



Finding Opportunity Away from the Crowd

Small capitalization stocks look attractive, and an actively managed small capitalization value strategy can harness the potential in these companies.

Opportunity in Small Capitalization Value

Small capitalization value stocks could be well positioned for outperformance in the coming years. We believe active management can be a prudent and effective approach to these companies. Our thesis is based on:

- Concentration issues in large and small capitalization indices
- Attractive valuations, both relative and absolute
- Supportive economic and government initiatives
- Potential responsiveness to lower interest rates
- Opportunities for active management in small capitalization value

We believe an active, long-term investment approach, focusing on sector diversification, intrinsic value (earnings and cash flow), and qualitative metrics (such as high-quality management teams) is the most effective way to exploit the opportunities that the small capitalization indices and passive ETFs may not capture. We employ this philosophy and approach in the Pinnacle Small Capitalization Value Portfolio (SCV).

The Concentration Problem

In the past couple of years, much has been written about how the U.S. stock market has increasingly become dominated by mega-cap stocks, with the "Magnificent Seven" stocks accounting for over 30% of the S&P 500 today. Furthermore, the largest three stocks in the S&P 500, Nvidia, Microsoft, and Apple, exceed the market capitalization of the entire Russell 2000 Index. We suspect the large capitalization growth theme is over-owned and fully priced.

The issue is not confined to large cap stocks. The Russell 2000 Small Capitalization Value Index has its own concentration issues. The Russell 2000 Value Index is made up of approximately 29% Financials.¹ If you seek small capitalization value exposure through this index, you are making a sizeable bet in the financial sector (small and regional banks, mortgage and loan brokers, REITS, and investment firms).

