August 2017

The Incredible Shrinking Stock Market & the Case for Small Cap Investing: The Supply-Demand Imbalance Continues

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About Palisade
Palisade Capital Management, L.L.C. ("Palisade") is an independent registered investment adviser and has been registered with the SEC since February 1995. Palisade's investment philosophy of comprehensive, bottom-up, fundamental investing has remained constant for over 20 years. Our Firm has managed Small Cap Core Equity and Convertible Securities portfolios for institutional investors and Private Wealth Management portfolios for high net worth individuals since our company's inception. Palisade's offerings have also expanded and evolved to meet the changing needs of our clients, including the development of alternative investment strategies through private funds.

Acknowledgement:

I would like to thank my friends at Furey Research Partners for their invaluable contributions to this essay.

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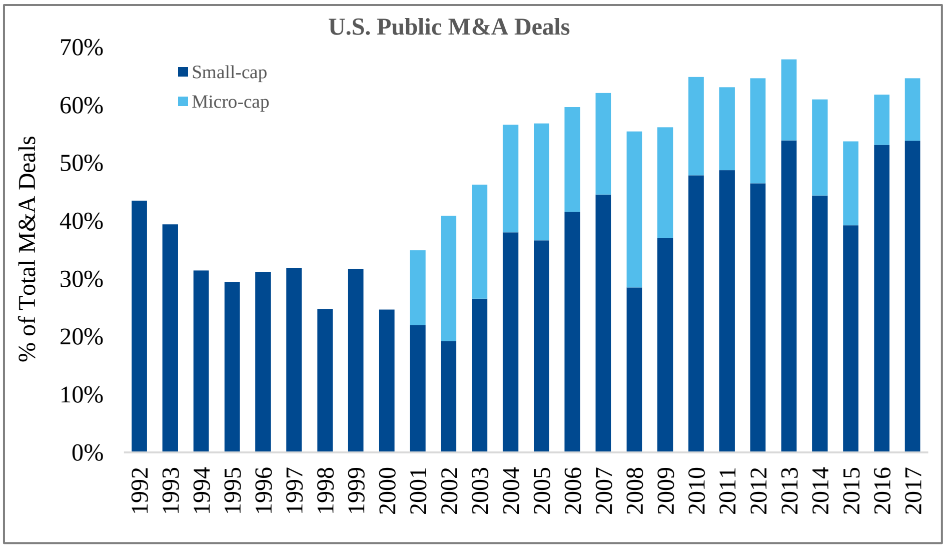
In 2013, I wrote an essay that focused on market dynamics that would continue to put upward pressure on all stocks, but would have a greater impact on small cap stocks. As I look today, the same dynamics remain in place and can potentially be a catalyst for a shift to small cap leadership. From July 31, 2013 through July 31, 2017, to the dismay of many, U.S. equities have out-performed global markets and returned 12.08% for the Wilshire 5000® Index and 9.56% for the Russell 2000® Index on an annualized basis. Institutional and individual investors remain concerned, confused, and in many cases, angry about the duration and strength of this rally. The bull market continues despite market strategists advising investors to rotate out of U.S. equities, which have been perceived to be expensive, and into European and Emerging Markets where overall valuations have been deemed relatively cheap. Over the same period of time, the MSCI EAFE Index has returned 5.09% and the MSCI Emerging Markets Index has returned 4.05% (annualized), perhaps reinforcing the old adage that you get what you pay for. Adding to investor confusion is the historic election of Donald Trump and the apparent inability of the Republican-controlled Congress to get anything done in the first six months of the new administration. With all of these apparent headwinds, other factors are clearly driving positive market returns. I believe the following factors have contributed to the recent market gains, and that they will continue to have a significant impact on stock market returns, particularly within the small cap universe, over the next several months:

The stock market, relative to its returns, continues to shrink. The number of companies listed on a major exchange has only risen modestly from 4,921 in July 2013 to 5,215 in June 2017. Similarly, the number of companies in the Wilshire 5000® Index has been essentially flat, consisting of 3,563 names in July 2013 compared to 3,465 in June 2017. In fact, the full market capitalization of the Wilshire 5000® Index only increased approximately 30% while the index had a cumulative return of more than double that (approximately 63%) over the same time period.[1]

Merger and acquisition activity remains robust, especially for small cap stocks. As the chart below illustrates, M&A activity for small cap and micro cap companies has been at elevated levels for the better part of the last decade (Figure 1).

