

EXAMINING THE SMALL CAP UNIVERSE

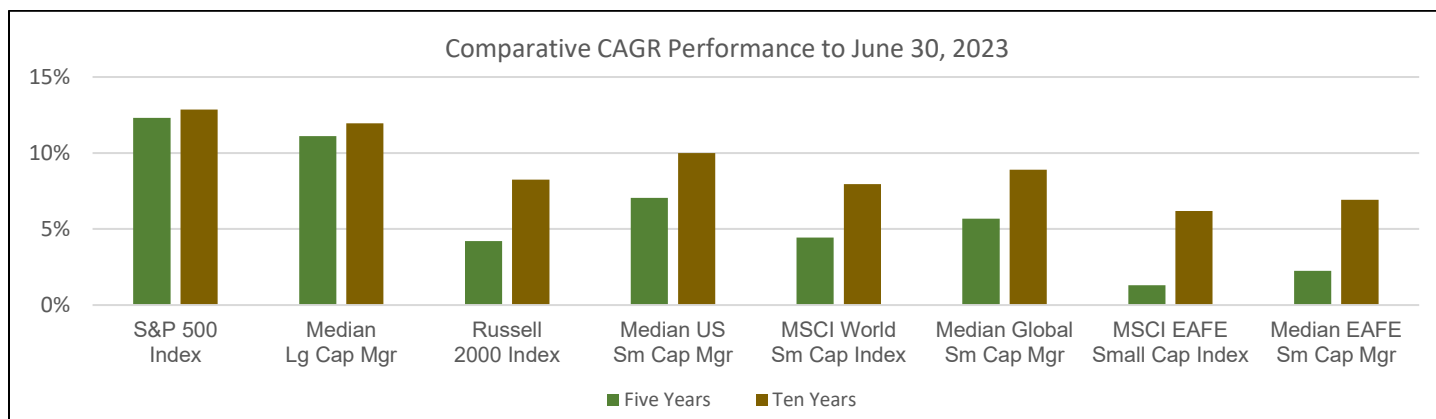
Part One:
Planning for the Extended
Maturity of Large Cap Equity

October 2023



EXAMINING THE SMALL CAP UNIVERSE

Part One: Planning for the Extended Maturity Cycle of Large Cap Equity



Ending 06/30/2023	S&P 500 Index	Median Lg Cap Mgr	Russell 2000 Index	Median US Sm Cap Mgr	MSCI World Sm Cap Index	Median Global Sm Cap Mgr	MSCI EAFE Small Cap Index	Median EAFE Sm Cap Mgr
Five Years	12.31%	11.12%	4.21%	7.06%	4.44%	5.69%	1.31%	2.26%
Ten Years	12.86%	11.96%	8.26%	10.00%	7.95%	8.90%	6.19%	6.93%

Performance provided by eVestment. eVestment is a global database of more than 26,000+ peer strategies that provide subscribers the ability to measure performance, conduct detailed statistical analyses and assess risk. The manager data, index returns, and peer group universes shown in the performance comparisons were provided by eVestment, by investment managers and index providers such as MSCI, S&P and Russell. A fee is paid by our firm to access this data.

Why has US large cap outperformed?

The S&P 500 has outperformed most other passive investment indices and active managers.

The S&P 500 has held on to its best performers and let their winners run. The biggest winners of the decade, such as Apple, Microsoft, Amazon, Nvidia and Google, now make up greater than 20% of the S&P index and drive a material amount of the index performance.

We think of the S&P 500 index as an admirable portfolio manager. It is constructed as a relatively concentrated, buy and hold strategy with limited turnover. For active managers to outperform this benchmark over long

periods without excessive trading, we believe they must put greater weight behind their best ideas compared to the benchmark, which is difficult since Apple makes up greater than 7% of the benchmark.

Market cap weighted passive investors (ETF's for example) own every public business that will eventually flourish. They too are buy and hold investors by design, and seldom trim their winners. They are low cost. They don't suffer from style creep, fits of emotion, lack of focus, and other human frailties. They are consistent, clear, and static in their approach. This also means they don't adapt, change, or evolve when circumstances do. They are truly victims- or beneficiaries- of circumstance.

