Small-Cap Stocks: A Revisit at the Year End

– Danke Wang, CFA, FRM, Portfolio Manager

At the beginning of the year, we provided our perspective on small-cap opportunities. Since then, the market landscape has witnessed substantial changes and developments. As the year draws to a close, now is an opportune time to revisit the insights we initially shared and highlight the emerging challenges and solutions.

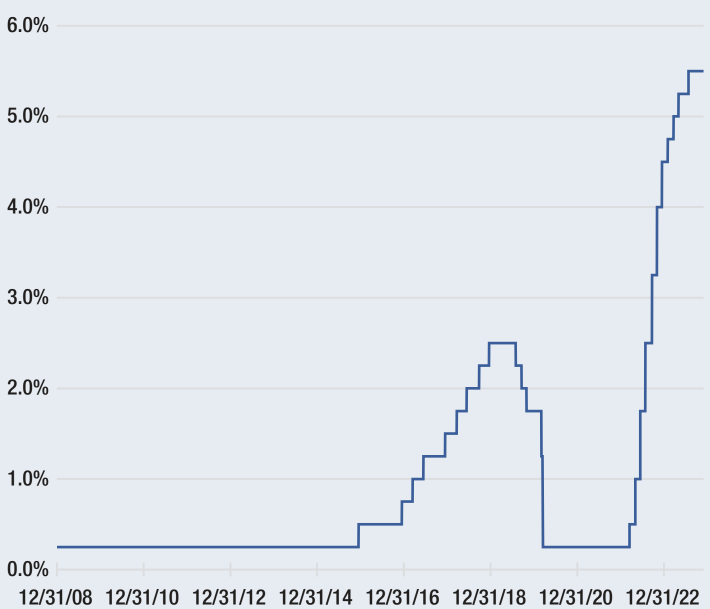
Key Takeaways

1. The flat read of October inflation fueled a market rally with small-cap performing the best, indicating the market may have bottomed out;
2. Interest rates may continue to stay high which could pose additional challenges to small-cap companies;
3. The Pacer US Small Cap Cash Cows 100 ETF (CALF) aims to invest in high-quality companies with higher profitability and lower leverage, potentially offering a significant advantage and reduced risk compared to the broader small cap markets.

Over the last 18 months, the Federal Reserve has undertaken an aggressive path of raising interest rates to combat inflation. This initiative has seen the policy rate ascend from 0.25% to 5.5%. Throughout this period, the market participants have been overwhelmed with various economic data regarding inflation and the job market, coupled with insightful commentary from Federal Reserve officials and the nuanced details unveiled in the Federal Open Market Committee (FOMC) minutes.

Against this backdrop, the financial community has been engaged in extensive discussions about the potential trajectory of the policy rate, which has contributed to heightened market volatility as investors and analysts navigate through uncertainties.