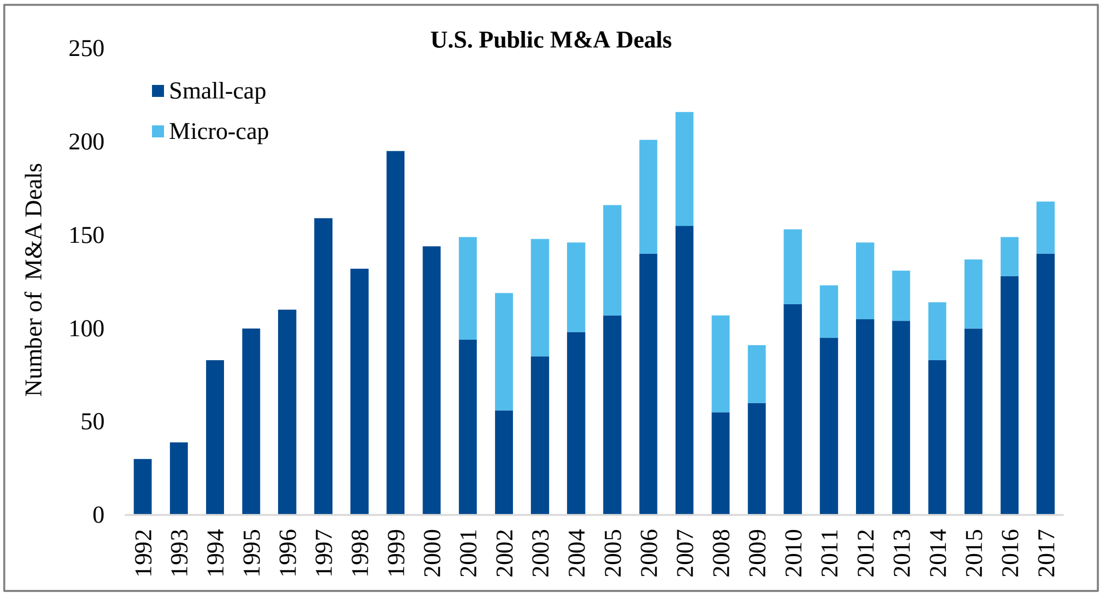
<u>*Figure 1: Small and Micro Cap M&A Deals as % of Total Public M&A Deals*</u>



Source: Furey Research Partners and FactSet, as of 6/30/17. 2017 figures represent data through June 30.

Additionally, the number of transactions involving small cap companies is beginning to accelerate again after peaking in 2007 (Figure 2).

Figure 2: Number of Public Deals



Source: Furey Research Partners and FactSet, as of 6/30/17. 2017 figures represent data through June 30.

Clearly, below-trend GDP growth has created a challenging environment for companies to grow organically. Very low interest rates and favorable debt markets have been a catalyst for accretive acquisitions paid for with cash. Small companies have been particularly attractive targets because they typically dominate smaller market niches. Acquirers often come to the conclusion that buying is less expensive than building. As cash deals are completed, that investor cash is typically recycled into other small cap stocks resulting in underlying demand for the asset class. The potential for repatriation of overseas cash by multinational corporations could also stimulate additional merger activity involving many smaller cap companies.

While IPO activity has accelerated, it is below trend and not keeping pace with companies being taken out of the market due to merger activity. Private companies seeking growth capital have more options today than in past cycles. According to the 2017 Preqin Global Private Equity and Venture Capital Report, private equity assets under management have reached an all-time high of $2.49 trillion as of June 2016 while, according to a survey by PwC, the value of venture capital investments in the United States was near an all-time high as well at approximately $58.59 billion in 2016.[2] Large capital allocators are increasing their exposure to private equity and alternative investments while reducing allocations to public equities and hedge funds. Though less liquid, returns for private equity and venture capital have been competitive with public equities over three, five, and ten year time periods as evidenced by the Cambridge Associates U.S. Private Equity and Cambridge Associates U.S. Venture Capital Indices returns (Figure 3).[3]

Figure 3: U.S. Private Equity and Venture Capital Index Returns as Compared to Public Equity Indices

