



Finding Strength in SMID Companies

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At SmartTrust®, we look to provide for diversified income and total return opportunities through innovative investment strategies. We use a bottoms-up approach to develop our Unit Investment Trust (UIT) product strategies, based in large part on the input received from the many advisors we are fortunate to work with across the country. In so doing, we look to only bring products to market when the strategy has value in the market and demand from the marketplace. The majority of SmartTrust® UITs offer diversified income opportunities, as well as the potential for total return, and have incorporated such underlying investment product types as individual taxable and tax-free bonds, individual stocks, preferred securities, business development companies (BDCs), closed-end funds (CEFs), real estate investment trusts (REITs), American depository receipts (ADRs), master limited partnerships (MLPs) and exchange-traded funds (ETFs).

This particular report will focus on investment opportunities that we see in stocks with smaller market capitalizations, typically referred to as small cap and mid-cap ("SMID" stocks). Market capitalization is determined by multiplying a company's stock price by the shares outstanding. Financial Engines defines small cap stocks as those associated with companies with market capitalizations of less than \$2 billion and mid-cap stocks as those associated with companies with market capitalizations between \$2 billion and \$10 billion. However, for these purposes, we define stocks with smaller capitalizations as those with market capitalizations between \$100 million and \$8 billion.

While many investors may only consider large cap stocks for their investment portfolios, perhaps due to the media coverage of widely recognized large cap stock indexes, such as the S&P 500 Index and the Dow Jones Industrial Average, or the lack of name recognition for some of the smaller sized companies, small cap and mid-cap stocks may be appropriate for investment consideration as well. Some reasons to consider small and mid-cap stocks for an investment portfolio include, but are not limited to, the following:

- **Diversification and Return Potential**
 - Diversification can be helpful in reducing risk in a portfolio, recognizing that that it does not assure a profit or protect against loss. Examples of portfolio diversification techniques can include investing across different asset classes (*i.e. U.S. stocks, international stocks, taxable bonds, municipal bonds, etc...*), sectors (*i.e. consumer discretionary, consumer staples, energy, financials, health care, industrial, information*

technology, materials, real estate, communication services, utilities) or market capitalizations (*i.e. large cap, mid-cap, small cap*). To best appreciate the diversification potential of including small and mid-cap stocks within a portfolio strategy it is important to understand correlation. Correlation can indicate how asset classes (*ex. small cap stocks and large cap stocks*) move relative to one another. The maximum correlation between two asset classes is either +1 or -1. A positive correlation of +1 indicates that the two asset classes move up and down at the same time while a negative correlation of -1 would indicate that the two asset classes move up and down at different times. Finally, a correlation of 0 would indicate no relationship at all between the two asset classes. For illustrative purposes, we built a correlation matrix using the portfolio analytics software from Kwanti, based on data from Morningstar, utilizing representative ETFs as proxies for global stocks, U.S. mid-cap stocks, U.S. small cap stocks and U.S. large cap stocks. The ETFs that were utilized for these purposes were:

- iShares MSCI ACWI ETF (Ticker: ACWI) – used as an asset class proxy for global stocks
- iShares Core S&P Mid-Cap ETF (Ticker: IJH) – used as an asset class proxy for U.S. mid-cap stocks
- iShares Core S&P Small-Cap ETF (Ticker: IJR) – used as an asset class proxy for U.S. small cap stocks
- iShares Core S&P 500 ETF (Ticker: IVV) – used as an asset class proxy for U.S. large cap stocks

Here is the resulting correlation matrix which shows that U.S. large cap stocks have a correlation of 0.67 to U.S. small cap stocks, 0.82 to U.S. mid-cap stocks and 0.91 to global stocks. These correlation levels may help to provide for diversification potential to a globally, diversified equities portfolios.

Ticker (Asset Class)	ACWI (global stocks)	IJH (U.S. mid-cap stocks)	IJR (U.S. small cap stocks)	IVV (U.S. large cap stocks)
ACWI (global stocks)	1.0			
IJH (U.S. mid-cap stocks)	0.7	1.0		
IJR (U.S. small cap stocks)	0.52	0.92	1.0	
IVV (U.S. large cap stocks)	0.91	0.82	0.67	1.0

These correlation levels can also correspond to levels of outperformance and underperformance respectively in different market cycles. Consider the following capital market index calendar year

returns through August 2018 and note how performance varies from year to year for three different U.S. market capitalizations:

Index (Coverage)	2018 YTD	2017	2016	2015	2014	2013
S&P 500 Index (U.S. large cap stocks)	9.94%	21.83%	11.96%	1.38%	13.69%	32.39%
S&P Midcap 400 Index (U.S. mid-cap stocks)	8.68%	16.24%	20.74%	-2.18%	9.77%	33.50%
S&P Smallcap 600 Index (U.S. small cap stocks)	18.30%	13.23%	26.56%	-1.97%	5.76%	41.31%

Source: Wells Fargo Advisors, based on data from Morningstar, as of September 5, 2018. You cannot invest directly in an index. Past performance is not an indication of future results.