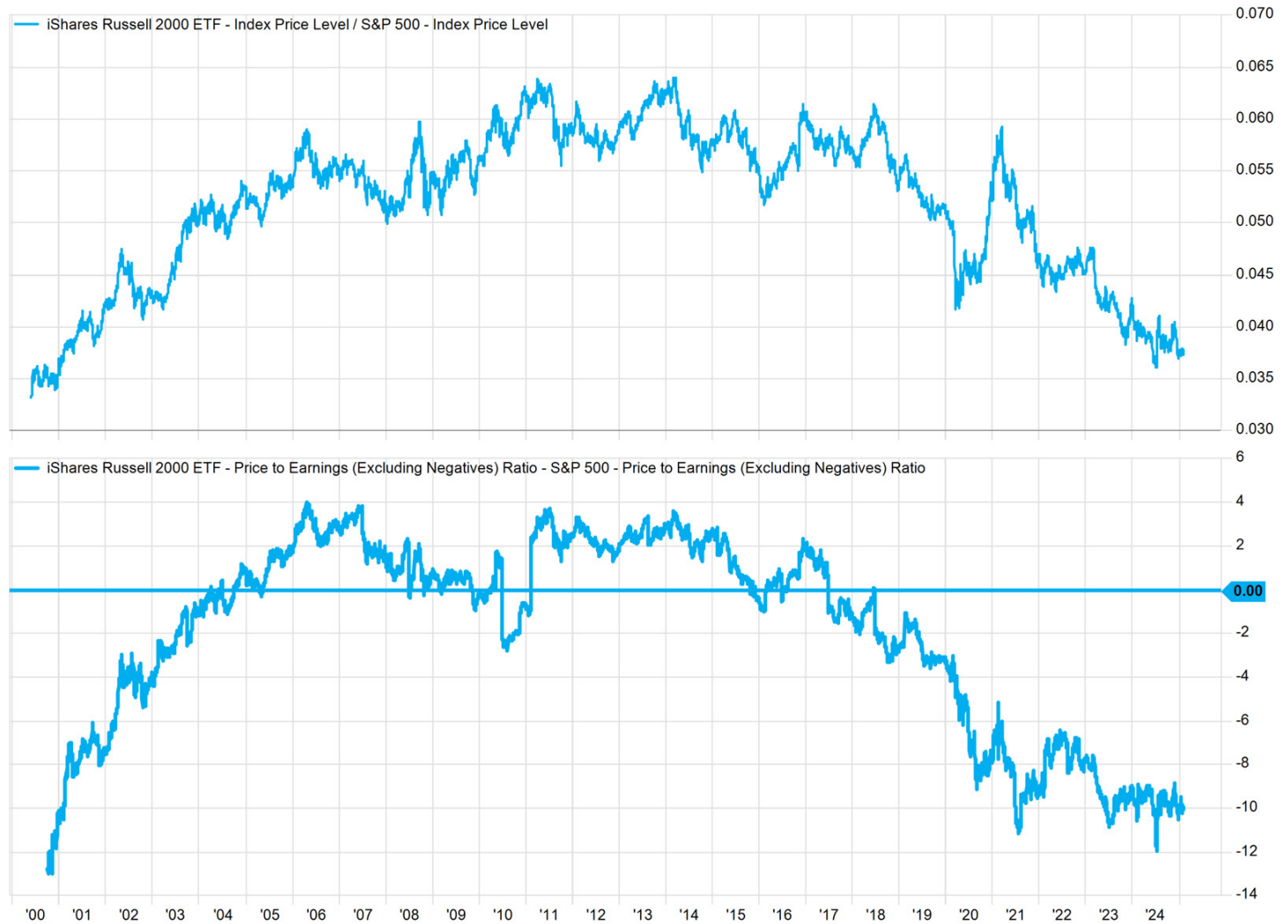
Valuation

The valuation metrics of small capitalization companies versus large capitalization reveal the potential for mean reversion (admittedly, this has been the case for

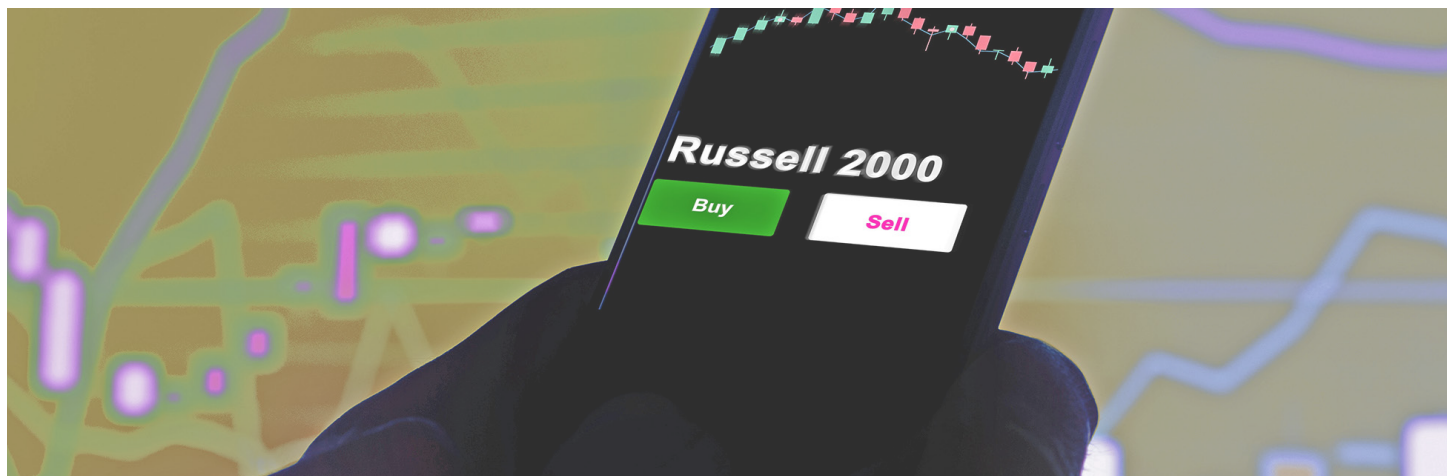
many years). Over the past decade, large capitalization stocks have outperformed small caps consistently, widening the valuation gap. As of year-end 2024, small

capitalization stocks in the Russell 2000 Index were trading at relatively lower earnings multiples.

