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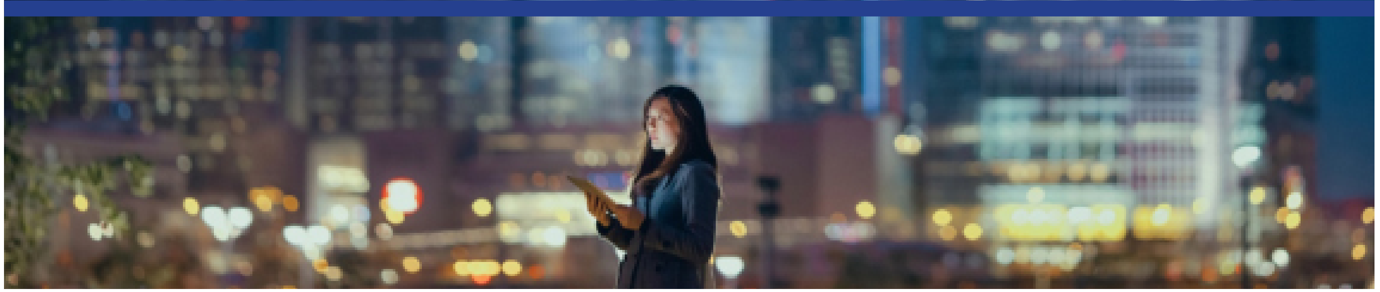

October 7, 2023

CIO Strategy Bulletin

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When Turbulence Creates Opportunity: The Argument for Selectivity in SMID

- Global markets have been gripped in a repricing of the US growth outlook, forcing up long-term interest rates and the US dollar, steepening the yield curve. In the process equities have weakened across the board.
- After a concentrated 2023 rally in certain large-cap S&P 500 companies, high quality companies with small and medium sized capitalizations (SMID) currently trade at a 30% discount to the S&P 500. When coupled with our outlook for moderating inflation and an eventual Fed pivot next year, it may make sense to build positions early.
- History shows that SMID has outperformed in most decades over the past century. This has been particularly true for profitable small and mid-sized firms, which have outperformed large caps since 1994.
- With a lack of buy- and sell-side analyst coverage in SMID, active management can be valuable in areas of the market where the variability of individual stock returns is high, and quality portfolios can be built using fundamental analysis.
- Historically, not only have quality SMID companies outperformed the broader market, but companies that are of the lowest quality have lagged the broader market.
- Beyond long-only managers, hedge funds may utilize a long-short SMID strategy to seek equity returns with low beta, volatility, and reduced drawdowns during periods of market stress. Strategies employed include investing in companies with strong fundamentals while shorting the lower quality end of the market.

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More Tightening, Less Recession

For the past 14 months, the 10s/1s Treasury curve has been inverted. For each of the last 10 US economic contractions, the downward sloping curve has been a reliable indicator of a coming recession, though at times by more than a year in advance. Over the last six decades, the yield curve has given only one completely false warning.[1]

An inverted yield curve is, by definition, a forecast from bond investors that short-term rates will fall. Long term bond holders suffer if the Fed does not cut short terms rates. This is what long-duration bond holders have been experiencing amid strong economic data, with the pain naturally spreading to other financial markets globally.

The Fed has pushed up all yields, but especially short-term rates, that are 550 basis points higher than their lows of two years ago. We can see this "rate shock" in action as long-term rates have both risen and become more volatile.

Contradictory Signals

The surge in Treasury borrowing and fears of Japanese monetary tightening have led to a buyers strike in the bond market (**Figure 1**). This has fed back directly on the value of all other assets. As long-term real interest rates rose, the yield curve steepened, equities are down 5.9% since August 1st, and the US dollar jumped higher in value (**Figure 2**). Crude oil - which was up 30% over just 3 months - came down last week. This "cross-market" activity is consistent with a tightening of monetary policy, not a recession.

In short, we see contradictory signals. Some economic data suggest that the US economy is resilient. Reversing the COVID period trend, US employment has grown faster than GDP by the largest amount since 1974. Other data suggest that the "rolling recessions" we have identified in some part of the US economy is ongoing.

