

4Q 2020

# Evolution of Small Cap Investing

The amount of data available on smaller companies is no small matter.

## Executive Summary

- **U.S. small cap equities are often held out as being a less followed market segment**, and while we agree with this notion, we also believe it is a data-rich part of the global equity market.
- **U.S. small cap equities have participated in the significant growth of index investing experienced globally**. We share some thoughts on the potential impact this might have on investing.
- **The renewed popularity of quantitative strategies, combined with smart beta investing, has raised concerns about crowded factors and positions**. We describe our response to this development.

The landscape for active investing continues to evolve. Changes in regulation and policy, technological advancements, investor preferences and easy access to vast amounts of data are a few areas with noticeable changes during the last decade. This evolution requires continued investment in R&D to keep pace with this changing landscape. At Algert Global, there are three

growing areas we have focused our R&D efforts on as it relates to U.S. small cap equities. First, we assess how an explosion of new data and the tools used to interpret this data have been a catalyst for innovative R&D. Second, we consider how the shift in investor sentiment away from active investing towards passive investing has influenced price discovery in U.S. small cap equities. Third, we consider whether crowding of factor exposures, is cause for concern amongst U.S. small cap stocks.

As a quantitative manager we think of data as building blocks for our stock selection models. A broad universe of companies, rigorous regulatory filing and disclosure requirements, vibrant capital markets and “internet-of-things” are all useful features we consider in the development of our models. The recent emergence of “big-data analytics” is not confined to investment management as it has become an integral part of other industries such as Retail, Healthcare and Insurance to mention a few. Big data analytics are even being utilized by professional sports organizations, including the NFL, where teams are now placing chips in players shoulder pad’s to track their positions, and to measure their acceleration and deceleration throughout games.

TABLE 1 | **EXAMPLES OF DATA ITEMS FOR ALGERT GLOBAL'S U.S. SMALL CAP UNIVERSE** (APPROXIMATELY 1,700 NAMES)

Type	Number	Date/Period
Company Earnings Calls	10,858 Calls	During 2019
SEC 8K	21,509 Calls	During 2019
SEC 10K	1,744 Calls	During 2019
SEC 10Q	5,313 Calls	During 2019
News articles	160,420 Calls	During 2019

Sources: Algert Global LLC, CapIQ, U.S. Securities and Exchange Commission

Table 1 represents the number of regulatory filings and investor conference calls as it relates to our U.S. Small Cap universe. While the data itself is not new, the format in which we are able to consume the data has evolved, moving

from Portable Document Format (PDF) to a text based format. Furthermore, historically you would be required to dial-in to company conference calls; today the transcripts of company conference calls are readily available in text format. This transformation combined with advancements in Natural Language Processing (NLP) allows us to “machine read” vast amounts of documents and to score them on a variety of measures. Meanwhile, the cost and availability of computing power has to a large extent been democratized by various cloud vendors as well as the overall decline in the cost of technology.

One may ask, if the cost and availability of data are less of a hurdle today, can NLP techniques remain unique? We believe so, as some of the skills and infrastructure needed are limited in large part to quantitative managers. More importantly however, by possessing more novel ideas and implementing them in a unique way, one can

**Below is an illustrative example of a conference call transcript with color coding on items that might be picked up by a NLP algorithm:**

#### **Wingstop Inc.**

#### **Q2 2020 Earnings Call – Michael Skipworth, Chief Financial Officer**

Thank you, Charlie. As you just heard, we **delivered** another **strong** quarter across the board, including **31.9%** same store **sales growth**, **44.7%** on a 2-year basis. Despite the **challenging** backdrop of COVID-19, we opened 23 net new restaurants, resulting in 1,436 system-wide restaurants at the end of the second quarter, which represents a **10.2% growth** rate. **Royalties** franchise fee and other **revenue increased** by **\$6.7** million to **\$27.9** million for the second quarter, driven primarily by our domestic same-store **sales growth** and 132 net franchise openings since the year-ago comparable period. Advertising fees and the related **income increased** **\$6.4** million to **\$19.9** million, due primarily to a **37% increase** in system-wide **sales** compared to the second quarter in 2019. Our company-owned restaurant **sales increased** **\$4.4** million to **\$18.3** million for the second quarter. This **increase** is due primarily to same store **sales growth** of **24.7%**, the acquisition of one franchise restaurant and the opening of 2 company-owned restaurants since the second quarter of 2019. The **cost** of **sales** as a percentage of company-owned restaurant **sales decreased** by 300 basis points compared to the second quarter of last year. This **decrease** was primarily due to a **22.7% decline** in the **cost** of bone-in chicken wings and our ability to **leverage costs**. This was partially offset by **higher** labor **costs** due to performance-based bonuses and incentive pay associated with COVID-19 for our team members and within the restaurant...