Russell 2000 Relative to S&P 500 (Price and P/E)

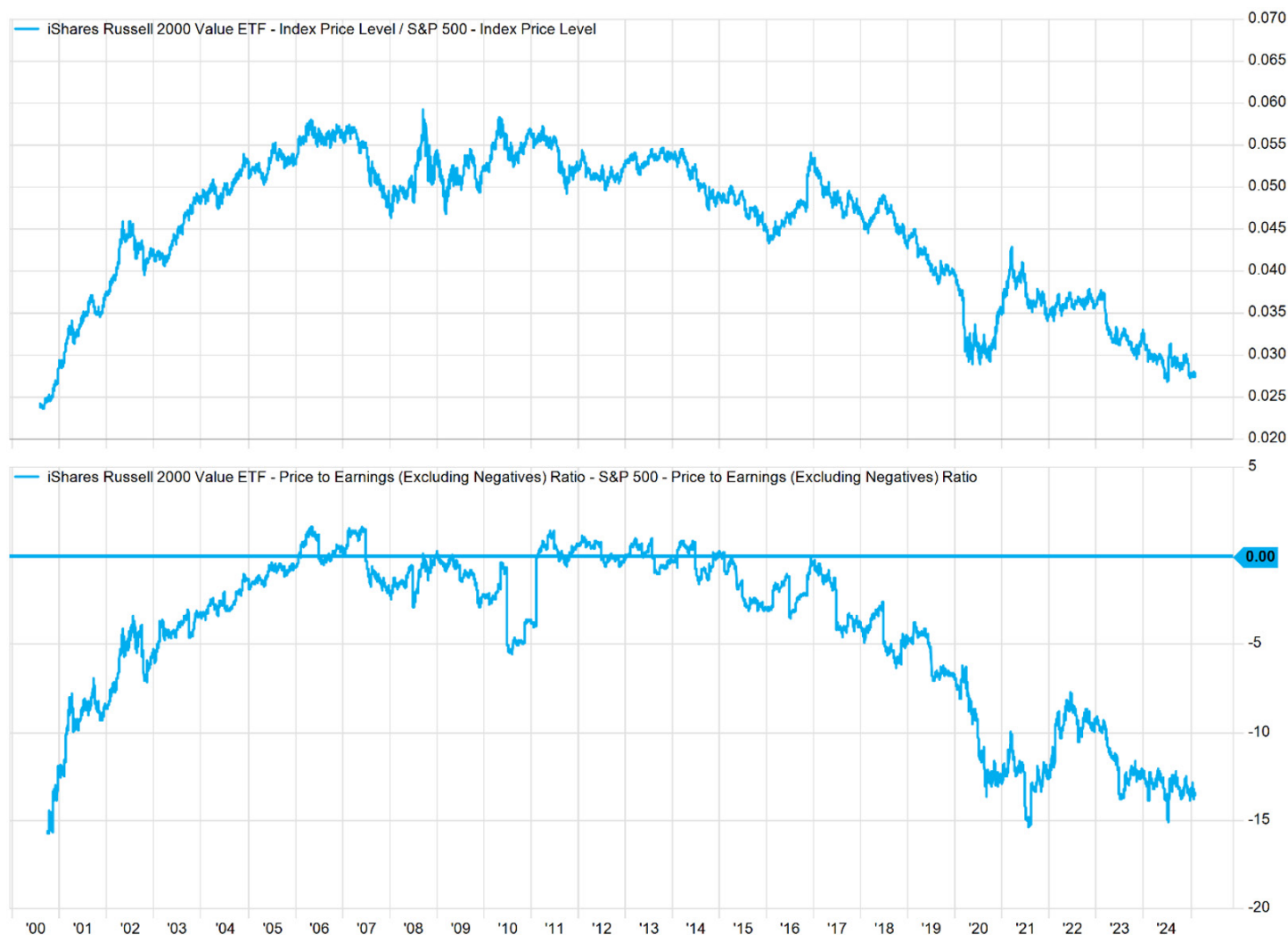


Source: Factset



The same dynamic is true in the Russell 2000 Value Index.