Federal Funds Target Rate - Upper Bound
12/31/2008 to 11/30/2023



Source: Pacer Advisors, Bloomberg

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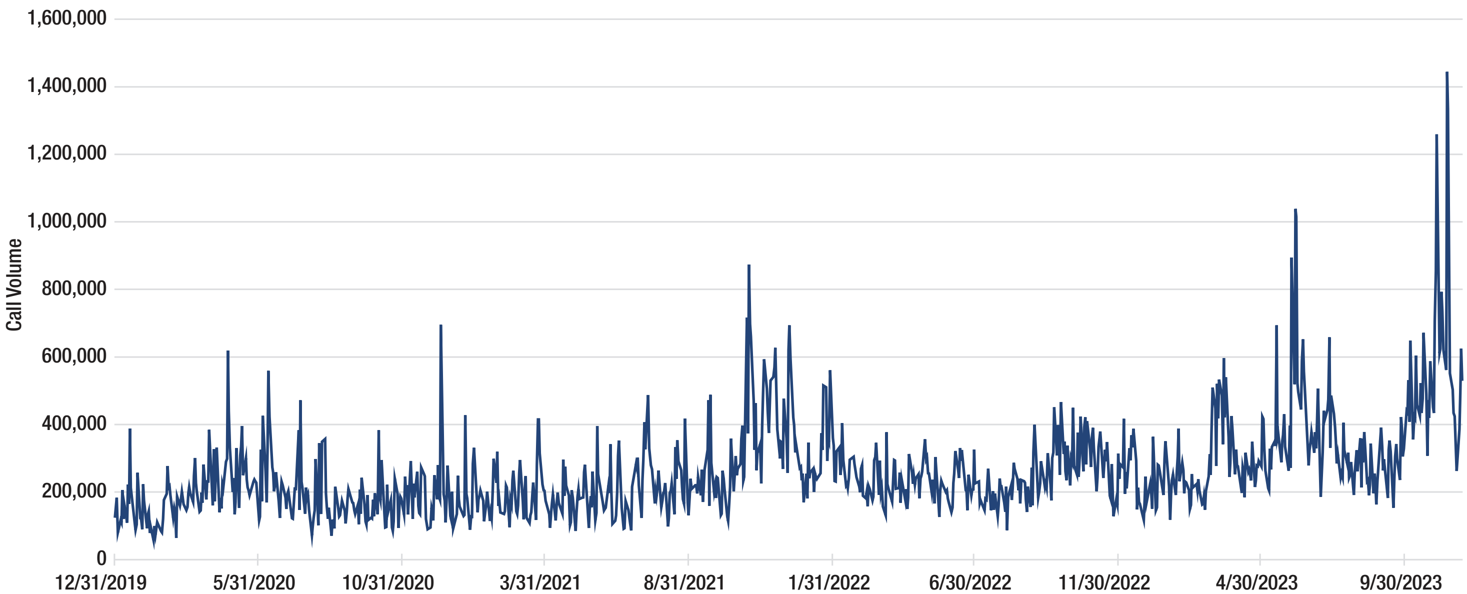
Following the flat read of October inflation, the equity market surged as Treasury yields fell sharply when traders took any potential Fed rate hikes almost completely off the table. As implied by the 30-Day Fed Funds futures pricing data, the probabilities of an interest rate hike for the next two FOMC meetings are zero, and the interest rate may start to decrease as early as March 2024.[1]

Among the stock market rallies, small-cap stocks stood out with the Russell 2000 Index up more than 5.4% as of 11/14/2023. The Russell 2000 ETF (IWM) call volumes rose to the highest level in 5 years. Such a price move coupled with heavy volume indicates a market that may have bottomed out and is being fueled by heavy institutional accumulation.

[(1)] see the "Implied Fed Fund Rates" chart

Russell 2000 ETF (IWM) Total Call Volume
12/31/2019 to 11/30/2023



Source: Pacer Advisors, FactSet

Despite signs of slowing inflation and the potential delay in further rate hikes, the outlook for small-cap stocks may not be as bright as what the recent stock price movements suggest.

Even with a pause in rate hikes since August 2023, officials from the Federal Reserve, on multiple occasions, have communicated a consistent message - if inflation persists above the 2% target, there is a strong likelihood that interest rates will be maintained at elevated levels for an extended period.

As shown in the chart below, the implied Fed Funds Rate for the next 2 years still sits above 4%, which is a level not seen since 2008 before the most recent hiking cycle initiated in 2022.

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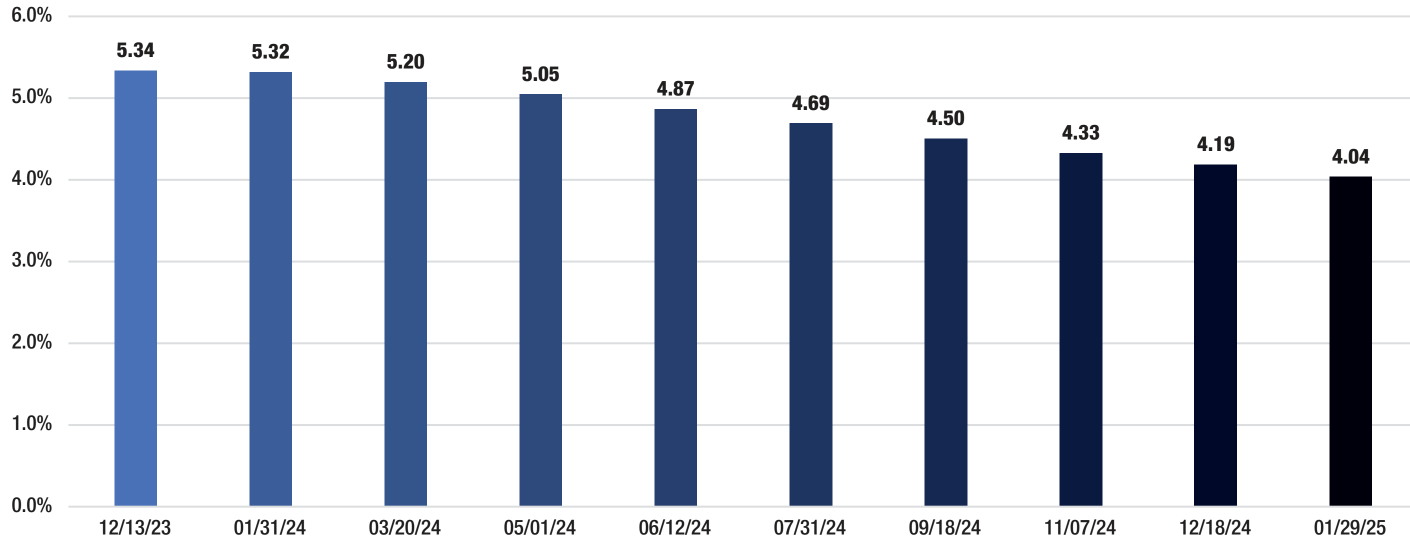
Implied Fed Funds Rate
as of 11/30/2023



