US Small Caps: **Tackling the Small Cap Challenge**

- The lack of information flow in US small caps and limited research coverage provides investors with opportunities to exploit an inefficient market.
- The typical US small cap strategy is fairly concentrated with around 75 stocks. This can lead to high idiosyncratic risks and volatility, while also leaving many undervalued companies undiscovered.
- Sitting between traditional fundamental and quantitative approaches, **Lazard US Systematic Small Cap Equity** offers an automated, style-agnostic solution that has historically proven successful in capturing the inefficiencies provided by a diverse market.

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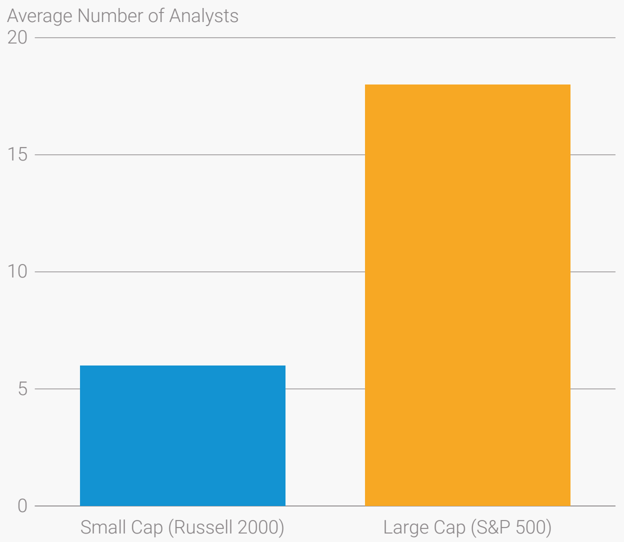
The US small cap market is defined by its inefficiency. In our view, inefficiency walks arm in arm with opportunity, making this asset class particularly suited to active management: active US small cap managers have a better record of outperforming than their active large cap counterparts, who can struggle to find an enduring edge in a highly efficient asset class.

The 2,000 stocks that make up the Russell 2000 index, the most widely used representation of the US small cap universe, comprise a diverse set of companies. They offer exposure to all corners of the dynamic US economy, with a greater domestic slant to their earnings than the S&P 500's constituents. Crucially, though, they receive much less focus and research coverage than their big-cap brethren (Exhibit 1).

Exhibit 1
The Lack of Information Flow in US Small Caps



Number of Analysts	Small Caps (Russell 2000 Index, %)	Large Caps (S&P 500 Index, %)
0	6	0
1–2	17	0
3–5	34	1
6–10	33	12
11+	10	86

As of 10 July 2024
Based on EPS data. For illustrative purposes only.
Source: FactSet

The Coverage Conundrum

Yet small cap stocks require even closer attention than large caps. Smaller companies typically exhibit a higher velocity of change, meaning their operating results tend to have a more immediate and material impact on their share price than large cap stocks. We believe they have far greater potential for outsized growth than larger stocks—after all, to quote legendary small cap investor Jim Slater, elephants don't gallop. Finally, although home to many high-quality companies, the US small cap universe features many speculative and expensive companies, as well as a high percentage of unprofitable names: around 40% of Russell 2000 index constituents were loss-making, as of 30 June 2024.[1] Wheat needs to be separated from chaff.

In our view, the constantly recurring inefficiencies in the US small cap market are fundamental in nature, making stock-specific, bottom-up research crucial. However, the size and diversity of the universe pose a challenge for the traditional investment manager. They would require a firm to employ more analysts than is economically feasible under the capacity constraints of the small cap market opportunity. The result is that a typical US small cap strategy is fairly concentrated, with around 75 stocks. This can lead to high idiosyncratic risks and volatility, while potentially leaving many undervalued companies undiscovered and alpha on the table.

To solve this problem of scale while fully exploiting the opportunities provided by the myriad individual inefficiencies found in the asset class, we developed a fully automated approach rooted in fundamental analysis. We believe the analysis of company operating results and corporate news flow should be unbiased, rational, consistent, and based on sound economic principles—all properties that lend themselves to automation.

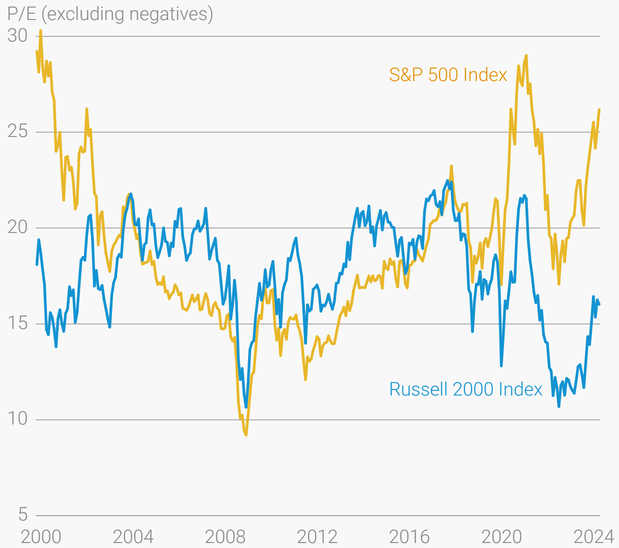
Automated Fundamental Analysts: Our AI Expert System