Russell 2000 Value to S&P 500 (Price and P/E)



Source: Factset

Low valuations can persist and are not, as a single factor, a catalyst for higher returns, but we believe the dramatic difference between large and small capitalization valuations may push large allocators to search for opportunities in small caps. This is likely to be a gradual process, probably catalyzed by the mediocre future returns that normally result from large capitalization stocks trading above 20x forward earnings projections.

Another valuation consideration is the slightly alarming fact that over half the Russell 2000 Index companies have negative GAAP earnings. We concentrate on profitable companies that can produce free cash flow

and believe this approach produces a better long-term risk-to-reward profile. Looking at just the profitable companies in the Russell 2000 paints a more relevant, for us, picture for small capitalization stocks. We combined the 975 profitable companies from the Russell 2000 into an index and compared it to Nvidia's stock. Granted, Nvidia is a uniquely profitable company growing at an incredible pace. However, with Nvidia trading at 31x sales, those expectations are built into the price of the stock. The profitable companies in the Russell 2000 are selling at a much more reasonable 1.3x sales.²

Nvidia vs. Russell 2000

Company / Index	Market Value (12/31/2025)	Net Sales LTM	Net Inc LTM
Nvidia (one very profitable company)	\$3,538,070	\$113,269	\$63,074
<i>Multiple</i>		31.2x	56.1x
Russell 2000 (975 profitable companies)	\$2,156,696	\$1,641,486	\$124,016
<i>Multiple</i>		1.3x	17.4x

Small Capitalization Companies Well Positioned to Thrive

Small capitalization stocks should benefit from improvements in economic conditions. Smaller companies normally have greater sensitivity to U.S. economic growth, as their revenues are derived primarily from domestic markets, and the Trump Administration has made crystal clear that it plans to encourage companies to re-shore in the U.S. through tax and tariff incentives. It is difficult to predict how Trump's policies will affect the U.S. economy, but the Administration is clearly pro-business and perhaps pro-small business. In his Senate confirmation hearings, Treasury Secretary Scott Bessent said, “I believe Wall Street has done great the past few years, and Main Street has suffered. I think it’s Main Street’s time.”

The Institute for Supply Management’s (ISM) Purchasing Managers’ Index (PMI) appears to forecast

