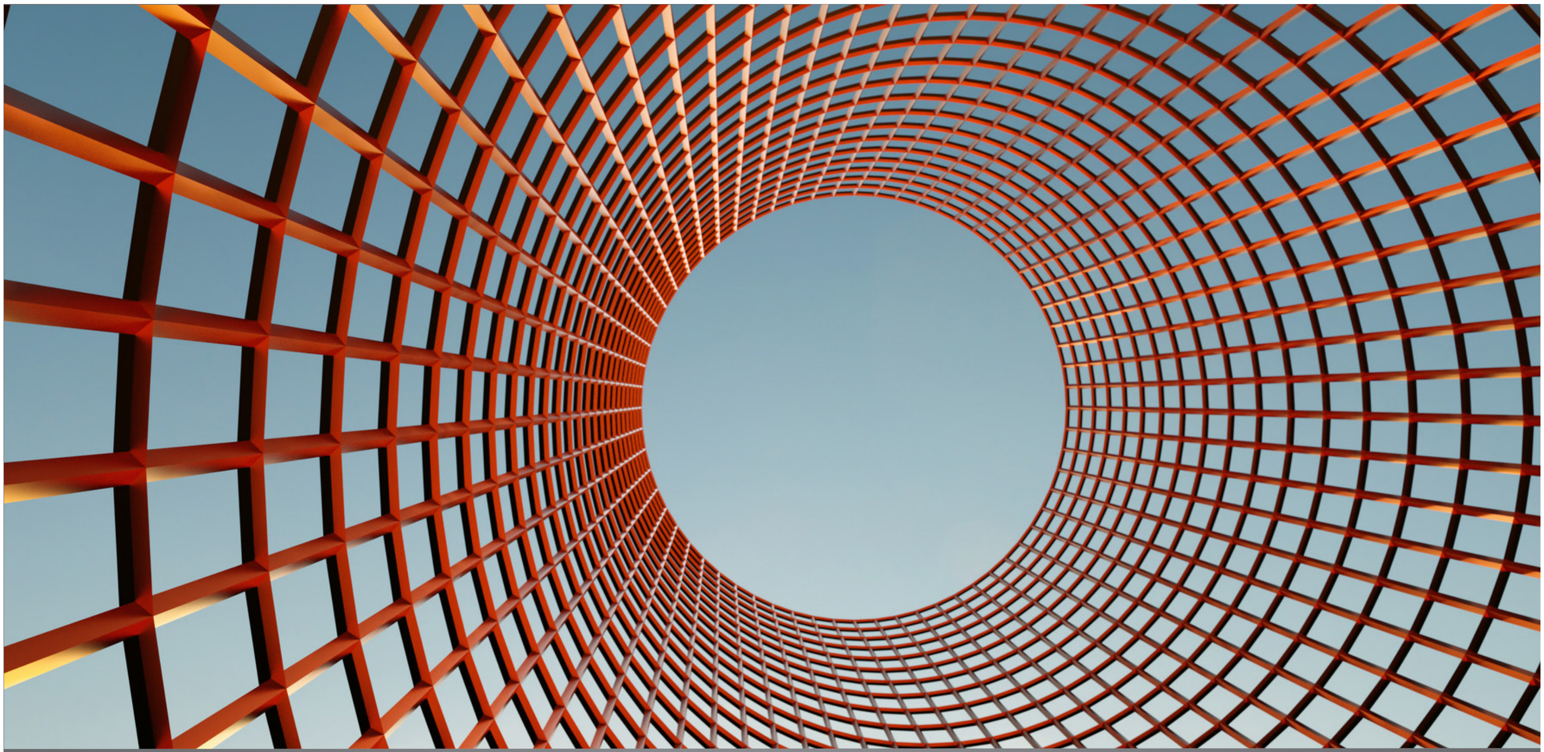


The Case for Small Cap Optimism

Artisan Partners Growth Team

ARTISAN PARTNERS
Insights

For Institutional Investors Only—Not for Onward Distribution

ARTISAN PARTNERS

The Case for Small Cap Optimism

Why do investors invest in small caps?