What is clear is that higher yields are giving equities competition in a big way. Five-year investment grade corporate yields (about equal to the Citi Global Wealth's Global Investment Committee's suggested duration) rose to 6.2% in the past week. Corporate earnings and dividends need to "outgrow" that rate over time.

In essence, markets have fallen under the weight of a hawkish reassessment of US monetary policy.

So, What Does The Fed See and Do?

The Fed believes its policy is **"necessarily restrictive"** for now. Fed Chairman Powell suggested rates will be higher for longer to quell inflation. Whatever the immediate data shows – including an untimely spike higher for employment in September – we believe that the economy will slow in the coming year (**Figure 3**). And lower inflation is not the Fed's only mandate.

The Federal Reserve is tasked by Congress with maintaining "maximum employment, stable prices and moderate long-term interest rates". The Fed interprets its inflation mandate as a long-term trend of 2% as measured by the Personal Consumption Expenditures Price Index. "Maximum employment" and "moderate long-term interest rates" are more subjective measures.

In the coming year, we expect the Fed will have more to worry about than merely its inflation mandate. We strongly suspect that the Fed's view of the employment outlook will weaken next year (**Figure 4**), suggesting a less restrictive monetary policy at that point. If inflation subsides in a sustained way, as described by Chairman Powell in July, the Fed wouldn't need to wait for a collapse in employment before easing. In fact, it would try to *avoid* a collapse.

Of course, recessions are inevitable. There have been plenty of credible warnings since the Fed embarked on its shocking policy reversal more than 18 months ago. The longest period for an inverted curve has been 20 months. If the Fed waits too long, the economy will see a turbulent landing, if not a hard one. But if the Fed gets it right, a softer landing for the US economy remains a distinct possibility.

[1] There have been 11 distinct inversions of the 10s/1s Treasury curve and only 10 recessions since 1957.

Figure 1: US Treasury 10-Year Nominal Yield and Treasury Inflation Protected Security Implied Inflation Rate (%)

Figure 2: US Broad Trade-Weight Dollar Index

Source: Haver Analytics as of October 3, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 3: US Non-Farm Employment Month/Month Change (thousands)

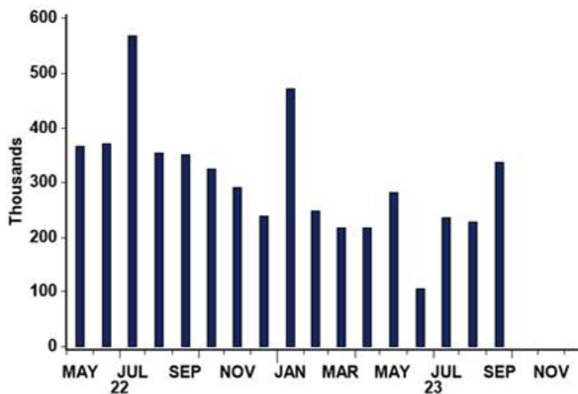
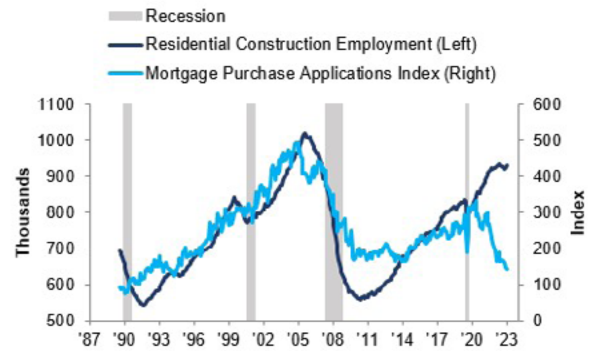


Figure 4: US mortgage purchase applicatio volumes vs residential construction employment



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When Turbulence Creates Opportunity: The Argument for Selectivity in SMID Today

In our view, depressed small cap valuations may provide an attractive entry point for core portfolios even when adjusted for today's higher rate environment (**Figure 5**). We suggest a focus on high quality small firms who have been left behind in the mega-cap surge, while avoiding low quality companies that are found in passive indices.