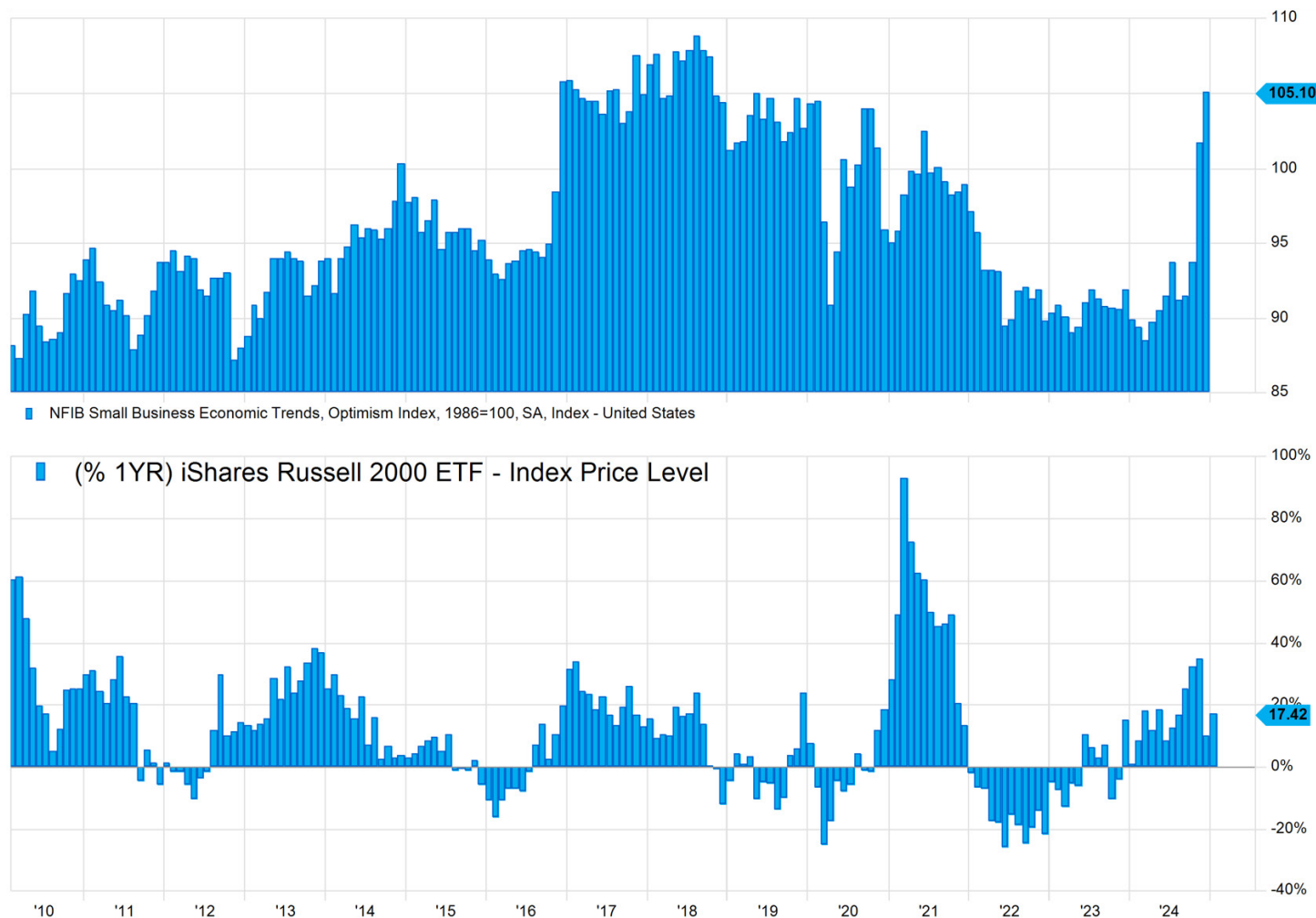
a potential improvement in results for “Main Street.” In January, the Manufacturing PMI turned positive to 50.9% (a reading above 50% denotes expansion, a reading under 50% economic contraction). This was the first positive reading in 26 months, with all four sectors (New Orders, Production, Employment and Supplier Deliveries) expanding.³ This is meaningful for small capitalization stocks because a recovery in the Manufacturing PMI historically has led to earnings growth for small capitalization companies. According to Tom Lee of Fundstrat, ISM manufacturing typically leads Russell 2000 growth by about four months, and this has happened in every up cycle since 1996.⁴

Small businesses may already sense an upturn. According to the National Federation of Independent Businesses (NFIB), the Small Business Optimism Index increased 3.4 points in December to 105.1, the second consecutive month above the 51-year average of 98 and the highest reading since October 2018⁵.



Small Business Optimism Leads the Russell 2000

Small Business Optimism vs Russell 2000 One Year Rate of Change



Source: Factset

Lower Interest Rates = Small Capitalization Outperformance?

