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A Strengthening Case for Small Cap Stocks – October 2022

However, Careful Selection Needed – Highlights from Lord Abbett Report of 10/18/2022

Amid a challenging market, valuation and earnings data suggest fresh opportunities in small caps.

Over the last few years, the dispersion between small cap valuations and large cap valuations has widened meaningfully. Small caps (as measured by the Russell 2000® Index) are trading at roughly a 20% discount when compared to the long-term average (from 10/31/2002 – 10/14/2022). Historically, when small caps have traded at valuation levels like those seen today, there has been compelling forward performance as measured by total return.

While the discounted valuation levels may seem unsurprising given the concerning macroeconomic backdrop—an increasingly hawkish U.S. Federal Reserve, strong inflation, and the potential for a U.S. recession—we believe the steep discount in valuations may not be warranted. From an earnings perspective, we continue to see analysts’ expectations for the earnings of large cap stocks (based on the Russell 1000® Index) revised downward, while earnings expectations for small caps have remained more resilient.

Expected Earnings for Small Caps Remain Resilient Versus Larger Peers

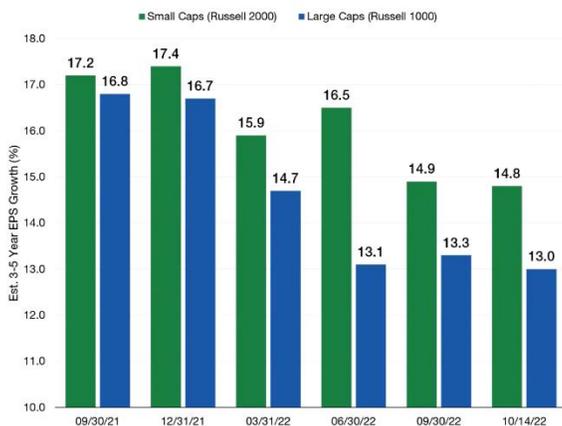


Chart shows the estimated three- to five-year earnings-per-share growth for the Russell 1000® Small Cap Index and Russell 2000® Large Cap Index at the indicated dates.

While both have declined, less so for the small cap index.

Source: FactSet. Data as of October 14, 2022.

Another consideration for investors interested in small caps is the current strength of the U.S. dollar. Dating back to the 1970s, during periods of dollar increases of 15% or more, small caps, as represented by the Russell 2000® Index, have returned 13.2% annualized versus 10.3% for the S&P 500® Index. Lord Abbett this report not separately sourced

In the past, we have noted that small cap companies historically have derived most of their revenue from U.S.-related operations. This has helped to shield their overall competitive position and profitability versus firms that derive a larger share of revenues outside the U.S. Companies with a greater non-U.S. focus may be hurt by a stronger dollar in two ways. First, they may see weaker demand for their goods and services, as the strong dollar makes their offerings more expensive for non-U.S. buyers. Second, they may see a negative impact on profits from currency-translation factors.

Final Thoughts – Careful Selection Needed

While there are reasons to be optimistic about the small cap space, we believe challenges, such as inflation and higher interest rates, will lead to a difficult operating environment for companies across the market capitalization spectrum. This will likely result in a greater dispersion between the winners and the losers in the equity market, particularly in small caps.

Active managers with time-tested fundamental research capabilities and expertise in security valuation may be best positioned to identify those winners—and steer clear of the losers. Further, limited coverage by securities analysts across the asset class may actually depress valuations of otherwise strong small cap companies. Firms with research focused on these smaller companies may be in the best position to identify

compelling opportunities in under-followed stocks and potentially generate attractive returns. Valuation and earnings data suggest fresh opportunities in small caps.

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Small-cap funds may be subject to a higher degree of market risk than large-cap funds or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Russell 1000 Index® measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

Investors cannot invest directly in indexes. The performance of any index is not indicative of the performance of any investment and does not take into account the effects of inflation and the fees and expenses associated with investing.

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