Mesirow

# Equity Market Review
## Small and SMID Cap Strategies

STRATEGY SUMMARY AS OF DECEMBER 31, 2022

| | |
|---|---|
| **Equity Management AUM** | $790.0M |
| **Portfolio Managers** | Kathryn Vorisek<br>Leo Harmon, CFA, CAIA<br>Andrew Hadland, CFA |
| **Investment Philosophy** | We believe that excess returns can be produced by investing in attractively valued stocks that are poised to appreciate due to catalyst driven earnings and cash flow growth. |
| **Vehicle Offerings** | • Separately Managed Account<br>• Collective Investment Trust<br>• Mutual Fund (Mesirow Small Company Fund) |
| **Investment Objectives** | • Generate attractive risk-adjusted returns<br>• Consistently outperform the benchmark over a market cycle<br>• Participate in rising markets and protect capital in down markets |

## Market commentary

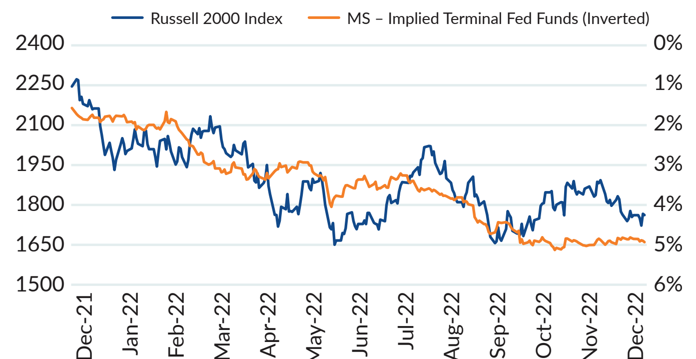
As investors, we often find it necessary to break away from traditional patterns to add value. But sometimes, following conventional wisdom may be more sensible. In a year like 2022, when inflation was persistently high and rising rates seemed to be the only weapon of mitigation, the old axiom, "don't fight the FED," never seemed more applicable.

### When I fight authority, authority always wins!

Trends and volatility in equity prices were inextricably linked to Fed interest rate policy expectations in 2022 (Figure 1). For owners of risk assets, it was the first time in 30 years that the Fed did not provide a backstop for asset prices (the proverbial Fed put). Instead, the Fed deemed inflation the bigger enemy and was seemingly willing to sacrifice both asset prices and economic growth to get inflation down to its long-run target.

**Equity markets moved in lockstep with rate expectations in 2022**

FIGURE 1: **RUSSELL 2000 VS. EXPECTED FED FUNDS RATES (INVERTED)**




Data as of 12.31.2022. Source: MEM and Bloomberg. Past performance is not indicative of future results.

Given the historic amount of fiscal and monetary stimulus placed into the economy during the pandemic, equity prices were already impacted by concerns over higher sustainable levels of inflation as well as rising input and wage costs.

Past performance is not indicative of future results. Please see disclosures at the end of this commentary for additional, important information.

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In addition, persistent supply-chain issues and a spike in underlying inflation driven by the Russia/Ukraine conflict gave the Fed very little room to maneuver. As such, the prospect of a "soft landing" appeared less probable as rising rates pressured valuation multiples for equities. Furthermore, the resulting slowdown in demand led to slower overall economic activity which, along with a corresponding reduction in corporate earnings expectations, placed additional strain on equity markets. Markets rallied in the 4th quarter of 2022 as investors believed interest rate policy would moderate as inflation data peaked. However, despite powerful intermittent rallies throughout the year, the trend in equity prices was clearly negative and produced significant losses in 2022 for most indices.

| Index | 4Q2022 | YTD |
|---|---|---|
| Russell 2000 Value Index | 8.4% | -14.5% |
| Russell 2000 Index | 6.2% | -20.4% |
| Russell 2500 Value Index | 9.2% | -13.1% |
| Russell 2500 Index | 7.4% | -18.4% |

Data as of 12.31.2022. Source: MEM, Bloomberg and FTSE Russell.

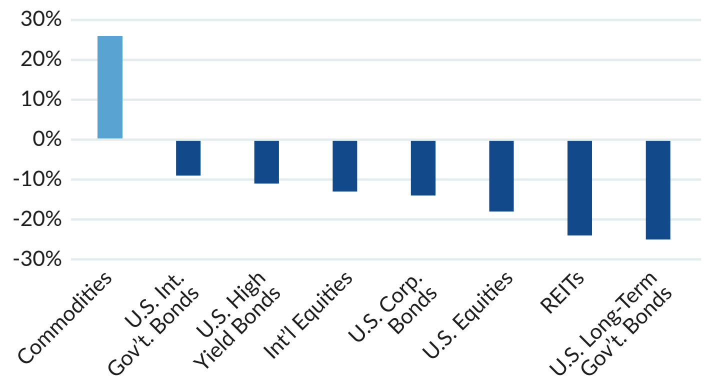
For the 4th quarter, the market was driven higher by cyclical sectors: Materials, Energy, Industrials, and Consumer Discretionary were the best performers while Healthcare, Communications Services, and Technology lagged. For the year, market leadership was extremely narrow. Energy and Utilities were the only sectors that produced positive or near-positive returns, being driven by inflation in energy prices and broader defensive positioning. Communication Services, Healthcare, and the Consumer Discretionary sectors were the year's biggest losers.