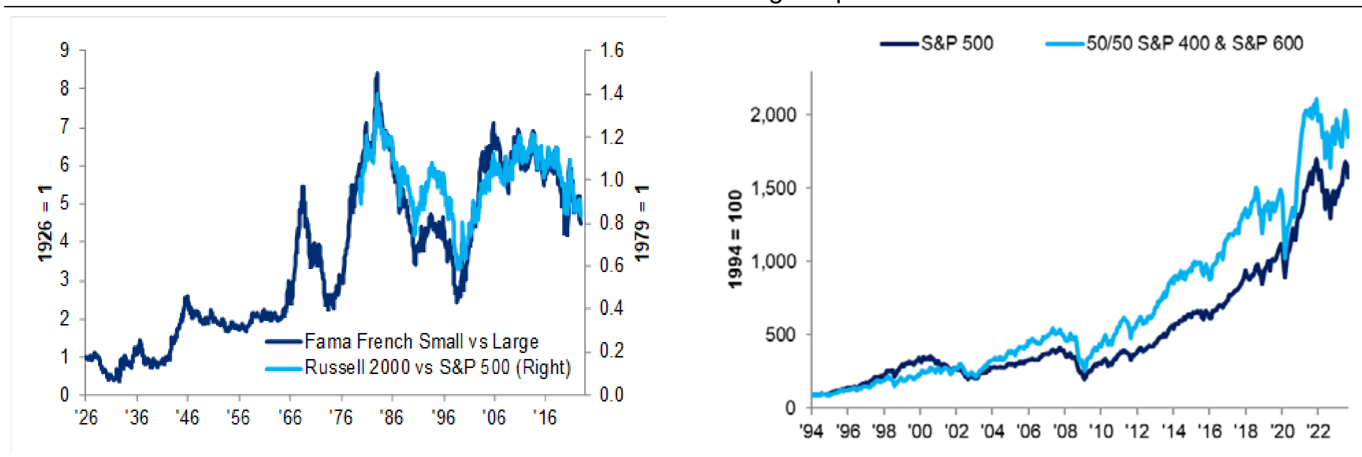
While recent performance has favored investors with a hefty allocation to large caps, history shows that SMID has outperformed in most decades over the past century (**Figure 6**). This has been particularly true for profitable small and mid-sized firms, which have outperformed large caps since 1994.[2]

[2] SMID outperformance has been measured between 1926 to date as shown in **Figure 9**, Proxies used to measure profitability of SMID firms vs large caps firms include S&P 400 and S&P 600 for small and mid sized firms and S&P 500 for large caps. Data sourced from January 1994 to through September 2023.

In today's market environment where seven companies are responsible for nearly 100% of S&P 500 gains for 2023, managers focused on fundamental analysis are able to identify market inefficiencies in the small- and mid-cap spaces across both traditional and alternative asset classes.

Figure 5: Russell 2000 vs. S&P 500 companies

Figure 6: Long-term Outperformance of SMID vs. large-caps



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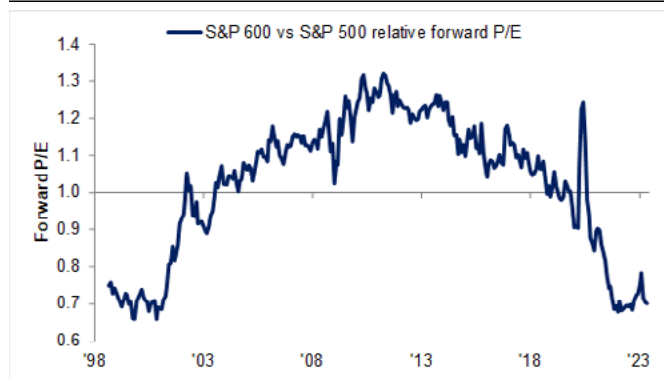
What is the theoretical basis for "smaller is better"? Smaller firms tend to generate less buzz than larger companies, are often less liquid, and garner less buy and sell side coverage. Indeed, fewer eyeballs can lead to a systematic valuation discount, which may be a precursor to future outperformance. And, as with many of our 2023 portfolio changes, we favor increasing portfolio diversification.