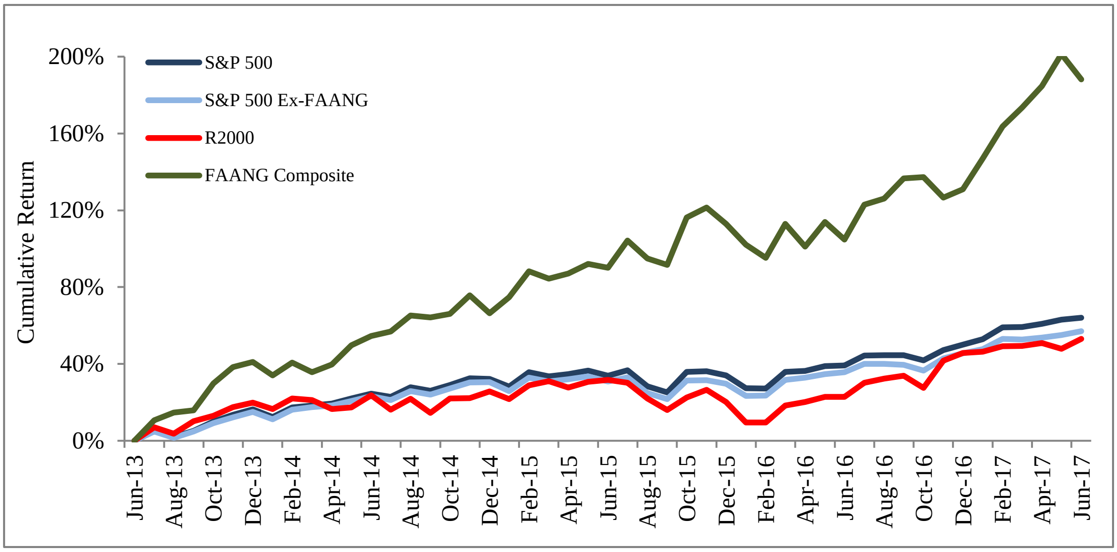
	3 Yr	5 Yr	10 Yr
CA U.S. Private Equity[3]	**10.0%**	**13.2%**	**10.0%**
CA U.S. Venture Capital[3]	**11.7%**	**14.0%**	**9.4%**
Russell 2000® Index[4]	6.7%	14.5%	7.1%
S&P 500® Index [5]	8.9%	14.7%	7.0%

Periods ended 12/31/2016.

Private equity and venture capital returns are generally not highly correlated to equity markets during times of stress and can provide a bit of cushion during periods of weakness. Private company valuations do not change instantly the way public company valuations do but, rather, are revalued over time easing downward pressure on overall portfolio returns. Also, thanks to Sarbanes Oxley and other regulations, companies need to be bigger and have more critical mass to support the additional expense of lawyers, accountants, and consultants. The current administration's focus on reducing regulations could, over time, drive the cost of capital down and make public ownership more attractive.

Small cap stocks have under-performed large cap stocks from July 2013 through June 2017 but the gap is not as great as it appears. Though the Russell 2000® Index of small cap stocks has underperformed the S&P 500® Index over this period, the out-performance of a few mega-cap stocks, collectively known as FAANG (Facebook, Amazon, Apple, Netflix, Alphabet (fka Google)), masked broader weakness in the S&P 500® Index, particularly in 2015 (Figure 4).

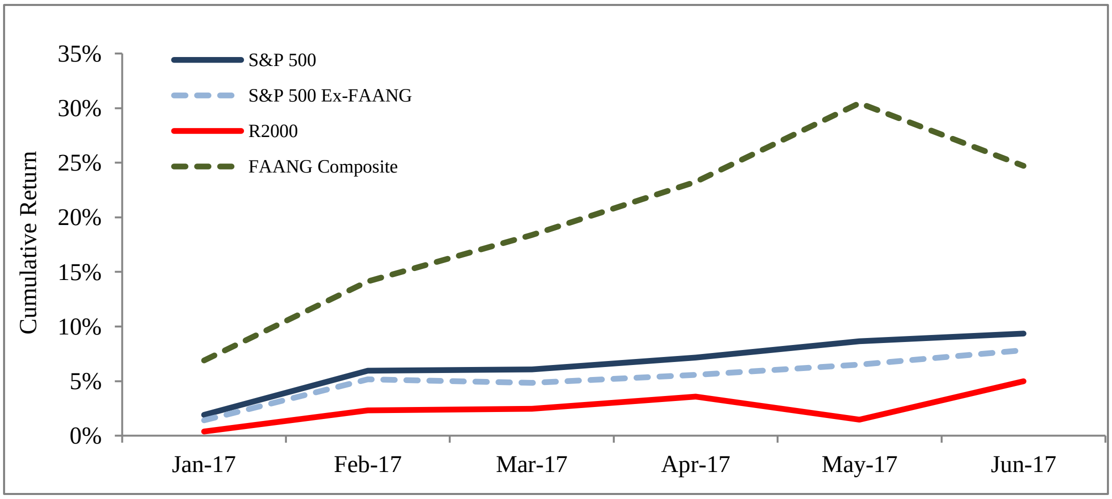
Figure 4: S&P 500®, S&P500® ex-FAANG Composite, Russell 2000®, FAANG Composite, Cumulative Returns June 2013 – June 2017[6,7]



Source: Palisade, FactSet. As of 6/30/17.