Interest rates are impossible to predict, but the Federal Reserve appears inclined to lower rates, and President Trump is clearly supportive of this bias. As mentioned above, we think small capitalization stocks are poised to outperform on a fundamental recovery in earnings growth, but lower interest rates could create a more favorable environment for small capitalization companies in multiple ways. First, lower rates reduce borrowing costs, which is critical for many small companies carrying variable debt. The lower cost of capital promotes investment, enhances profitability, and accel-

erates earnings growth. Second, lower rates increase the present value of future cash flows, boosting valuation multiples. Small capitalization stocks, which often trade based on growth expectations, may see an outsized benefit from this valuation uplift. Finally, lower interest rates can encourage mergers and acquisitions (M&A) activity, as companies can secure cheaper financing for deals. Small capitalization firms are likely targets for M&A, and fewer government regulations may grease the skids for more combinations. These transactions can produce windfalls in specific companies but also higher valuations for profitable small capitalization companies in general.



Advantages of Active Management in Small Capitalization Value

We believe active management offers significant potential advantages in the small capitalization value space. The Russell 2000 Value Index faces exposure imbalances, reliance on outdated valuation metrics for some companies, and market capitalization creep.

Active managers can navigate/exploit these issues by focusing on truly small companies with promising capacity for free cash flow generation, attractive return on invested capital (ROIC), and highly qualified and focused management. The Pinnacle Small Capitalization Value Fund takes a concentrated, sector-diversified approach, avoiding the index concentration in financials and identifying undervalued companies with robust growth potential and company-specific catalysts.

We see four major issues (opportunities) with the small capitalization value indices: unbalanced concentration, the rigidity of what is considered “Value,” market capitalization creep, and the constraints of staying within a Value “box”.

1. The wrong type of concentration. The Russell 2000 Value Index is made up of approximately 29% financials.⁶ By comparison, the Pinnacle SCV financial exposure is approximately 15% of the portfolio and currently consists of three

banks with top quartile returns, a regional insurance provider with consistent profitability, and two countercyclical finance companies. Furthermore, all have company-specific catalysts outside of attractive valuation. For example, two of our regional banks, Atlantic Union (AUB) and First Bank of North Carolina (FBNC), are some of the largest community banks in their respective footprints, and both operate in high-growth, low-unemployment areas of the country.

2. The wrong type of valuation to produce long-term returns. The Russell 2000 Value Index relies on a company’s price/book ratio to warrant inclusion. That is a problem since the price/book ratio is not useful in analyzing all industries, in our opinion. We believe the price/book ratio can be useful for capital-intensive businesses like energy, transportation, manufacturing, and financial companies. But focusing on a low price/book may exclude some high-quality industrial, consumer discretionary, health care, and information technology stocks.

Second, a simple price/book ratio ignores intangible assets. In our service-based economy, that ratio penalizes a lot of interesting companies. To use a few well-known large cap stocks as examples, Apple, Google, and Microsoft never had low price/book ratios (but have had low price/earnings ratios, on occasion, over the years), yet all have been some of the best long-term, intrinsic

sic value purchases over the past 25 years. In the Pinnacle Small Capitalization Value Portfolio, OneSpaWorld (OSW), REV Group (REVG), and Climb Global Solutions (CLMB) are all unique companies that operate niche yet wide-moat businesses that have steadily grown over time. Simply focusing on a low price/book ratio would have excluded these types of companies from our investment process.

Third, price/book does not consider real-time asset values. The GAAP book value of an asset reflects its original cost minus depreciation. But, the market value today may be significantly higher if the value or earnings power of the asset has increased over time. For example, Tidewater (TDW) is an energy sector holding in our portfolio. The stock trades at approximately 2.5x book value and has traded as high as 3.5x book value.⁷ That multiple would normally be considered expensive, but the future cash flows from these vessels, driven by a relatively tight offshore vessel market, are a better indicator (replacement value is also more useful). We also own Alexander & Baldwin (ALEX), a Hawaii-based REIT. ALEX has property on its books going back over twenty years. We can safely say assets in Hawaii are worth much more today than they were twenty years ago.