Passive investors own businesses that no longer continue to flourish. They don't actively redistribute their portfolio when the relative growth outlook of previous, though still material, weight winners diminish.

We believe circumstances are changing and strength of passive large cap investing is nearing a turn towards weakness. Equity investors should look to active managers to generate the type of risk-adjusted returns delivered by US large cap passive strategies over the last cycle. In the sections below, we describe why we believe what has transpired with US large cap companies over the last 10+ years will likely not persist over the next 10 years.

The Great Cash Flow Migration

There have been two big shifts in the past ten years or so: a) a dramatic shift of economic activity - and therefore capital - into digital applications and b) we've seen the emergence of nearly global applications. The third big shift we've seen is the flow of profits and money locked in regional networks or economies to predominantly US-domiciled companies and the shareholders who own them. A local French classified ad has probably been substituted by the Facebook marketplace, a local record

shop by Apple Music, bookstores, general merchandise, and computing infrastructure by Amazon. Apple is a landlord, the likes of which has never been seen – the mall owner of the digital world. Google occupies a similar place in search – it has become a noun. Microsoft in cloud applications and infrastructure. Netflix in video streaming. We think this phenomenon has caused a good chunk of the money to flow into a relatively small number of companies in a single region. This makes sense given

- 1) networks experience increasing returns to scale;
- 2) the internet is standardized and ubiquitous; and,
- 3) innovation and scale happened first in the US.

It's no wonder US large cap indices have done so well and it's no wonder the US market ended up high levels of concentration and it's therefore no wonder that passive investors have enjoyed the ride of a lifetime. However, as investors, we must be forward looking, and we ponder whether the best of times are behind us.

Everything has a Lifecycle

Everything has a lifecycle, including industries and companies, and maturity, like old age, is something that has yet to be solved for.

Network	Current Penetration	Mature Penetration	Commentary
Fixed Access (High Speed Internet)	65%	70 - 80%	May be substituted for fixed wireless in underpenetrated markets.
Mobile Access (Mobile Phones)	86%	90%	Already at mature state.

Internet	Current Penetration	Mature Penetration	Commentary
Global Internet Access	70%	90%	Gap between mobile phone and internet access likely to close reasonably quickly.

Activity	Current Penetration	Mature Penetration	Commentary
Merchandise (e-commerce)	23%	45 - 55%	Large categories like grocery, auto, furniture will see greater shifts but not full penetration in all geographies. China at 50%.
Digital Advertising	67%	90 - 100%	Some outdoor applications to remain analogue.
Payments	65%	90 - 100%	Developed markets nearly fully penetrated.

Activity	Current Penetration	Mature Penetration	Commentary
Consumer Applications	70%	90 - 100%	Mobile phones and mobile apps already highly penetrated with some legacy desktop computing applications still to shift.
Enterprise Computing Applications	60%	70 - 80%	Legacy horizontal applications like ERP to move slowly over time as will vertical applications in financial services and communication services.
Computing Infrastructure	60%	90 - 100%	Large financial services and legacy communication service provider workloads to move over time.

Sources: Statista, BIS, emarketer, Laurus estimates

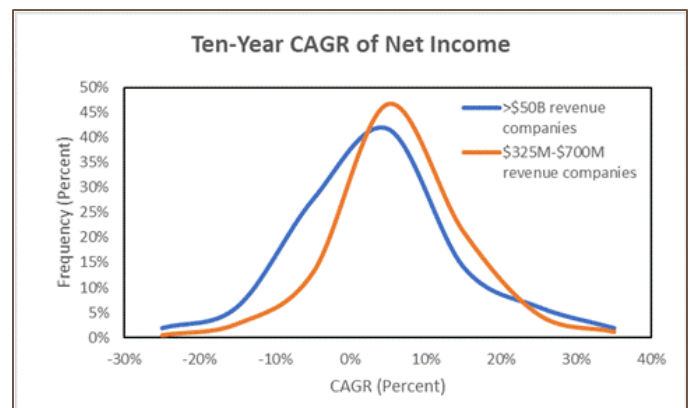
Networks have size limits. They reach saturation. We don't see digital networks being replaced by new technology. They will continue to benefit from getting faster and bigger. New applications will be developed. Killer applications like AI may change the winners or the losers but we believe the biggest part of the migration is done. The onramps are mature, most big demand categories that can be digitized are already majority penetrated. Real economy transactions are going to continue to migrate to digital networks, but we believe the pace will slow. The big US names like Apple, Google, Meta, Amazon, and Microsoft are great businesses, maybe even the greatest ever, and it makes sense to be allocated to larger US companies who can still innovate and to catch those that will ride the next wave. But we believe investors should look to other areas for growth should our thesis prove to be correct.