Small-cap stocks have often outperformed large-cap stocks over the long term, a phenomenon known as the small-cap premium. It was first publicly documented in Rolf Banz's 1981 paper, "The Relationship between Return and Market Value of Common Stocks," published in the Journal of Financial Economics[1]. The Russell 2000® Index was created in 1984 and supporting research followed. Most notably, Eugene Fama and Kenneth French included the small-cap factor in their landmark 1992 three-factor model, which expanded on the capital asset pricing model (CAPM) to estimate asset returns[2].

Reasoning for why investors may demand higher returns for small-cap companies include:

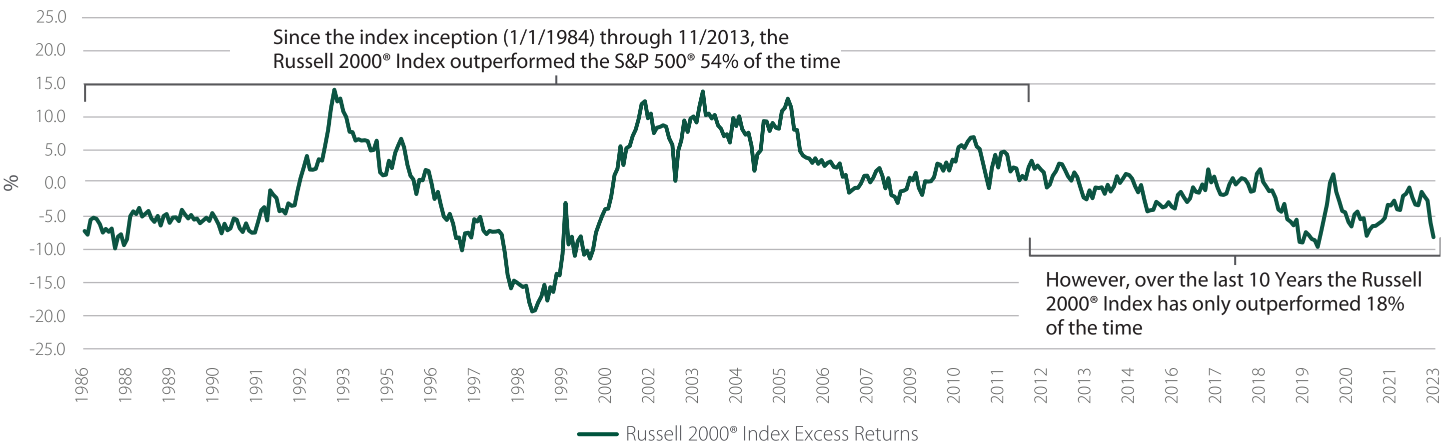
- Greater (perceived) investment risk
- Relatively lower market liquidity
- Better fundamental growth and investment upside potential

Over the first ~25 years of its existence, the Russell 2000® Index outperformed the S&P 500® Index 54% of the time (Exhibit 1). However, it has underperformed for much of the last decade and significantly over the past few years.

Based on YTD performance, the Russell 2000® Index is on track to have its worst calendar year of relative performance versus the S&P 500® since 1998 (Exhibit 2).

Exhibit 1: Small Cap vs Large Cap Historical Rolling Returns (%)

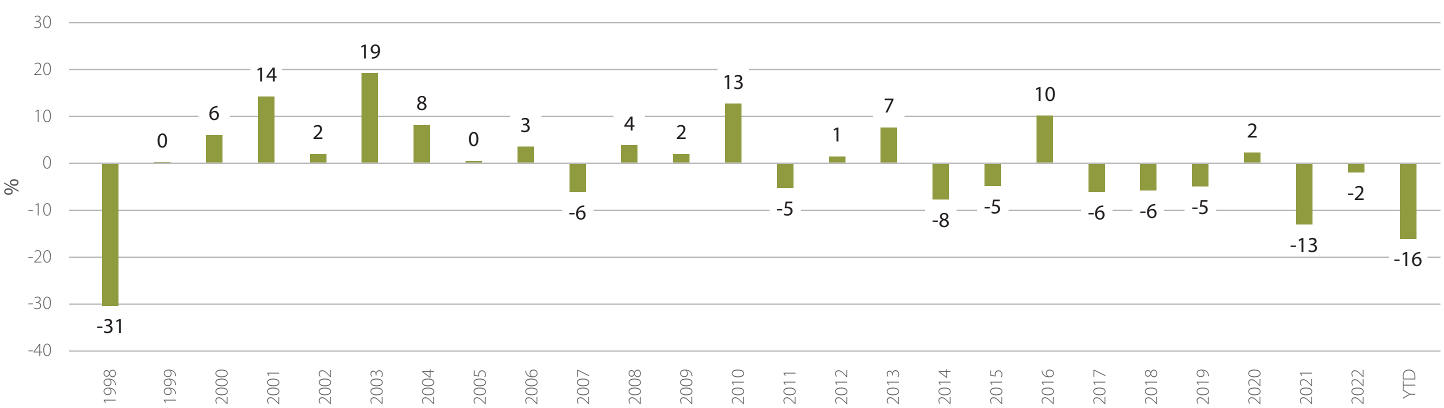
Russell 2000® Index vs S&P 500® Index Rolling 3-Year Excess Returns