## And the winner is...nobody. Well, almost nobody

Though equity markets struggled throughout the year, it was an equally dismal year for most major asset classes (Figure 2). Portfolios with classic 60/40 portfolio allocations experienced their worst performance in seven decades. The big winners were commodity-based portfolios driven by global money supply growth and higher inflation.

### Most major asset classes declined in 2022

FIGURE 2: 2022 RETURNS BY MAJOR ASSET CLASSES



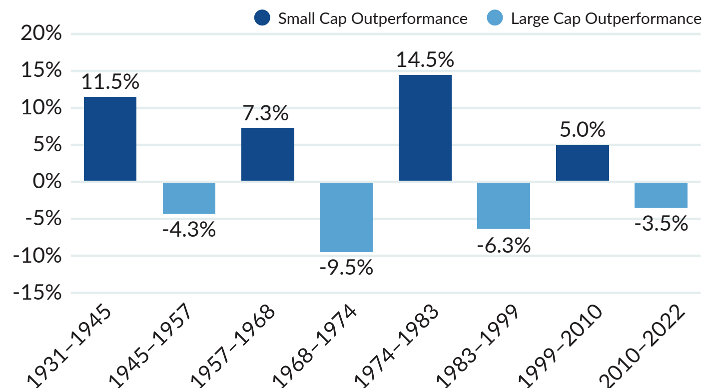

Data as of 12.31.2022. Source: MEM and Furey Research Partners.

## Large is in charge, but small is ready to brawl

Performance cycles for large cap versus small cap tend to be fairly long and mean-reverting through time. The median cycle runs about 11.5 years and outperformance over those years can be fairly robust, particularly when small cap is leading (Figure 3). Over the past 12 years, large cap has dominated small cap. However, we may be poised for the beginning of a small cap cycle. That view is supported by the length of time large cap has outperformed, plus historically low relative valuations for small cap equities similar to the start of the last small cap cycle in 1999 (Figure 4).

### A new small cap cycle could be forming after 12 years of large cap leadership

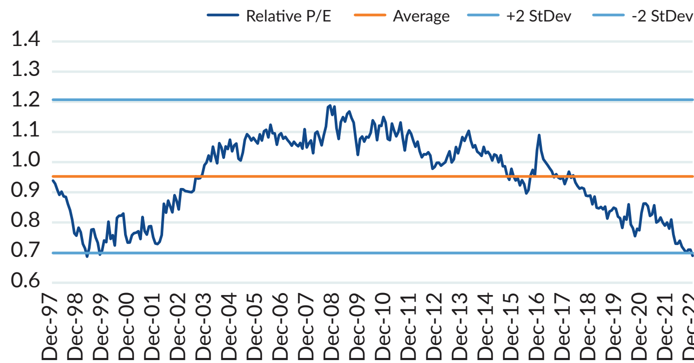
FIGURE 3: SMALL CAP LESS LARGE CAP – RELATIVE RETURNS (ANNUALIZED 1931–2022)




Data as of 12.31.2022. Source: MEM and Furey Research Partners.

### Small cap is historically attractive relative to large cap

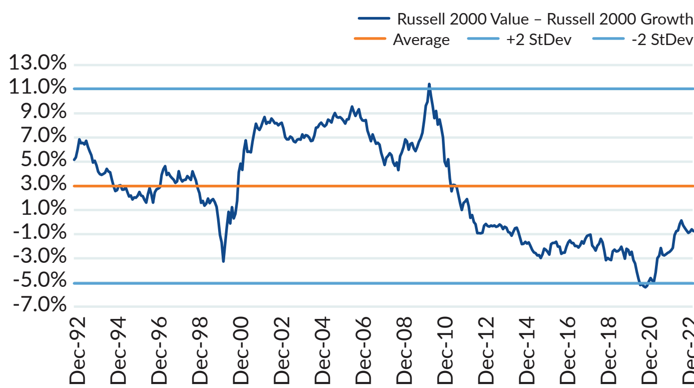
FIGURE 4: **RELATIVE P/E RUSSELL 2000 VS. S&P 500**




Data as of 12.31.2022. Source: MEM, FactSet, FTSE, JP Morgan Asset Management, Bloomberg and CSFB.