Source: Pacer Advisors, FactSet

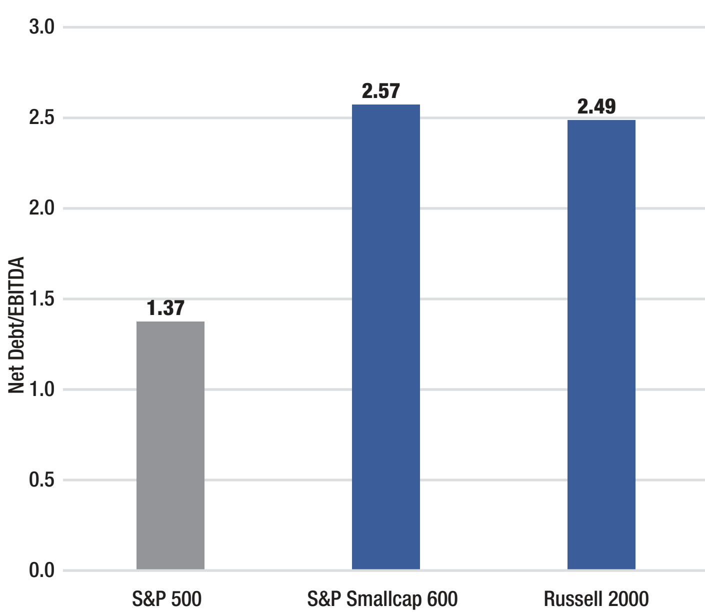
This data, coupled with the consensus among leading economists and central bankers, suggests that interest rates may remain high. Such adds a layer of caution to the overall outlook for small-cap stocks.

As highlighted in our January 2023 perspective "Small Cap Stocks: A Closer Look at the True Opportunity", small-cap companies find themselves grappling with historically elevated levels of leverage, significantly surpassing that of large cap counterparts.

Meanwhile, the prevalence of floating-rate debt, constituting more than half of small-cap companies' debts (in contrast to only one-fourth for large-caps),[2] has exacerbated their financial strain over the past 12 months. The surge in financing costs has exerted considerable pressure on the profitability of small-cap companies as demonstrated by the higher interest expense as a share of EBITDA among small-cap stocks.

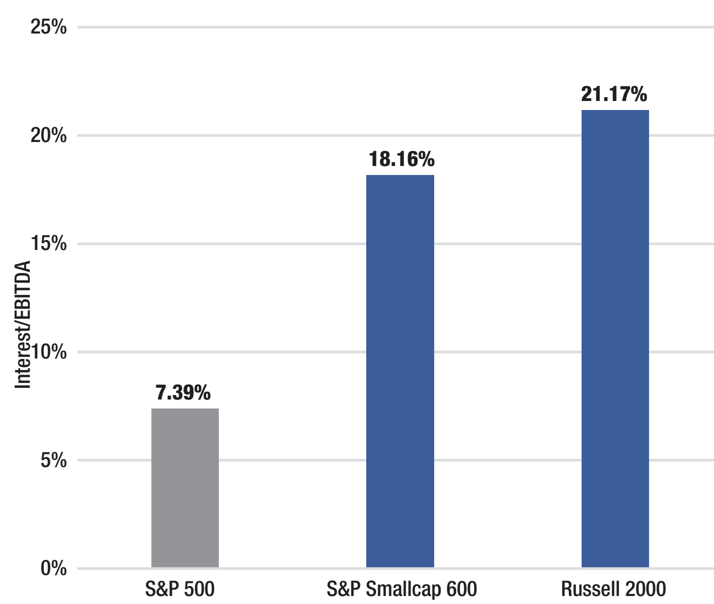
(2)Pacer Perspective – January 2023: Small Cap Stocks: A Closer Look at the True Opportunity