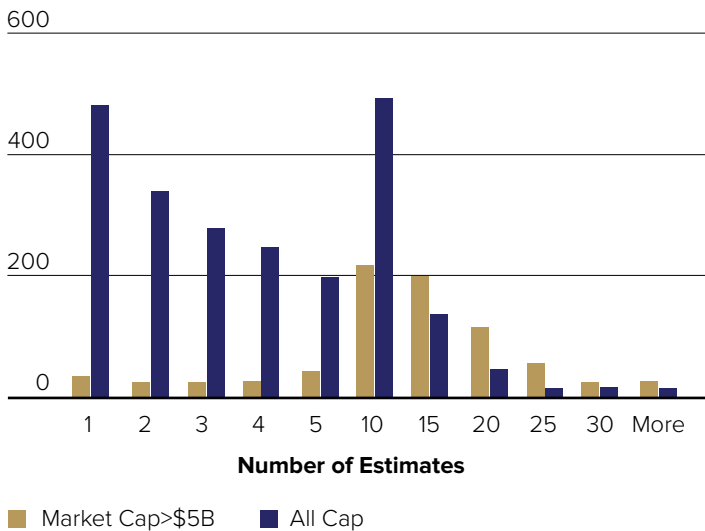
...Given the ongoing **uncertainty** with COVID-19 and the broader impact on the U.S. economy, we are not providing fiscal 2020 guidance with the exception of our estimate for net new restaurant development. Our Wingstop business model has demonstrated its resiliency as we have navigated in this crisis and are thankful to all of the Wingstop team members and brand partners for their hard work and dedication during these **challenging** times. We remain focused on our vision of becoming a top 10 global restaurant brand, and we believe we are well positioned to **grow** our global market share, both during and after this pandemic. As we look **ahead** to the second half of 2020 and beyond, our long-term strategy remains unchanged, anchored by our 3 main **growth** pillars: sustained same-store **sales growth** by **growing** brand awareness; maintaining **best-in-class** unit economics for our brand partners; and continuing to **expand** our global footprint. With that, we're happy to take your questions. Operator, please open the line for questions.

Source: CapIQ, Algert Global LLC. References to company names are for illustrative purpose only and should not be construed as investment advice or an investment recommendation for any of those companies. Other company call transcripts vary and this example is not reflective of all past or future call transcripts that Algert Global may rely upon. Future call transcripts will vary from the above example.

utilize the same data and arrive at different conclusions. In our experience, the most innovative, differentiated and successful outcomes tend to occur when healthy skepticism is applied to new data and technology. An example of this would be the application of “true- and-tested” fundamental valuation metrics combined with the information gleaned from company conference calls using NLP.

While these datasets are not unique to U.S. small cap equities, we believe this market segment tends to be less followed by market participants when compared to its large cap brethren. One proxy for this is sell-side analyst coverage across different market capitalization ranges. Table 2 illustrates the variability of the number of IBES estimates by capitalization ranges.

TABLE 2 | FREQUENCY OF FY1 I/B/E/S ESTIMATES FOR US UNIVERSE (AS OF 6/30/2020)



Source: Algert Global LLC, I/B/E/S

Next, we consider the significant growth in passively managed assets and its potential impact on active investing. While passive investing has historically been synonymous with market capitalization weighted methodologies, today, indices come in all types of “flavors.” For the purpose of this paper, we generally include all index investing but specifically break out factor or smart beta index funds as we discuss crowding in our next section.

Index investing is rich in data points we find interesting. For example, we consider a single stock, Nektar Therapeutics (NKTR). Today, Nektar is a constituent in approximately 3001 different indices as well as 492 U.S. based ETF’s whose

**The table below can serve as a proxy for the growth of passive ownership which has almost doubled in the last 7 years for NKTR.**

holdings alone make up over 17% of the free float of NKTR. Expanding our view to include the last filings<sup>3</sup> from Blackrock, Vanguard, State Street and other large managers of passively managed strategies, these managers now hold nearly 25% of the stock.

TABLE 3 | U.S. LISTED ETF’S HOLDING IN NKTR PER CAPITAL IQ

Year	Number of ETF’s Holding NKTR	% Held of Shares Outstanding
2012	40	9.3%

Source: Capital IQ, ETFChannel

In our view, this would imply that an increasing percentage of the capital invested in Nektar has come from passive investors who have not formulated a return expectation for the stock. Therefore, active investors that still engage in price discovery should in theory see less capital chasing and benefit from these mispricings. Also, what might move the price of individual stocks has evolved to be more and more influenced by index related activities such as rebalancing and index flow based trading. Traditionally, mispricings may have arisen from investor behavior biases, fundamental mispricings, risk premiums etc., and while those certainly still exist, newer “technical factors” are now also a part of the equation. What do we mean by technical factors? First off, it is important to understand that we believe passive funds are focused on matching the index and as such are indifferent to how attractive or unattractive the underlying stock prices or company fundamentals might be. Some index constituents might in fact be trading at lofty P/E ratios, but that fact is irrelevant as any stock that an index provider includes in an index results in purchasing by those funds. One extreme example of this mechanical buying without scrutiny of the underlying stock was the addition of Longfin (LFIN) by an index provider in 2018. Within 6 weeks, the index provider had reversed its decision of including LFIN, but only after index funds buying pressure had pushed the stock up over 100%\*. Upon deletion from the indices, the stock dropped as index funds liquidated their positions. According to the Financial Times, index funds lost more than \$10M on this trade alone.<sup>4</sup> Admittedly, this is an extreme example, but academic research shows that the prices of stocks can experience large swings predominately driven

by index related trades rather than any major fundamental changes to the underlying stocks.<sup>5</sup>

Table 4 is another data point illustrating how prevalent passive investing has become in the U.S. small cap market. The results show that the majority of the top 10 funds ranked by AUM are passively managed.