Our team has spent over a decade building a unique framework of 25 diversified and uncorrelated concepts that each exploit a specific fundamental inefficiency. These concepts, which we call Automated Fundamental Analysts, are easy to understand, yet complex to implement. Two examples of our many concepts include "Competitive Advantage"—identifying companies exhibiting sustained margin improvement—and "Accelerating Growth"—companies showing a meaningful inflection in their operating results. These Automated Fundamental Analysts continuously re-evaluate the entire market in real time, making buy and sell recommendations based on whether a company is currently mis-priced. Our investment process is designed to take advantage of slow and deliberate thinking yet acts quickly and decisively. To learn more about our Automated Fundamental Analysts approach, please see "Lazard US Systematic Equity: Automated Fundamental Analysts".

Our approach has resulted in a diversified portfolio of around 400 names historically driven mainly by idiosyncratic alpha focused on operating fundamentals and valuation. And we believe our approach has worked. From its launch in August 2015 to 30 June 2024, our strategy has exceeded the Russell 2000 index by 488 basis points, annualized gross of fees (380 basis points net of fees, annualized), and produced a first percentile-ranked information ratio among US small cap core strategies.[2]

Looking ahead, we are excited by the current market opportunity in US small cap stocks, especially given signs in mid-July of a potential turning point for the asset class on the back of lower-than-expected inflation numbers and hopes of rate cuts. Despite significantly higher revenue and earnings growth forecasts, valuations relative to large cap stocks are at their most attractive in a generation: the Russell 2000 index sits at close to a two standard deviations discount to the S&P 500 index, the largest valuation gap since the turn of the century (Exhibit 2).

Exhibit 2
US Small Caps Trade at a Historical Discount to US Large Caps



As of 30 June 2024
For illustrative purposes only.
Source: Lazard, FactSet

Meanwhile, we believe our portfolio compares highly favorably versus the Russell 2000 (Exhibit 3), offering compelling valuation support, with historically higher returns on equity and cash generation.

Exhibit 3
Lazard US Systematic Small Cap Equity Strategy Investment Characteristics vs. Russell 2000 Index

	Lazard	Russell 2000 Index
Price/Earnings	21.3	48.3
Free Cash Flow (%)	7.6	2.9
Return on Equity (%)	10.2	4.3
Price/Cash Flow	9.4	12.2

As of 30 June 2024
Source: Lazard, FactSet

We currently see a clear split within the small cap universe between high-quality and speculative companies. Many of the former are trading at attractive discounts, meaning investors are not being forced into a trade-off between quality and valuation. This is fertile ground for active management, and we believe our process of systematically combining multiple fundamental sources of potential alpha is well positioned for this clear market opportunity.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 Source: Lazard, FactSet.

2 Ranking provided by eVestment and determined using reported returns as of 30 June 2024. Ranking shown is for the US Small Cap Core Equity Universe based on default reported returns. Only managers that report performance were included in the ranking. The universe includes all traditional asset managers who classify as US Small Cap Core Equity. Lazard pays eVestment for data and research related to industry and asset flows and peer comparisons. Lazard did not pay eVestment for its rank amongst the US Small Cap Core Equity Universe.

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The Lazard US Systematic Small Cap Equity Strategy incorporates an "expert system" as an integral component of its proprietary quantitative investment process. An expert system is a type of Artificial Intelligence (AI) designed to address complex problems using a series of if/then rules, as opposed to conventional procedural code. The Investment Team uses the expert system to integrate a knowledge base (representing facts and rules) drafted by the Investment Team with a decision engine (representing potential decisions across an investable universe) selected by the Investment Team. The use of AI serves as a supplementary tool to enhance the efficiency of the Investment Team's process by identifying potential investment opportunities within the investable universe based on predetermined parameters.

For the avoidance of doubt, the expert system does not currently have machine-learning capabilities. Specifically, the expert system does not possess investment discretion, autonomous decision-making capabilities or the ability to make independent judgment over time. The criteria underlying the selection of investment opportunities by automated fundamental analysts is created by the Investment Team, who exercise their professional judgment and expertise in the development of their proprietary quantitative models and implementation of the expert system.

A quantitative investment strategy relies on quantitative models and quantitative filters, which, if incorrect, may adversely affect performance.

The Russell 2000 Index is designed to represent the "small cap" market of US equity securities, composed of approximately 2,000 of the smallest securities in the Russell 3000 Index. The Russell 3000 Index is a market-capitalization-weighted equity index maintained by FTSE Russell that provides exposure to the entire US stock market. The index tracks the performance of the 3,000 largest US-traded stocks, which represent approximately 98% of all US-incorporated equity securities. The index is unmanaged and has no fees. One cannot invest directly in an index.

The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy. The index is unmanaged and has no fees. One cannot invest directly in an index.

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