Net Debt/EBITDA (Weighted Average)
as of 11/30/2023



Source: Pacer Advisors, FactSet

Interest Expenses as a Share of EBITDA (Weighted Average) as of 11/30/2023



Source: Pacer Advisors, FactSet

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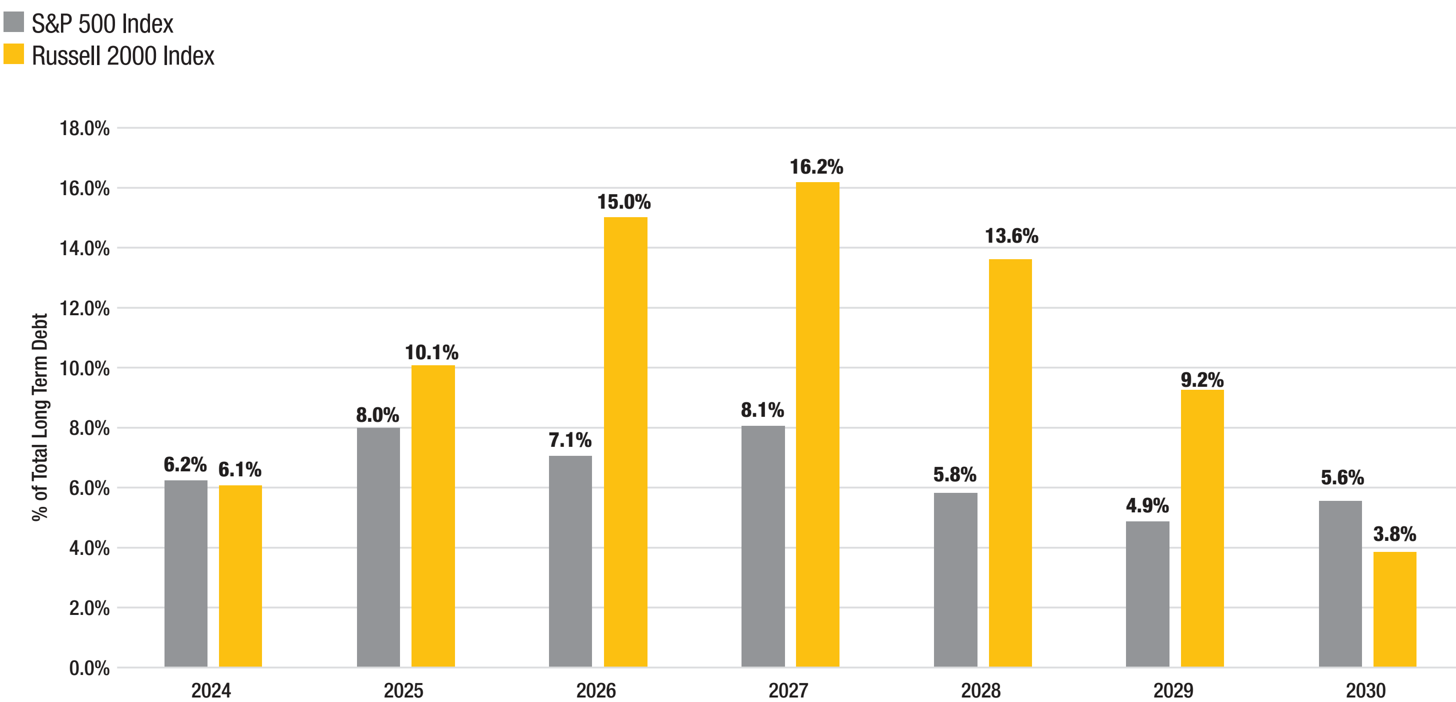
Furthermore, the above analysis does not yet capture the full extent of the changing rate environment. Given the potential longer than anticipated period of high interest rates, the prospect of maturing debt poses a lingering challenge for small-cap companies. Notably, a substantial portion of long-term debt within the small-cap sector is set to mature in the next four to five years. This scenario raises concerns about possible higher refinancing costs for these companies, suggesting that they may have to pay even higher interest in the near future if they issue new debt to sustain their operations.

