The **PACER PERSPECTIVE**
January 2023

Small Cap Stocks: A Closer Look at the True Opportunity

– Danke Wang, Portfolio Manager

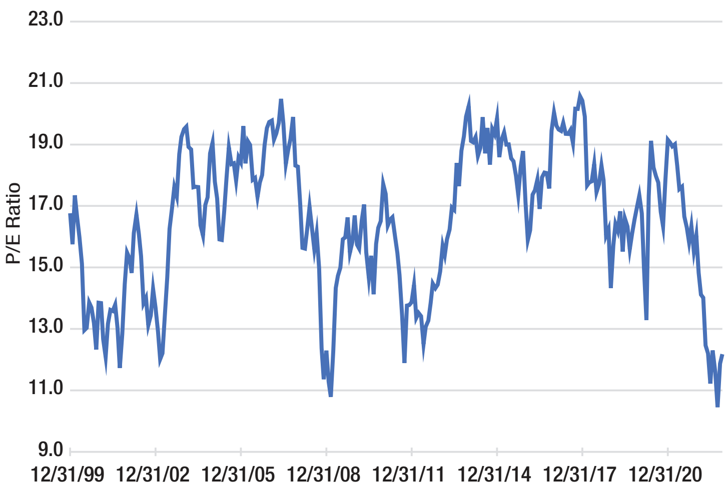
2022 brought on the highest inflation in 40 years and the worst calendar year performance for the stock market since 2008. With concerns of an impending recession looming, and a potential 5% Fed funds rate on the horizon, now seems like a good time to revisit the small-cap investing landscape, especially opportunities in quality value small-cap stocks.

Key Takeaways

- Small-cap stocks are trading at a record discount relative to large-cap companies. However, based on relative free cash flow yield and a P/E multiple that factors in non-earners, small-cap names may be more expensive than they seem.
- Small-cap companies' leverage issues are still concerning, particularly in a higher fed fund rate period which we are currently in.
- High free cash flow yielding small-cap stocks demonstrate higher quality and a lower valuation than the broad-based benchmark, offering better potential amid a macro recovery.

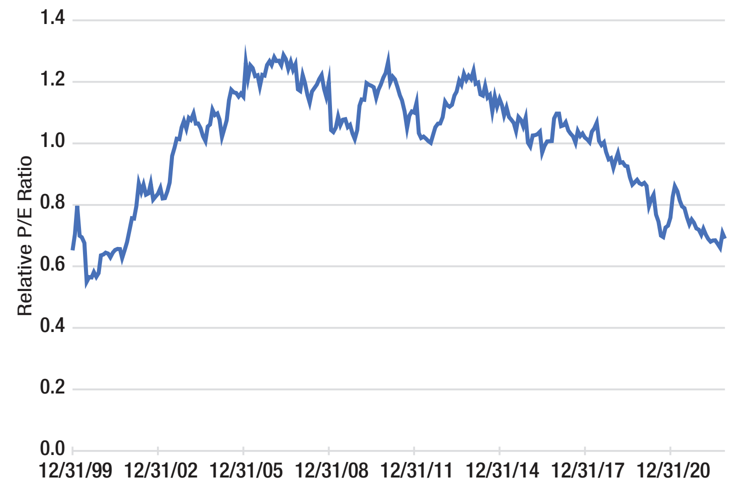
From a valuation standpoint, small-caps appear to have already priced in a deep recession. The Russell 2000 Index's forward P/E (price to earnings) is now in line with the 2008 lows and is lower than the levels reached during the 2001 recession. Relative to the Russell 1000 Index, the Russell 2000 Index's 11.42 forward P/E is nearing its lowest level since 1999, indicating an almost 40% discount to the large-cap peers.