TABLE 4 | **SMALL CAP FUNDS**

Firm Name	Product Name	Product AUM (\$MM) As of 6/30/2020	Strategy
Vanguard	Vanguard Small-Cap Index Fund	\$87,144.14	Passive
BlackRock	Russell 2000 Equity Index Fund	\$53,757.19	Passive
T. Rowe Price	US Small-Cap Growth Equity Strategy	\$40,485.28	Active
BlackRock	iShares Russell 2000 ETF	\$36,680.00	Passive
State Street Global Advisors	Russell Small Cap Completeness Index	\$31,379.28	Passive
Vanguard	Vanguard Small-Cap Value Index Fund	\$26,580.74	Passive
Vanguard	Vanguard Small-Cap Growth Index Fund	\$25,803.31	Passive
Dimensional Fund Advisors LP	US Small Cap Equity Strategy	\$20,196.18	Active
T. Rowe Price	US Small-Cap Core Equity Strategy	\$18,071.06	Active
Northern Trust	NT Russell 2000 Index Equity Strategy	\$18,065.78	Passive

Source: Capital IQ, ETFChannel

The prevalence of these passive funds leads many active managers to try to exploit what we often refer to as “uninformed flow” or “price insensitive buyers or sellers”. In the short term, active managers might try to trade with the

flow as it pushes prices over the shorter term. Over longer horizons however, active managers might seek to identify stocks whose flows have pushed prices away from what stock-specific fundamentals might support. As opposed to the first example, in this scenario, active managers might bet on a reversal to a price closer to what the manager believes the fundamentals can support.

Lastly, we address a frequently asked question from investors; is the increased AUM in quantitative funds and the popularity of various factor or smart beta index strategies a cause for concern? A legitimate question given Morningstar’s estimate that over \$860 billion is now invested in various smart beta index funds<sup>6</sup> and an additional \$1.2 trillion invested in active quantitative strategies. The short answer is yes; not only does Algert Global monitor these flows, we explicitly build into our process ways to mitigate our exposure to crowded exposures both from a factor lens but also on an individual stock lens. An important part of our investment process seeks to limit the amount of generic factor exposures in our portfolios although we do not seek to eliminate them totally as these factors are also drivers of return. The role of factors like value, momentum and low volatility vary with economic conditions and the amount of capital allocated to these strategies. We’ve incorporated this into our risk budgeting process by monitoring how these factors are being priced. To do this, we develop a pricing base line by examining the historical valuation of these factors. We use a historical factor valuation to determine whether a factor is currently cheap or expensive. Expensive factors tend to be crowded factors and as a result likely have a lower expected return going forward.

In conclusion, the pace of change in the U.S. Small Cap investment landscape continues to present opportunities and challenges for active managers. At Algert Global, ongoing evolution of our investment insights has been part of our culture since our founding in 2002. Improved data sets, enhanced technology and the need for innovative ideas are not new. To illustrate this point, we calculate the correlation of the insights we use today versus those used a year ago to be approximately 80%, implying that 20% of the insights are new in the last year. This pace of innovation has been fairly consistent in the last several years and we believe it will become increasingly important as markets evolve in the years ahead.

1 Capital IQ; 2 www.etfchannel.com; 3 SEC 13f filing; 4 Financial Times (April 3rd, 2018) <https://www.ft.com/content/acb5ddb6-3341-11e8-ac48-10c6fd-c22f03>; 5 Israeli, D., Lee, C.M.C. & Sridharan, S.A. Rev Account Stud (2017) 22: 1048. <https://doi.org/10.1007/s11142-017-9400-8> 6 <https://www.morningstar.com/articles/992082/did-strategic-beta-products-pass-the-test>

## About North Square

Founded in 2018 and headquartered in Chicago, IL, North Square Investments is an independent, multi-boutique investment firm dedicated to delivering differentiated active investment strategies to the market. With an experienced senior management team, a board composed of industry veterans including John Amboian, Neil Cummins and Brian Gaffney, and backed by Estancia Capital Partners, North Square is a leader in aggregating best-in-class active managers and delivering select, in-demand investment strategies to financial intermediary partners for the benefit of their clients.

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## About Alkert Global

Alkert Global is a San Francisco-based leader in systematic investment strategies founded in 2002. Alkert takes an active, fundamentally driven approach to exploit inefficiencies in global equity markets resulting from investor behavioral biases. The firm currently sub-advises the North Square Dynamic Small Cap Fund.

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