Source: FactSet. As of 30 Nov 2023. **Past performance does not guarantee and is not a reliable indicator of future results.**

Exhibit 2: Small Cap vs Large Cap Annual Excess Returns (%)

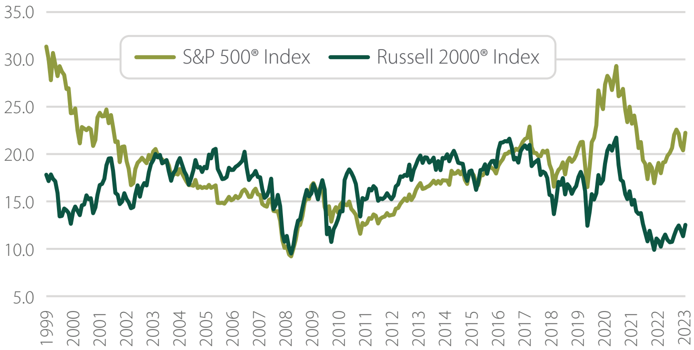
Russell 2000® Index Excess Return vs S&P 500® Index



Source: FactSet. As of 30 Nov 2023. Data is showing price returns of the S&P 500® Index versus the Russell 2000® Index. **Past performance does not guarantee and is not a reliable indicator of future results.**

Small-cap underperformance has opened up the widest valuation gap since 2000 (Exhibit 3). The S&P 500® Index's trailing PE of 22.3 gives it a 71% valuation premium over the Russell 2000® Index's 12.6.

Exhibit 3: Trailing 12-Month Price to Earnings Ratio



Source: FactSet. As of 30 Nov 2023. **Past performance does not guarantee and is not a reliable indicator of future performance.**

Exhibit 4: S&P 500® Trailing 12-Month Price to Earnings Ratio Premium vs Russell 2000® Index

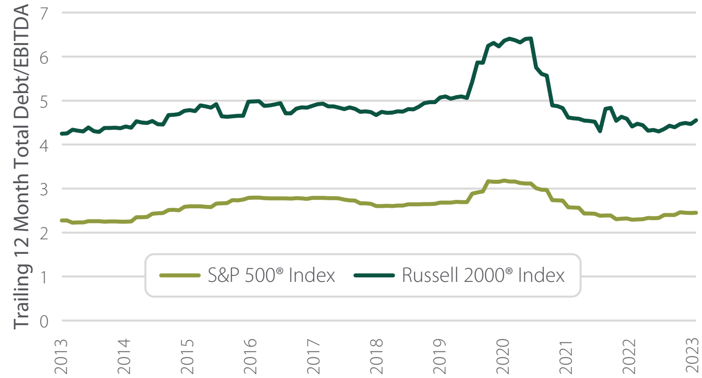
Source: FactSet. As of 30 Nov 2023.

What is weighing on small-cap performance?

The underperformance over the past couple years may have been for good reason. Smaller companies are typically more sensitive to interest rates and the economic cycle than larger companies. The Fed's aggressive rate hikes and market concerns of an impending economic recession, due in part to the Fed's actions, have weighed on small-cap stocks.

Interest rates matter more because many smaller companies are not as profitable and are more dependent on debt markets than their bigger counterparts (Exhibit 5), which tend to have more cash on their balance sheets. Smaller companies borrow more often to grow, and they are among the first firms to be affected when banks tighten lending standards.

Exhibit 5: Small Cap vs Large Cap Debt Profiles



Source: FactSet. As of 30 Nov 2023.