- **Reduced Impact of a Strengthening U.S. Dollar and/or Trade and Tariffs Dynamics**

- Many smaller companies are essentially insulated from a rising U.S. Dollar valuation or negative fallout from international trade agreement tensions as the majority, if not all, of their sales and revenues come from domestic markets as opposed to larger, multi-national companies who derive a significant part of their revenue from overseas operations. For example, according to a June 24, 2018 U.S. News article entitled, “*Small and Mid-Cap Stocks Benefit from Tax Cut*” companies in the small cap-oriented S&P SmallCap 600[®] Index have 79% of their revenues derived from the U.S., while companies in the mid-cap oriented S&P MidCap 400[®] Index have 73% percent and companies in the large cap-oriented S&P 500[®] Index have the lowest percentage at 71%. Furthermore, “mega cap” companies in the multi-national, blue chip-oriented S&P 100 Index derive even more of their revenues outside of the U.S. with just 54% derived domestically according to the August 26, 2015 Business Insider article entitled, “*Bigger stocks are more exposed to the turmoil overseas.*”

- **Larger Relative Benefactors of Recent Corporate Tax Cuts**

- Small and mid-sized companies are expected to receive a greater benefit from the recent corporate tax reform compared to larger companies who may pay a relatively significant portion of their taxes overseas. Benefiting small to mid-cap companies could use these tax savings to invest back into their growing companies in a number of different ways such as business expansions, debt reductions, balance sheet cash stockpiling, dividend increases, acquisitions and even stock buybacks.

With respect to the latter, most investors probably would not associate stock buybacks with small caps. These investors would be surprised to know that companies with smaller capitalizations do buy back their own shares, though perhaps not to the same extent as their large cap counterparts, and those that do have often outperformed. To this end, according to the April 25, 2015 Barron's article, "Small-Caps Stand Tall in the Buyback Game", from the end of 2013 through April 17, smaller companies that bought back a lot of their shares outperformed the Russell 2000 by 3.5 percentage points, on average. In addition, a study performed by WisdomTree entitled, "*Long-Term Record Indicates Small Caps with Net Buybacks Have Been Strong*" showed not only that firms that were buying back shares tended to outperform firms that were issuing shares but that the firms on the smaller end of the market capitalization spectrum also tended to do better than the firms on the larger end of the market capitalization spectrum.

- **Takeover Opportunities**

- Companies with smaller capitalizations may be more likely to be acquired by larger companies, creating the potential for capital appreciation associated with any consummated mergers or acquisitions. Lending credence to this smaller company acquisition likelihood, consider the following U.S. deal size statistics according to the *August 2018 Flashwire US Monthly* report, as published by FactSet, for the 12 months ended July 31, 2018:

Deal Size	Number of Deals
\$1 Billion +	375
\$500 Million - \$999.9 Million	257
\$250 Million - \$499.9 Million	310
\$100 Million - \$249.9 Million	507
\$50 Million - \$99.9 Million	459
\$25 Million - \$49.9 Million	402
\$10 Million - \$24.9 Million	452
Under \$10 Million	945
Undisclosed	8,648
Total	12,358

The question then becomes how best to find those small to mid-cap companies whose stocks offer the greatest growth potential.

A SmartTrust[®] UIT Strategy for Strong SMID Company Exposure

At SmartTrust[®], we approached the idea of building an investable portfolio of "strong" small to mid-cap (*i.e.* SMID) companies very methodically. Our resulting **SMID Strength Trust** is a 15 month unit investment trust (UIT) that seeks total return potential through capital appreciation and dividend income.

Our initial universe of securities for consideration in each series of our SMID Strength Trust is derived from companies in the S&P MidCap 400[®] Index and companies in the S&P SmallCap 600[®] Index. As points of reference, the S&P MidCap 400[®] Index covers over 7% of the U.S. equity market and seeks to measure the risk and return characteristics of U.S. mid-cap companies and the S&P SmallCap 600[®] Index covers approximately 3% of the U.S. equity market and seeks to measure the risk and return characteristics of U.S. small-cap companies.

From this initial pool of approximately 1,000 securities, we further narrow down the securities for further consideration to those stocks with market capitalizations of between \$100 million and \$8 billion and average 30 day trading volumes of \$500,000 or more as of the time of selection.

At this point, we select the final portfolio of 30 stocks using factors which we believe are indicators of company strength. The 5 factor model employed for these purposes include *earnings, price, dividends, free cash flow (FCF) and share buybacks*. Growth rates over the last year and estimated growth rates over the next year were used for the first three of the five factors, while balances and activity over the last year were considered for the last two of the five factors listed below as follows.

- **Earnings**, based on:

- earnings per share growth over last year; and
- estimated earnings per share growth over next year;

- **Price**, based on:

- price per share growth over last year; and
- estimated price per share growth over next year;

- **Dividends**, based on:

- dividend per share growth over last year; and
- estimated dividend per share growth over next year;

- **Free cash flow (FCF)**, based on trailing twelve month free cash flow balances; and

- **Share buybacks**, based on share buybacks over last year.

Analyst ratings are also considered when determining the final securities for each series of the Trust strategy. The 30 securities selected for the portfolio are approximately equally weighted at inception and will vary thereafter.

Risk Factors

It is important to remember that investing in companies with smaller capitalizations comes with unique risks and considerations. For example, small to mid-cap equity securities are often more volatile and

have lower trading volumes than stocks of larger companies. Small and mid-size companies may also have limited products or financial resources, management inexperience and less publicly available information.

While no screening criteria can guarantee a positive total return, we believe that the security selection approach employed at SmartTrust®, as described throughout this whitepaper, can be helpful in creating a portfolio strategy that seeks to provide total return potential during the life of the Trust by investing in a portfolio of strong small to mid-cap U.S. companies.

If you are interested in learning more about this particular Trust strategy, or any of our other innovative UIT portfolio strategies, please contact your Financial Advisor or visit www.smarttrustuit.com.

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