Unless interest rates decrease at a much faster pace, the burden of interest expenses is expected to persist, adding further strain to the earnings of small-cap companies.

% of Long-Term Debt Maturing Each Year (ex Financials)
as of 11/30/2023



Source: Pacer Advisors, FactSet

The convergence of these above factors underscores the formidable challenges faced by small-cap stocks. Therefore, it is rational for investors to exercise caution and employ strategic decision-making in managing their small-cap portfolios.

It is essential to note, however, that not every small-cap company is equally affected by the higher interest rate environment.

Emphasizing profitability may serve as an effective strategy for investors. Particularly with approximately 40% of the Russell 2000 Index companies currently unprofitable as shown in the below table, avoiding troubled firms becomes a prudent approach.

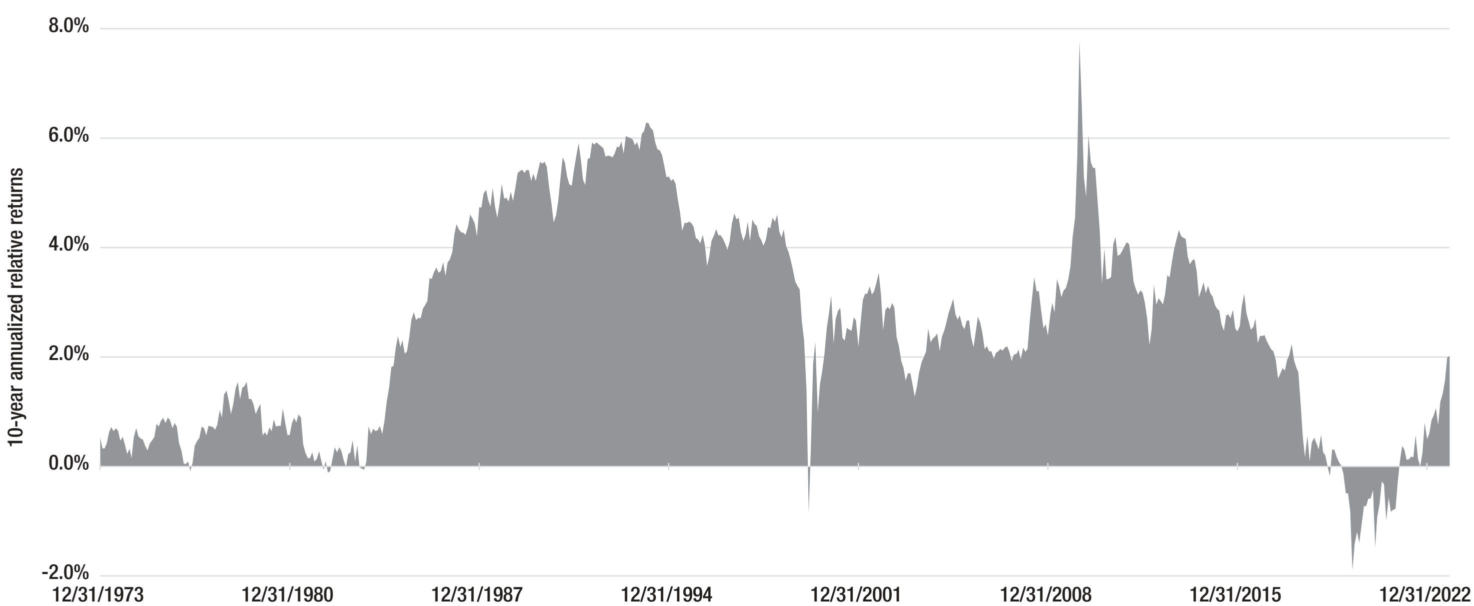
% of Names with Negative Profit
as of 11/30/2023

	Russell 2000 Index	S&P SmallCap 600 Index	S&P 500 Index
% of names with Negative LTM Net Income	41.13	20.76	6.36
% of names with Negative LTM FCF	35.64	17.28	10.74

LTM: Last 12-Month
Source: FactSet, Pacer Advisors

Small-cap stocks with elevated levels of profitability tend to outperform the broader small-cap benchmark for most of the time on a 10-year rolling basis going back to the 1970s. This pattern highlights the significance of profitability as a key driver of success within the small-cap segment. Investors, recognizing this trend, may have the opportunity to capitalize on the potentially better returns offered by high-profit small-cap stocks.