3. *Not actually investing in small capitalization companies.* Instead of getting a portfolio of small capitalization companies, the Russell 2000 and MSCI Small Cap ETFs hold a significant percentage of

mid-cap companies (defined as companies with a market capitalization between \$2 billion and \$10 billion). For example, the Russell 2000 Index is 58% midcap, and the MSCI USA Small Cap Value Index is 71% mid-cap. The average market cap of the Russell 2000 is actually a mid-cap level \$3.6 billion, with the largest holding being \$14.7 billion equity market capitalization.⁸ The Russell 2000 Value Index has a similar 49% weighting in mid-cap stocks, with an average market cap of \$2.9 billion.⁹ This compares with an average market cap of \$1.7 billion for the Pinnacle Small Capitalization Value Portfolio with only three of thirty four positions over \$3.0 billion market capitalization.¹⁰

4. *Value with potential for growth is a better strategy,* in our opinion, for small capitalization investors. Buying companies with low Price/Earnings or Price/Book multiples is a reasonable start, but limiting exposure to those companies can cap upside potential. Consider this: if you owned the S&P 500 Index but sold it at the end of 2011 when it traded over 2x Price/Book and became “expensive”, you would have missed out on the next 480% return. In the Pinnacle Small Capitalization Value Portfolio, we are looking to buy companies we believe are undervalued and/or out of favor, but we want those companies to transition from value to core to growth. For example, our first purchase of Prestige Consumer Healthcare (PBH) was in May 2018. At the time, the stock was trading at 10x earnings and 1.4x book value – at the low end



of its historic range. In the past seven years, earnings and book value per share have nearly tripled, and valuation has improved. Had we sold PBH in early 2024 when it crossed over arbitrary valuation metrics that made it look “expensive”, we would have missed out on over 35% stock appreciation

(as of February 6, 2025). Furthermore, the earnings and cash flow growth outlook are still strong, and the balance sheet is the strongest it’s been in years. Not all our positions turn out this well, but this path is our goal. We want value stocks that can grow out of a value characterization.

Conclusion

In the Pinnacle Small Capitalization Value Portfolio, we implement the philosophy and opportunities discussed in this paper. We invest in a relatively concentrated yet diversified group of small capitalization companies that can produce earnings and free cash flow and that appear, to present an exceptional risk/reward profile. We try to identify undervalued and overlooked small capitalization companies with the potential for significant upside. The managers employ a rigorous and systematic bottom-up, fundamental analysis to uncover small businesses with solid balance sheets, attractive returns on investment, and/or solvable operational challenges. This approach focuses on companies that can transition from value to core and potentially to growth, capturing a full-cycle recovery. The portfolio managers are supported by Pinnacle’s highly experienced small/mid capitalization investment team and similarly deep trading and administration teams.

¹ FTSE Russell (as of 12/31/2024)

² Source: Factset

³ Source: Institute for Supply Management

⁴ Tom Lee, Fundstrat Flash 2/4/2025

⁵ NFIB Small Business Optimism Index report December 2024

⁶ FTSE Russell (as of 12/31/2024)

⁷ Source: Factset

⁸ Source: Factset, FTSE Russell as of 12/31/24

⁹ Source: Factset

¹⁰ As of 12/31/24

This commentary is limited to the dissemination of information pertaining to Pinnacle Associates, Ltd. (“Pinnacle”) and general economic market conditions. This commentary is an example of Pinnacle’s Small/Mid Cap Equity investment process and should not be construed as a recommendation, personalized advice, or an offer or solicitation to buy or sell any securities. Past performance is not indicative of future results, and there is no guarantee that the views and opinions expressed in this commentary will come to pass. Pinnacle is neither a law firm nor an accounting firm, and no portion of this commentary should be construed as legal or tax advice. You are advised to consult with separate legal or tax advisors with respect to any legal or tax advice. Pinnacle is an investment adviser registered with the SEC. For information pertaining to the registration status of Pinnacle, please refer to the Investment Adviser Public Disclosure website (www.adviserinfo.sec.gov). For additional information about Pinnacle, including fees and services, send for our written disclosure statement as set forth on Form ADV Part 2A.