### Small cap value still has room to outperform small cap growth

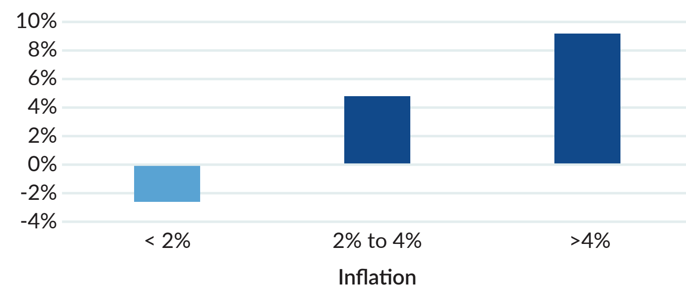
FIGURE 5: **10-YR ROLLING ANNUALIZED RETURNS R2000 VALUE – R2000 GROWTH**




Data as of 12.31.2022. Source: MEM, Bloomberg and FTSE Russell..

### Higher average inflation benefits small cap value

FIGURE 6: **MEDIAN ANNUAL RELATIVE RETURNS SMALL CAP VALUE VS. SMALL CAP GROWTH AT LEVELS OF INFLATIONS (1930–2022)**




Data as of 12.31.2022. Source: MEM and Furey Research Partners.

## What's the value in that?

Value-based indices outperformed growth for both the fourth quarter and the year as multiple compression driven by higher rates had a more negative impact on longer-duration growth equities. This marked the second consecutive year of small cap value outperformance, which last happened in 2006. We're hoping it also marks the early stages of a value leadership cycle. While rolling 10-year returns for small cap value have dramatically improved relative to growth, they are still significantly below long-term averages (Figure 5). In addition, embedded fiscal and monetary stimulus should provide higher average inflation in future years, which would support higher relative returns for small cap value (Figure 6) as long-term interest rates normalize and long-duration assets experience further valuation compression.

## Soft landing becoming harder

Many measures of economic data have remained positive, driven by strong employment formation and consumer spending from excess savings. Nevertheless, the lagged effects of tighter monetary policy weighed more heavily on economic data in the second half of the year. This led to both a slowdown in economic activity and a reduction in earnings expectations for many companies. Much of the growth in corporate revenue was a result of price increases (as opposed to real volume demand) and higher input costs continued to pressure corporate profit margins. Additionally, the impact of higher inflation has been a global phenomenon. Tighter monetary policy in many areas of the world has prompted similarly negative effects on global economic data.

## Darkest before the dawn, but the sun will rise

To this point, the Fed's efforts to slow inflation without triggering significant damage to the economy has been admirable. Inflation trends and expectations are in decline, and we would expect marked improvement as we move through 2023. However, levels of inflation remain higher than the Fed's baseline goal, which will likely lead to a higher-than-expected Fed funds rate for a longer period than previously imagined. As a result, we expect continued deterioration in economic activity for an indefinite period, possibly leading to what some have dubbed "the most anticipated recession ever."

Past performance is not necessarily indicative of future results.

We believe equity prices will remain in a wide, volatile trading range until questions related to the depth and duration of the economic slowdown are answered. In addition, we expect earnings reports will remain challenging for the first half of the year. Companies will likely lower their growth and profitability expectations as they struggle with slowing demand, an inability to pass through higher prices and rising input costs.

In the interim, we continue to monitor several factors with respect to tactical portfolio positioning:

- A pause and/or pivot to the Fed tightening cycle
- Duration of economic stagnation and timing of recovery
- The impact of the removal of zero-COVID policies in China
- Risk factors related to liquidity and credit that could signal more material downside for equities
- Pricing power and margin stability as inflation persists
- Earnings revisions and changes in growth cadence for 2023

Although a recessionary environment for the economy and markets may be anticipated, the bottoming process for equity markets could still take several more quarters as we navigate through both the dangers and opportunities presented. We expect the first part of 2023 to be more problematic as investors adjust to lowered expectations. However, the second half should lead to value-added opportunities when negative fundamentals are further priced into equities and investors begin to anticipate a recovery in earnings well before the inflection in economic data. Despite the near-term headwinds, we foresee a positive equity market return in 2023, albeit with a significant level of volatility. In the meantime, we will continue to work diligently to identify value-added investment prospects that are poised to excel regardless of the market environment.

Benchmark definitions: The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The Russell 2000 Index offers investors access to the small-cap segment of the U.S. equity universe. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The Russell 2000 includes the smallest 2000 securities in the Russell 3000.

The Russell 2000 Value Index offers investors access to the small-cap value segment of the U.S. equity universe. The Russell 2000 Value is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate small-cap value manager's opportunity set.

The Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment. Both indices are completely reconstituted annually to ensure large stocks do not distort the performance and characteristics of the true small to mid-cap opportunity set and that the represented companies continue to reflect value characteristics. (Source: Russell).

The S&P 500 is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization. Please see the following GIPS disclosure for additional benchmark definitions.

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