High profit small-cap stocks[3] relative to broad small-cap, 10-year annualized relative returns
6/30/1973 to 10/31/2023



Source: Pacer Advisors, Fama & French
(https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html)
(3)High profit small-cap stocks = stocks with high Operating Profitability (measured by annual revenues minus cost of goods sold, interest expense, and selling, general, and administrative expenses divided by book equity)

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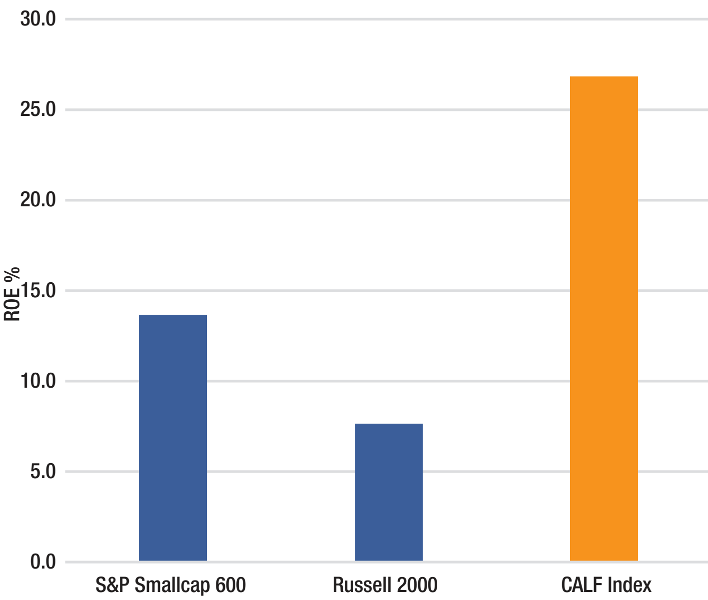
Our Solutions

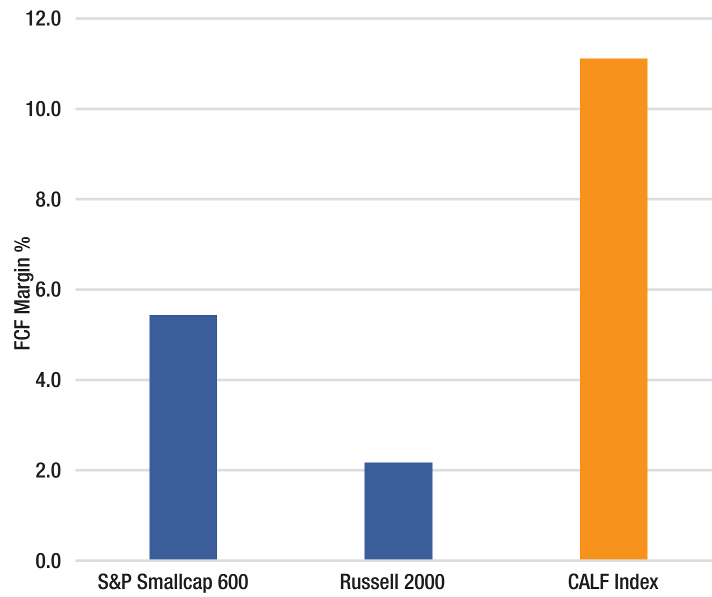
The **Pacer US Small Cap Cash Cows 100 ETF (CALF)** tracks the Pacer US Small Cap Cash Cows Index (CALF Index), investing in the top 100 highest free cash flow yielding companies within the S&P 600 Index. The fund aims to offer investors a way to gain exposure to high-quality companies with high free cash flow and strong balance sheets. These selected companies exhibit higher profitability and lower leverage compared to the broader small-cap benchmarks, which in turn, effectively mitigates the negative impact of interest burden on corporate earnings. The level of interest expense as a share of EBITDA is high among small-cap stocks, above 16% for the Russell 2000 Index and the S&P 600 Index, but considerably lower for the CALF Index.