Cheaper May Be Better

After a challenging period for smaller shares in 2022 and much of this year, small- and mid-caps are now historically cheap relative to their larger firm peers (**Figure 7**). Quality SMID indexes currently trade at a 30% multiple discount to the S&P 500. We believe this presents an attractive entry point for multi-year holding periods. While valuations are not a great short-term timing tool, when coupled with our outlook for moderating inflation and an eventual Fed pivot next year, we suggest building positions in the asset class.

Figure 7: Small-cap valuations relative to large-caps



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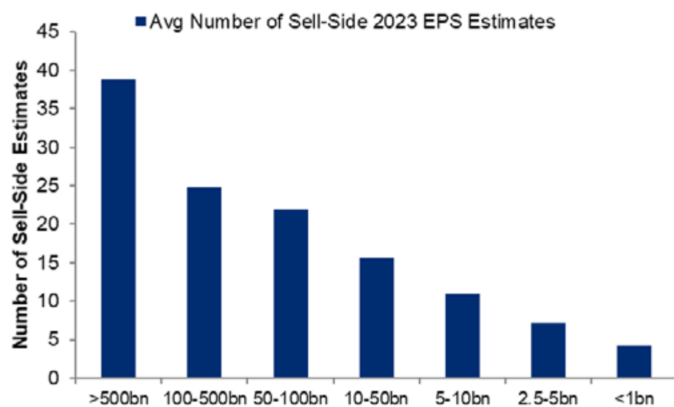
Active Management and SMID

Ever since John Bogle pioneered index investing in 1976 with the creation of Vanguard's 500 Index Fund, passive equity investing has come to dominate equity markets. In the last ten years alone, the percentage of capital allocated to passively managed equity ETFs and mutual funds has gone from 33% to 55%[3]. This evolution has provided benefits to investors, including reduced fee burdens and broadened exposure to equities for retail investors. But while index investing is a fantastic portfolio management tool, it fails to capture the potential for an active manager to utilize their research capabilities to generate unique investment theses in a SMID environment where there are simply fewer eyes tracking the individual companies. (**Figure 8**).

Figure 8: Sell side single stock coverage, by company size



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[3] Source: Bloomberg as of December 31, 2022.

Dispersion Benefits Active Managers

Active management is most valuable in areas of the market where dispersion is high. On an index level, dispersion measures the variability of returns for the component stocks. Within US equities, dispersion among small- and mid-cap companies is persistently higher than for large caps. The current degree of uncertainty on the economy given higher interest rates has pushed recent dispersion to around the 75th percentile of monthly values for both small and mid-cap companies, whereas it is below the 50th percentile for large caps.

Quality Matters

We have seen outperformance from quality companies within SMID cap indices. But what is quality? Within the indices, these are the companies that have the best rankings based on return on equity, earnings quality, and financial leverage ratios (**Figure 9**). An active manager is going to do deep dives on a prospect's industry trends, balance sheet risk, capital needs and cash flows, barriers to entry and competitive positioning, management quality, cost structure, etc. to make an investment decision. For example, leverage is a significant factor to consider across the SMID space, which could become an issue if rates stay higher for longer. And small companies exhibit a much broader dispersion of leverage profiles than large caps, not to mention a high percentage of companies that are simply unprofitable. (**Figure 10**)