Why small cap over large cap?

In the short term, valuation is a function of investor sentiment, but as long-term investors, we understand that the ultimate size of the business in 10 years, measured by the amount of free cash flow that the business generates, will be the primary driver of the value of the business. Based on that premise, we are looking for companies that can grow. As a result of the law of large numbers, smaller companies on average should grow faster than larger companies. When we consider the top 5 weights in the S&P 500 index (Apple, Microsoft, Amazon, Nvidia, Google), we often ask the question: what is the probability that these firms can 5-10x in size from here?

For a company to grow 5x in 10 years, it needs to compound earnings at approximately 17.5% annually. Credit Suisse has collected a sample of company data

from 1950 - 2015 on base rates of growth, segmented by company size. The result was that only 14.1% of companies with sales >\$50B (proxy for large cap companies) grew between 10-20% annually over a 10-year period, whereas 21.2% of companies with sales between \$325M - \$700M (proxy for small cap companies) grew between 10-20% annually over a 10-year period. This might sound intuitive and obvious, but statistics prove that smaller companies grow faster than larger companies! What's more surprising is the difference in the magnitude of growth rates between these two cohorts. The average 10-year compound annual growth rate in net income of smaller companies is 1.7x greater than that of larger companies.

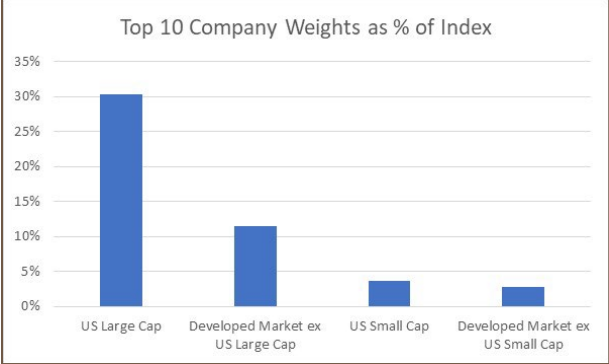


Courtesy of Credit Suisse

Why small cap active management over small cap passive?

In theory, small caps should outperform large caps over the long run because on average, smaller companies should have more room to grow. However, this has been the case over the last 15 years with the S&P 500 outperforming the Russell 2000.

We believe at least some of this outperformance can be explained by index construction. We've already explained how the S&P 500 has a much higher concentration in their top 10 weights than most other equity indices. The bigger businesses kept growing bigger. We believe the majority of an investors' returns over the long term will be driven by a handful of stocks. Just look at Berkshire Hathaway's equity holdings. Our job is to make sure we hold on to these stocks at material weights in our portfolio. We are big believers of not selling our winners. The largest weight in the Russell 2000 is <50 bps while the largest weight in the S&P is



>7%. As a result of success, the US small cap index has to sell its winners. We think this "graduation" of higher

quality businesses out of the Russell 2000 index is detrimental to the performance of the index over the long term.

At Laurus, we believe that taking an active, concentrated approach to small cap stock selection will result in superior performance over the long term against the

benchmark. We are not governed by the same constraints as the index. We are not forced to sell good companies. Our mantra is to buy at \$2B market cap, do nothing, and wait to sell at \$25B.



FOR MORE INFORMATION, PLEASE CONTACT:

In the U.S. and Canada

Christopher (Chris) Page

President & Chief Executive Officer

chris.page@lauruscounsel.com

(647) 479-2061

Raymond Lam, CFA

Vice President & Portfolio Manager

raymond.lam@lauruscounsel.com

(647) 479-2054

Laurus Investment COUNSEL

120 Adelaide Street West | Suite 1901 | Toronto ON | M5H 1T1

TOLL FREE: 844.430.5501

FAX: 866.404.3963 www.lauruscounsel.com