ROE (Weighted Average) as of 11/30/2023



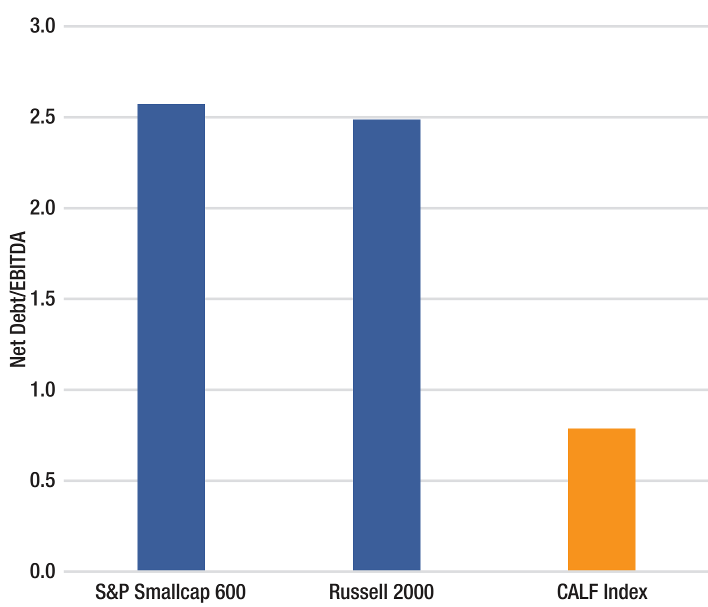
Source: Pacer Advisors, FactSet

FCF Margin (Weighted Average) as of 11/30/2023



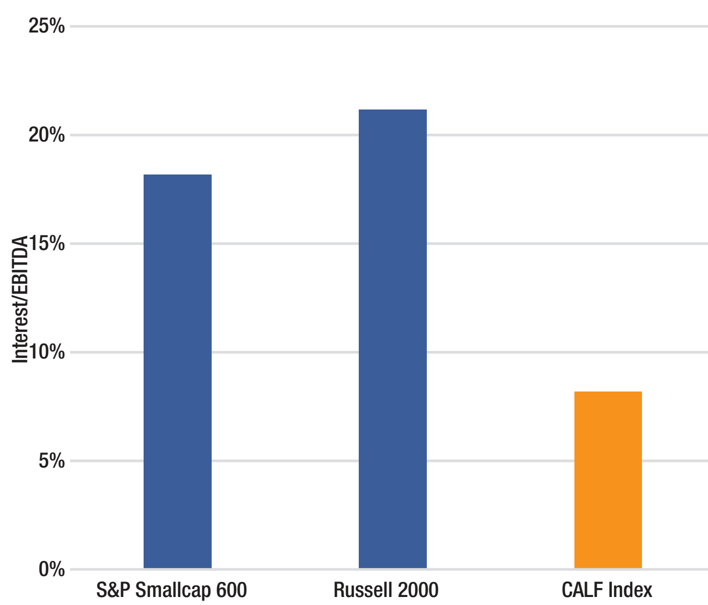
Source: Pacer Advisors, FactSet

Net Debt/EBITDA (Weighted Average) as of 11/30/2023



Source: Pacer Advisors, FactSet

Interest Expenses as a Share of EBITDA (Weighted Average) as of 11/30/2023



Source: Pacer Advisors, FactSet

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At the same time, a noteworthy distinction emerges in the realm of earnings among the companies within the CALF Index when compared to broader indices. Notably, a significantly lower percentage of companies in the CALF Index reported negative earnings over the last 12 months. In contrast, the figures for the Russell 2000 stand at 41%, and for the S&P 600, it is 20%.

% of Names with Negative Profit
as of 11/30/2023

	CALF Index	Russell 2000 Index	S&P SmallCap 600 Index	S&P 500 Index
% of names with Negative LTM Net Income	7.00	41.13	20.76	6.36
% of names with Negative LTM FCF	--	35.64	17.28	10.74

LTM: Last 12-Month Source: FactSet, Pacer Advisors

These features position companies well to navigate a potentially higher interest rate environment, highlighting their resilience and ability to weather challenges with greater ease compared to the rest of the small-cap universe.