So far, 2017 looks a bit like 2015 as FAANG continues to help the S&P outperform the Russell (Figure 5).

Figure 5: S&P 500®, S&P500® ex-FAANG Composite, Russell 2000®, FAANG Composite, YTD Cumulative Returns Through June 2017[6,7]



Source: Palisade, FactSet. As of 6/30/17.

The catalysts are in place for the Russell 2000® to stage a comeback relative to the S&P 500 ®. The surprise election of Donald Trump ignited a powerful rally led by small cap stocks. The president was elected on a platform of bringing manufacturing back to the U.S. and revitalizing industries and jobs that have been lost to foreign competitors. Considering that the constituents of the Russell 2000® Index derive approximately 80% of their revenue from the U.S., the "buy American goods" mantra creates a tail wind for those domestically-focused small cap companies.[8] The administration and Congress have focused on reducing the corporate tax rate and reducing regulations for a variety of industries. The resulting "Trump Trade" effect can be seen in the performance of financials and domestically-focused industrial companies that have rallied considerably post-election because they stand to be the most significant beneficiaries of less regulation and lower tax rates. Though recent legislative stumbles by Congress and the administration have created some uncertainty on the timing and size of potential tax cuts, the trend to eliminate unnecessary regulations does not necessarily require Congressional approval and is a major factor in the increase in business optimism. Additionally, repatriation of overseas cash could generate enormous tax revenues (in addition to serving as the aforementioned potential boon for merger activity) that could be used to offset the costs of lower corporate taxes.

Infrastructure spending means more than bridge and road repair. When President Obama was elected, he emphasized investment in clean technologies like wind, solar, and nuclear while de-emphasizing fossil fuel. Despite these priorities, a technological boom in fracking and other extraction and discovery techniques dramatically led to increased U.S. production of oil and natural gas. This in-turn reduced our reliance on foreign energy sources and has potentially positioned the U.S. as an exporter of energy products, particularly liquefied natural gas, to countries that need a reliable energy source. However, the U.S. infrastructure was designed to import energy products. I believe that there is potential for an elevated level of capital spending in the U.S. to reverse this stream and allow for these exports to occur, resulting in huge demand for industrial products and services made by U.S. companies. This topic is very important and will be addressed in our next white paper which will be a collaborative effort with some of my senior analysts.

CONCLUSION

The nine year upward trend for stocks has run counter to the opinions of seasoned market professionals. This rally has occurred against the backdrop of slow economic growth and abnormally low interest rates. The prospects for accelerating growth in the U.S., and now around the world, could create a shift in corporate priorities from buybacks to increased capital investment, benefitting small caps more than large caps. As tax policy becomes more certain, regulation becomes more business friendly, and economic growth begins to go global, revenue growth could accelerate while spreading increased profits over a smaller share base. The path won't be linear and stocks could get bumpy during the "sausage making" process of hammering out a tax deal, but once done, I believe small cap prospects will improve.

Footnotes:

1. World Federation of Global Markets; Wilshire Indices; Palisade Capital Management; and FTSE Russell, 2017. The Wilshire 5000 Total Market Index℠ is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data. The Wilshire 5000 does not have a defined investment objective, nor does it charge fees and expenses.
2. 2017 Prequin Global Private Equity and Venture Capital Report; The Money Tree Report; PwC, Thomson Reuters, NVCA, January 2017.
3. Cambridge Associates LLC, Frank Russell Company, Standard & Poor's, and Thomson Reuters Datastream. Private indexes are pooled horizon internal rates of return, net of fees, expenses, and carried interest. Because the U.S. Private Equity and Venture Capital indexes are capital weighted, the largest vintage years mainly drive the indexes' performance.
4. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current Index membership. The Index does not have a defined investment objective, nor does it charge fees and expenses.
5. The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500® does not have a defined investment objective, nor does it charge fees and expenses.
6. iShares Core S&P 500® ETF ex-Facebook, Alphabet, Apple, Amazon and Netflix (S&P 500® Index proxy).
7. FAANG Composite is comprised of total returns for Facebook, Alphabet, Apple, Amazon and Netflix using the iShares Core S&P 500® ETF average index weights (S&P 500® Index proxy).
8. Palisade Capital Management; FactSet; FTSE Russell, August 2017.