth	7.1%
S&P MidCap 400	4.0%
S&P 500	3.6%
S&P 100	2.9%

Source: Strategas, "Taper Tantrum" period is from 10-Year Treasury Yield trough (May 2, 2013) to peak (September 5, 2013).

**Furey Research Partners and FactSet.*

Benefits of Westwood's Management Style in Today's Environment

The stock market has experienced an extended period of relatively consistent returns generated across stocks of varying quality. This environment benefited broad swaths of the market and was partly a response to the Fed's efforts to add liquidity to the economy through the QE program. Now that the QE program has ended and the economic recovery is maturing in the United States, investors are likely to be more discriminating. As the bull market extends into its seventh year, stocks have also been encountering increased volatility.

Active management and well-researched stock selection can make a significant impact on portfolio management, especially in the small-cap stock arena, where fewer companies are closely monitored by research analysts.

At Westwood, we have been managing SmallCap Value portfolios with strong risk-adjusted returns since 2004. We have employed the same research process since our firm's inception in 1983, which utilizes proprietary fundamental research, bottom-up portfolio construction and diligent risk management. Proprietary fundamental research, a key benefit of Westwood's investment process, is critical to our goal of building a portfolio of well-positioned, small-cap value stocks. We have four portfolio team members supported by 17 fundamental research analysts, who are all sector specialists, covering stocks across the market-cap spectrum. Our managers fully leverage the knowledge of our investment team to identify smaller companies with undervalued earnings growth potential. This method is designed to avoid "value traps," as portfolios are aligned with earnings growth. The portfolios we manage are "true" small-cap value, concentrated portfolios with a maximum of 70 holdings. Our average-weighted market cap is $1.4B as of March 31, 2015. In addition, we manage our position sizes, which are initially targeted at 2%, such that positions rarely exceed 2.5% of the portfolio.

We believe this is the most effective way to position our small-cap value portfolios for long-term capital appreciation.

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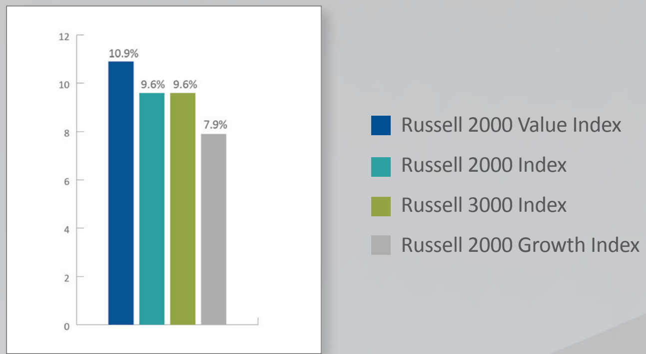
Small-cap Value Stocks Long-Term Story

The benefit of owning small-cap value stocks within a diversified portfolio is demonstrated in the long-term, historical track record. Over a 20-year time horizon (ending March 31, 2015), small-cap value stocks have outperformed: the broader U.S. market, the small-cap universe in general, and small-cap growth stocks, as shown in Figure 4.

20-Year Performance Comparison

[Figure 4]



Source: Russell, as of March 31, 2015. Returns are annualized.

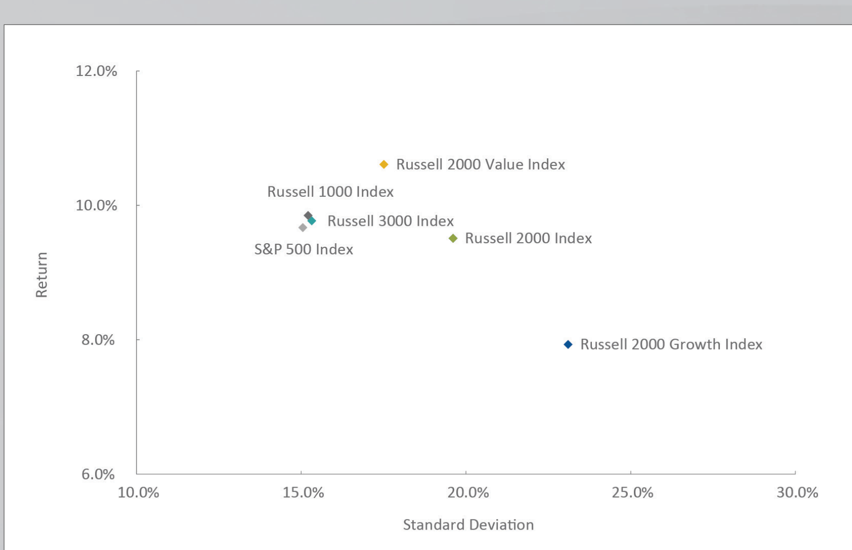
Performance trends vary over time, but the record of these Russell indices is an indication of the underlying benefits that we believe can be obtained from small-cap value stocks over the long term.

Favorable Risk-adjusted Return Characteristics

Based on the Russell indices, small-cap value stocks exhibit risk-return characteristics that look attractive compared to other equity asset categories. The Russell 2000 Value Index has generated higher risk-adjusted returns compared to the similar small-cap growth index and the broader Russell 3000 Index. This historical comparison indicates that investors can seek to enhance portfolio returns using small-cap value stocks without significantly adding to a portfolio's risk, as shown in Figure 5.

Risk/Return Profile

[Figure 5]



Source: FactSet as of March 31, 2015. Annualized index data from March 31, 1995 to March 31, 2015.

We are confident that investors will benefit from investing in the Westwood SmallCap Value strategy today. Please contact your Westwood representative to learn more about our SmallCap Value offerings and how it may be incorporated into your investment strategy.

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200 Crescent Court, Suite 1200, Dallas, TX 75201

214.756.6900 | www.westwoodgroup.com