In conclusion, interest expenses are likely to continue moving substantially higher for small stocks, posing challenges for those relying heavily on debt financing in the near future. Given the lack of profitability for many small firms, strategic investment choices, particularly focusing on profitability and free cash flow, can offer an advantage and reduced risk compared to the broader small cap markets. The **Pacer US Small Cap Cash Cows 100 ETF** presents an avenue for investors to navigate this landscape by gaining exposure to companies with strong fundamentals.

					Total Returns (%) as of 11/30/23			Total Returns (%) as of 9/30/23			
	Ticker	Total Expenses	Fund Inception		1 Month	3 Month	YTD	1 Year	3 Year	5 Year	Since Fund Inception
Pacer US Small Cap Cash Cows 100 ETF	CALF	0.59%	6/16/17	NAV	9.05	1.44	21.50	30.02	20.09	9.27	10.17
				Market Price	9.03	1.52	21.44	30.02	19.99	9.19	10.12
Pacer US Small Cap Cash Cows Index					9.00	1.39	21.48	30.34	20.71	9.68	10.52
S&P SmallCap 600 Value Index[1]					9.00	-4.33	1.31	10.26	15.38	3.23	5.88
S&P SmallCap 600					8.27	-4.06	2.89	10.08	12.10	3.21	6.48

[(1)]The Value Index listed above is being included to provide a performance comparison of a value index, which the Adviser believes is a more suitable comparison based on the investment strategy of the Fund

Returns less than 1 year are cumulative. Returns greater than 1 year are annualized. Performance quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate, so shares may be worth more or less when redeemed or sold. Current performance may be lower or higher than the performance quoted. Visit http://www.paceretfs.com for the most recent month-end performance. Index returns are for illustrative purposes only. Index performance does not reflect any management fees, transaction costs, or expenses. You cannot invest directly in an index.

NAV (net asset value) is the value of one share of the Fund calculated daily. The NAV return is based on the NAV of the Fund. It may not reflect the actual return for the investor.

Market Price is the price investors can buy and sell ETF shares for in the stock market and is used to calculate market return. It is based on the price at the listed exchange market close. This is when NAV is determined for most ETFs. If shares trade at another time, the return may differ. Market and NAV returns assume that dividends and capital gain distributions have been reinvested in the Fund at Market Price and NAV respectively.

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Russell 2000 Index: The Russell 2000 Index refers to a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index.
S&P 500 Index: The S&P 500 Index is a popular gauge of large-cap U.S. equities and includes 500 leading companies, capturing approximately 80% coverage of available market capitalization.
S&P SmallCap 600 Index: Measures the performance of 600 small sized companies in the US equity market, with market capitalization ranging from $450 million to $2.1 billion USD. The index does not overlap holdings with the S&P 500 or S&P MidCap 400.
S&P SmallCap 600 Value Index: Measures value stocks using three factors: the ratios of book value, earnings, and sales to price. S&P Style Indices divide the complete market capitalization of each parent index into growth and value indices.
Small-cap: A stock from a public company whose total market value, or market capitalization, is about $300 million to $2 billion. The precise figures vary.
Large-cap: A company with a market capitalization value of more than $10 billion. The precise figures vary.
Return on Equity (ROE): The measure of a company's annual return (net income) divided by the value of its total shareholders' equity, expressed as a percentage.
Net Debt/EBITDA ratio: A measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA.
EBITDA: Earnings before interest, taxes, depreciation, and amortization; is calculated by adding interest, tax, depreciation, and amortization expenses to net income.
Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and long-term investments)
Free Cash Flow Yield: FCF/EV. Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.
Free Cash Flow Margin (FCF/Sales): Measures a company's total free cash flow relative to its sales.
Enterprise Value (EV): A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)
Sales: The value of what a company sold to its customers during a given period; also known as revenue.
Floating Debt: Debt on which the interest rate changes as the existing rate changes.
Fixed Debt: Debt on which the interest rate is fixed and does not change as the existing rate changes.
Fed Funds Futures: Contracts that are express the general market consensus of where the daily official fed funds rate will be at the time of contract expiration.
Call volumes: Call volume is the total number of call options contracts bought and sold in a particular time period. Call options are financial contracts that give the option buyer the right but not the obligation to buy a stock, bond, commodity, or other asset or instrument at a specified price within a specific period.

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