Smaller companies are also more sensitive to economic cycles than larger ones. Economists had warned of a recession in 2023, but it didn't happen. While it is not clear exactly when, or if, a recession may happen, the US economy is widely expected to slow in the coming quarters. The economic uncertainty has led investors to choose the relatively stronger balance sheets and higher-quality nature of large-cap companies.

So why are we optimistic from here?

Simply put, small caps may be at peak negativity.

After underperforming in Q3 of 2023, the Russell 2000® Index has trailed in 9 of the last 10 quarters (Exhibit 6) for just the second time in its history. The other time was late 1996 to early 1999.

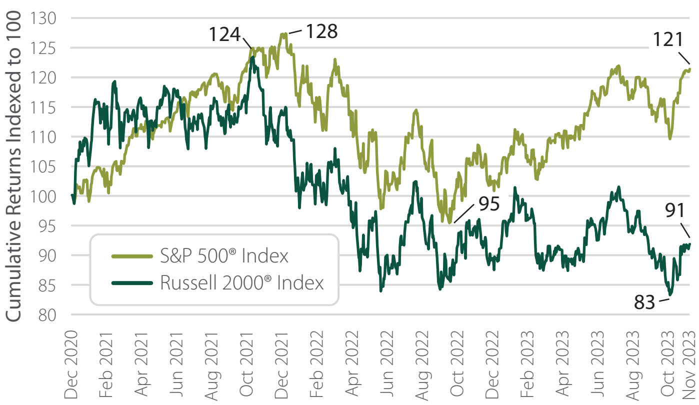
Exhibit 6: Small Caps Have Underperformed in 9 of the Last 10 Quarters
S&P 500® vs Russell 2000® Past 10 Quarterly Returns.

Date	S&P 500®	Russell 2000®	Excess
30 September 2023	-3.3	-5.1	-1.9
30 June 2023	8.7	5.2	-3.5
31 March 2022	7.5	2.7	-4.8
31 December 2023	7.6	6.2	-1.3
30 September 2022	-4.9	-2.2	2.7
30 June 2022	-16.1	-17.2	-1.1
31 March 2022	-4.6	-7.5	-2.9
31 December 2021	11.0	2.1	-8.9
30 September 2021	0.6	-4.4	-4.9
30 June 2021	8.5	4.3	-4.3

Source: FactSet. As of 30 Sep 2023. **Past performance does not guarantee and is not a reliable indicator of future performance.**

The S&P 500® Index has been climbing back from its bear market low made in October of 2022 and is closing in on its prior all-time high reached in December of 2021. Meanwhile, the Russell 2000® remains more than 25% below its all-time high and just made a new post-2021 low in October of 2023 (Exhibit 7).

Exhibit 7: Small Caps Just Recently Made New Lows



Source: FactSet. As of 30 Nov 2023. **Past performance does not guarantee and is not a reliable indicator of future performance.**

The Russell 2000® Index's drawdown that ended in October was among its worst ever (Exhibit 8). Given that financial markets are forward looking, it appears the small-cap drawdown has priced in expectations for a weaker economic environment in 2024. While we do not know whether the bottom is already in, we do know a significant amount of bad news has been baked into the index.

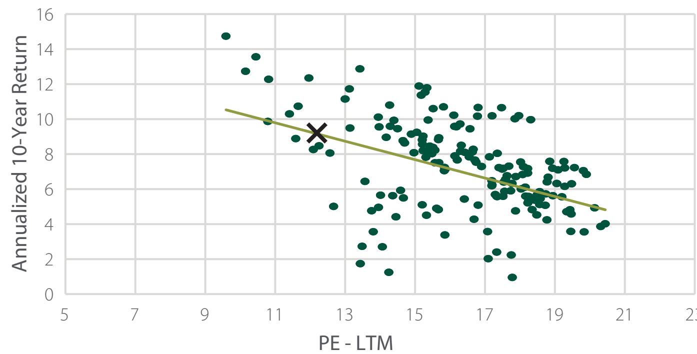
Exhibit 8: Previous Small Cap Drawdowns (Russell 2000® Index)

