



Small Cap Portfolio Analysis

We recently conducted an analysis of a professional investor's small cap equity portfolio, structured with equal allocations to a growth manager and a value manager. This approach aims to offer style diversification, along with the expectation that in any given market condition, one manager should outperform the benchmark, offsetting underperformance from the other. In this case, we used the Bloomberg 2000 Total Return Index as the benchmark, and the two managers exhibited a negative correlation of excess returns of 0.35, indicating a complementary relationship.

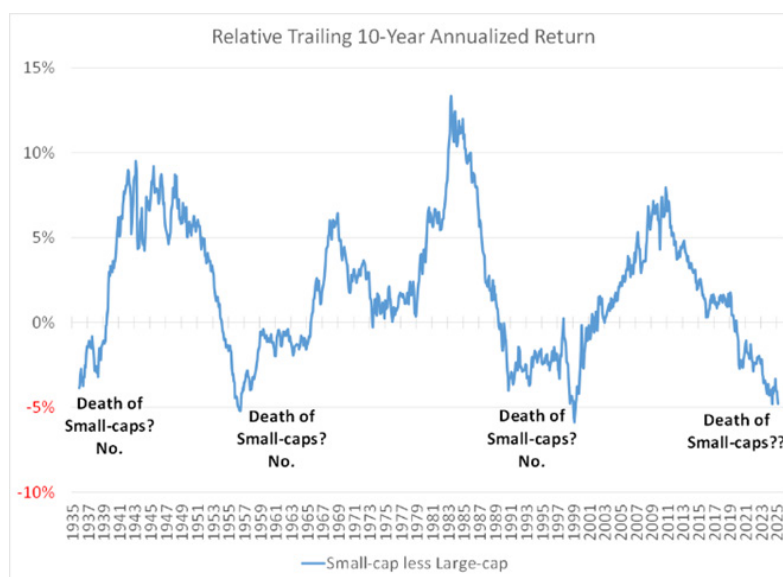
Growth Manager		Value Manager	
Wtd. Avg. Market Cap	\$4.1B	Wtd. Avg. Market Cap	\$4.0B
Number of Holdings	112	Number of Holdings	111
Up Market Capture	97.25%	Up Market Capture	98.19%
Down Market Capture	95.31%	Down Market Capture	86.15%

This structure has proven effective, with the portfolio outperforming the Bloomberg 2000 by 132 basis points annually over the past 13 years. Notably, it outperformed in 10 of those 13 years. However, two of the three years of underperformance coincided with periods when small caps exceeded large caps — a scenario less favorable for this particular structure.

	Average Annual Return	Cumulative Returns (1/12-3/25)
1/2 Growth Manager, 1/2 Value Manager	13.59%	413.95%
Bloomberg 2000	12.27%	353.73%

Market Context and Potential Challenges

Given the extended period of large-cap leadership, some market observers believe small caps are set for a stronger performance phase. However, this could pose challenges for the current portfolio, as both growth and value managers have weighted average market caps around \$4 billion, which is roughly 30% larger than the \$3 billion average of the small-cap index. In fact, a \$4 billion average market cap exceeds approximately 85% of the constituents in these indices, potentially limiting the portfolio's ability to fully capture small-cap rallies.



Source: Bloomberg

Past performance is not indicative of future results.

Downside Protection Potential vs Upside Participation

Additionally, both managers have historically offered better downside protection than upside participation, as shown in their up and down-market capture ratios. This conservative approach may restrict returns in a robust small-cap market environment. Research by Furey Research, dating back to 1986, indicates that in years when small-cap indices outperformed large-cap indices by more than 4%, the four quintiles with the smallest market capitalization companies outperformed the largest quintile by nearly 8% annually, while the smallest two quintiles outperformed by almost 9.5%.

Opportunity for Portfolio Enhancement

To address this potential headwind, adding a core small-cap manager with a lower average market cap and stronger up-market capture could enhance overall portfolio resilience. One option to consider is the Penn Capital Smaller Company Equity Strategy, which offers a differentiated profile:

Penn Capital Smaller Company	
Style	Small Cap Core
Weighted Average Market Cap	\$2.2B
Number of Holdings	108
Up Market Capture	116.51

Incorporating this strategy into a diversified blend with existing growth and value managers has the potential to significantly enhance returns. Historical hypothetical simulations indicate that a model portfolio evenly allocated among the three strategies would have yielded average annual returns of 15.56%, representing an additional 197bps of average annual outperformance while producing 534bps of added performance in years where small caps outperformed large caps. (shown in table and charts below)

	Average Annual Return	Cumulative Returns (1/12-3/25)
1/3 Growth Mgr, 1/3 Value Mgr, 1/3 Penn Capital Smaller Company	15.56%	506.20%
1/2 Growth Manager, 1/2 Value Manager	13.59%	413.95%
Bloomberg 2000	12.27%	353.73%

	Manager Annual Performance			Model Portfolio Total Returns			Relative Performance	
	Growth Manager	Value Manager	Penn Capital Smaller Company	1/2 Gr Mgr/ 1/2 Val Mgr	1/3 Gr Mgr/ 1/3 Val Mgr/ 1/3 Penn Cap Sm Company	Bloomberg 2000 TR	1/2 Gr Mgr/ 1/2 Val Mgr	1/3 Gr Mgr/ 1/3 Val Mgr/ 1/3 Penn Cap Sm Company
Dec 24	19.60%	9.03%	14.17%	14.31%	14.27%	11.95%	2.36%	2.32%
Dec 23	19.24%	21.84%	16.59%	20.54%	19.22%	17.09%	3.45%	2.13%
Dec 22	-23.78%	-8.85%	-17.10%	-16.31%	-16.57%	-20.08%	3.77%	3.51%
Dec 21	4.96%	27.40%	41.20%	16.18%	24.52%	18.58%	-2.40%	5.94%
* Dec 20	38.25%	-1.17%	53.37%	18.54%	30.15%	22.47%	-3.93%	7.68%
Dec 19	30.72%	25.95%	44.61%	28.34%	33.76%	24.29%	4.05%	9.47%
Dec 18	-10.59%	-14.22%	-13.17%	-12.40%	-12.66%	-10.91%	-1.49%	-1.75%
Dec 17	28.44%	6.60%	15.92%	17.52%	16.99%	14.10%	3.42%	2.89%
* Dec 16	10.12%	27.85%	25.38%	18.99%	21.12%	21.54%	-2.55%	-0.42%
Dec 15	4.41%	-3.31%	-7.61%	0.55%	-2.17%	-4.18%	4.73%	2.01%
Dec 14	7.72%	8.65%	-5.18%	8.19%	3.73%	5.50%	2.69%	-1.77%
* Dec 13	50.55%	37.28%	63.84%	43.91%	50.56%	41.11%	2.80%	9.45%
* Dec 12	18.57%	18.13%	21.31%	18.35%	19.34%	17.99%	0.36%	1.35%

* Years when the Small Cap index outperformed the Large Cap Index

Source: Bloomberg

Past performance is not indicative of future results.

Conclusion

Incorporating the Penn Capital Smaller Company strategy could enhance the portfolio by lowering average market cap exposure and boosting upside participation, thereby aligning more closely with the potential for small cap market leadership. This strategy also introduces exposure to smaller, potentially higher-return companies that are often overlooked by traditional growth and value mandates, resulting in a differentiated return profile.

If you would like to learn more about the Penn Capital strategies and how they work with your portfolio, please reach out to your sales rep or contact us at Info@penncapital.com

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