Figure 9: Leverage across small, medium and large cap US equities

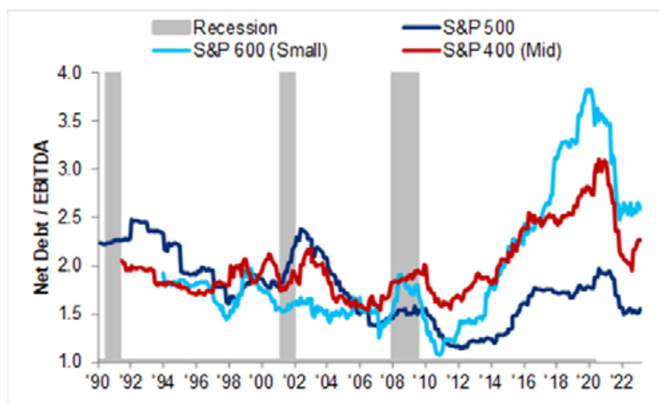
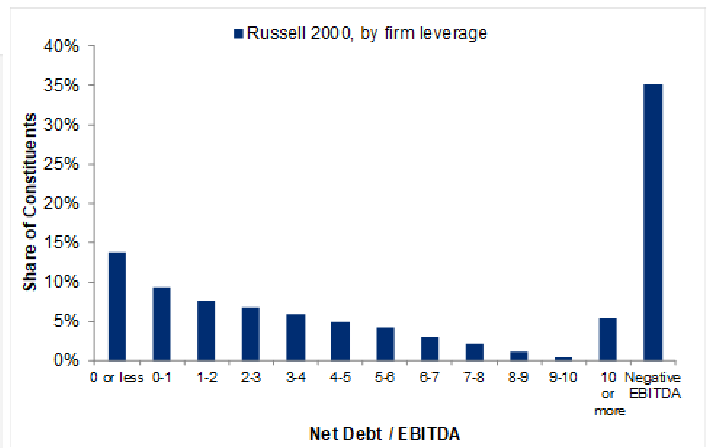


Figure 10: Distribution of firm quality across Russell 2000 constituents



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Long/Short and SMID Go Together

This provides a fertile backdrop to not only pick the winners, but short the losers. Focusing on volatile and less efficient part of the market like SMID cap companies provides the potential for long/short equity hedge funds to seek outperformance through stock picking. (**Figure 11**) Traditional managers must manage their portfolio quality via a long-only approach by overweighting quality companies and de-emphasizing lower quality firms (**Figure 12**).

Figure 11: Annualized return premiums for Quality indices relative to parent indices

Index	3-yr Annual Return	Quality Index	3-yr Annual Return	Quality Return Premium
S&P 500 TR	10.7%	S&P 500 Quality TR	11.4%	+ 70 bps
S&P 400 TR	11.9%	S&P 400 Quality TR	15.7%	+ 380 bps
S&P 600 TR	12.4%	S&P 600 Quality TR	14.1%	+ 170 bps
Russell 2000 TR	7.5%	Russell 2000 Quality TR	12.5%	+ 500 bps

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Figure 12: Russell 2000 quality index vs Russel 2000[4]

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By managing their net beta position via long and short balances across the portfolio, a hedge fund can then share in a significant portion of equity gains while limiting drawdowns during periods of volatility… "winning by not losing"[5]. It is evident that actively taking long exposure to quality and short exposure to the lowest quintile can provide additional returns for qualified investors. However, utilizing shorts into an investment strategy also exposes one to potential risk of short squeeze scenarios. Short squeezes occur when a highly shorted stock suddenly and quickly increases in price, thus forcing short sellers to buy shares to exit their positions.

The SMID Decision: Active over Passive

What active manager? What hedged manager? We think SMID investors must dig into the details to find well positioned managers that have a track record of stock selection and underwriting skills. For example, size matters. A fund should be large enough to support the research resources necessary for effective execution, while staying small enough to generate alpha and not "become the market." The market is full of funds that are improperly sized to execute on their stated strategy effectively. Also, in hedge funds, there is a wide range of approaches in the equity long-short game and qualified investors should evaluate a manager's historical track record in seeking equity returns with lower beta, volatility, and reduced drawdowns during periods of market stress. In the end, an active management approach can underperform the broad markets during periods of unrestrained optimism, but finding high quality active managers in both traditionals and alternatives may reward the patient investor in the long-term.

[4] 2021 SPAC/Meme Stock Boom" refers to the period from Fall 2020 to mid-2021 which was characterized by a significant amount of issuance in empty shell SPACs as well as elevated retail trading volumes in stocks with high short interest.

[5] Nick Atkeson, Andrew Houghton, Win by not Losing: A Disciplined Approach to Building and Protecting Your Wealth in the Stock Market by Managing Your Risk, 2013

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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Asset allocation does not assure a profit or protect against a loss in declining financial markets.

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