Date	Drawdown Peak
July 1984	-24.1
February 2016	-25.7
August 1982	-26.2
March 1980	-26.3
December 2018	-26.9
October 2011	-29.1
October 2023	**-31.0**
October 1990	-32.5
September 2001	-36.2
October 1998	-36.5
October 1987	-38.9
March 2020	-41.8
Octobere 2002	-44.1
March 2009	-58.9

Source: FactSet. As of 30 Nov 2023. Dates highlighted in orange are recessionary periods according to the Federal Reserve Economic Data. **Past performance does not guarantee and is not a reliable indicator of future results.**

Lastly, plotting the Russell 2000® Index's historical monthly trailing 12-month P/E ratios versus the subsequent 10-year annualized returns suggests that the 30 November 2023 valuation level (marked by an X in Exhibit 9) indicates a potential double-digit annualized return over the next decade if the trend were to continue.

Exhibit 9: Low Valuations Suggest Strong Forward Returns



Source: FactSet. As of 30 Nov 2023. Data is calculated monthly. **Past performance does not guarantee and is not a reliable indicator of future performance.**

Artisan Partners Growth Team

The following team members contributed to this report

Craigh Cepukenas, CFA
Portfolio Manager

Jay Warner, CFA
Portfolio Manager

Investment Process Highlights

We seek to invest in companies with franchise characteristics that are benefiting from an accelerating profit cycle and are trading at a discount to private market value.

Security Selection

We seek to identify companies with franchise characteristics that are selling at attractive valuations and are benefiting from an accelerating profit cycle. We look for companies that are well positioned for long-term growth, driven by demand for their products and services, at an early enough stage in their profit cycle to benefit from the increased cash flows produced by the emerging profit cycle.

Capital Allocation

Based on our fundamental analysis of a company's profit cycle, we divide the portfolio into three parts. Garden℠ investments are small positions in the early part of their profit cycle that will warrant a more sizeable allocation once their profit cycle accelerates. Crop℠ investments are positions that are being increased to a full weight because they are moving through the strongest part of their profit cycle. Harvest℠ investments are positions that are being reduced as they near our estimate of full valuation or their profit cycle begins to decelerate. We believe that adhering to this process increases the likelihood of delivering upside participation with downside protection.

Broad Knowledge

We overlay security selection and capital allocation with the capability to invest opportunistically across the entire global equity spectrum. It is our goal to have broad knowledge of the global economy to ensure that we are able to find growth wherever it occurs. This capability extends from the design of our team, which leverages the broad experience of the portfolio managers and the deep expertise of the analysts on the team.

Team Overview

We believe deep industry expertise, broad investment knowledge, a highly collaborative decision-making process and individual accountability are a powerful combination. Since the inception of the team in 1997, we have been committed to building a team of growth investors that retains these attributes and is solely dedicated to our process and approach.

Artisan Strategies Managed

- Global Opportunities Strategy
- Global Discovery Strategy
- U.S. Mid-Cap Growth Strategy
- U.S. Small-Cap Growth Strategy

For more information: Visit www.artisanpartners.com

[1] CBS News, Has the Small Cap Premium Disappeared

[2] Yahoo Finance, "How does the fama French 3 factor model work?"

Investment Risks: International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging and less developed markets, including frontier markets. Securities of small- and medium-sized companies tend to have a shorter history of operations, be more volatile and less liquid and may have underperformed securities of large companies during some periods. Growth securities may underperform other asset types during a given period. These risks, among others, are further described in Artisan Partners Form ADV, which is available upon request.

This summary represents the views of the portfolio managers as of 31 Dec 2023. Those views may change and the Team disclaims any obligation to advise investors of such changes.

The Russell 2000® Index measures the performance of roughly 2,000 US small-cap companies. The S&P 500® Index measures the performance of 500 US companies focused on the large-cap sector of the market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

Our capital allocation process is designed to build position size according to our conviction. Portfolio holdings develop through three stages: Garden℠, Crop℠ and Harvest℠. Garden℠ investments are situations where we believe we are right, but there is not clear evidence that the profit cycle has taken hold, so positions are small. Crop℠ investments are holdings where we have gained conviction in the company's profit cycle, so positions are larger. Harvest℠ investments are holdings that have exceeded our estimate of intrinsic value or holdings where there is a deceleration in the company's profit cycle. Harvest℠ investments are generally being reduced or sold from the portfolios.

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