Russell 2000 Index Foward P/E
1999 - 2022



Source: Bloomberg

Forward P/E Russell 2000 Index Relative to Russell 1000 Index 1999 - 2022



Source: Bloomberg

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The Real Value of Small-Caps

Usually, when the P/E multiples are low, we'd expect a relatively high free cash flow yield (free cash flow/enterprise value) number, indicating suppressed market prices. However, that is not currently the case in small-caps.

Unlike large-caps, small-cap companies' free cash flow yield levels are off their 2021 post-COVID high due to weak free cash flow (FCF) generation. Notably, the Russell 2000 Index's FCF has been trending downward since 2021. There has been a scarcity of FCF in the small-cap world, as demonstrated by the measly 0.06% median FCF margin among companies within the Russell 2000 Index. Meanwhile, the median FCF margin for companies in the Russell 1000 Index stands at 7.78%. Small-caps currently carry FCF yields well below their large-cap peers, and trade at some of the lowest FCF yield levels in the past 20 years.

Russell 2000 Index FCF Yield
1999 - 2022

Source: Factset

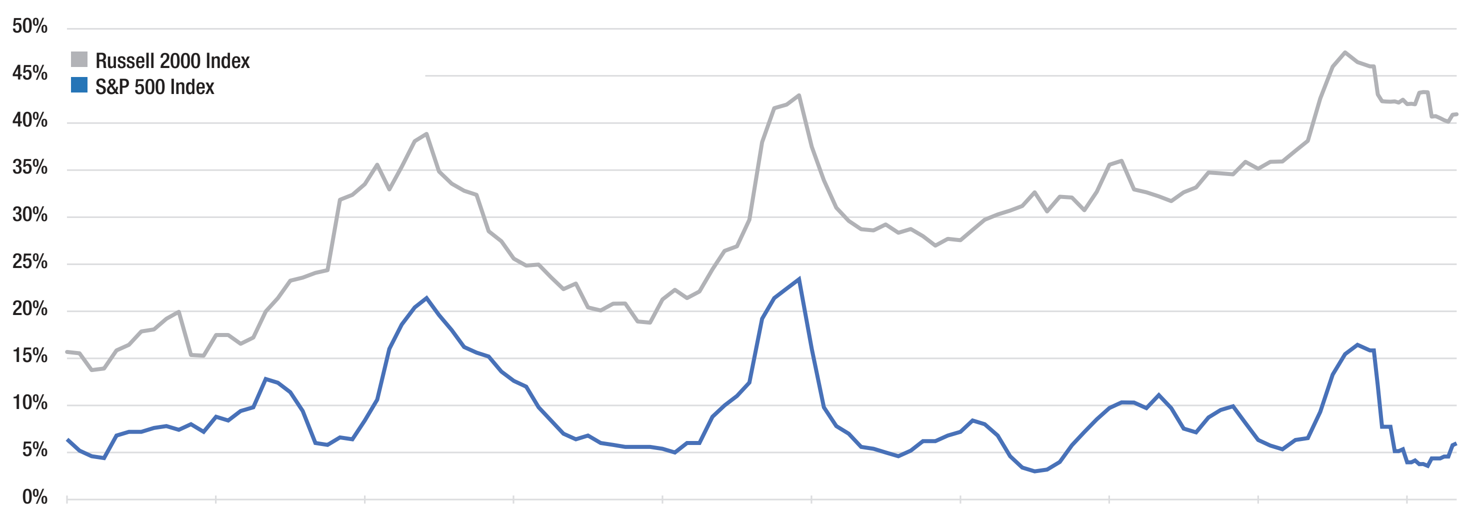
FCF Yield Russell 2000 Index Relative to Russell 1000 Index 1999 - 2022

Source: Factset

Clearly, there is a deterioration in small-cap fundamentals, which justifies their low valuations. But the question is: are small-caps cheap enough to invest in now?

As we highlighted previously, almost half of the companies in the Russell 2000 Index are currently generating negative earnings. Even though, the negative impact of COVID pandemic has faded, 40% of the small- cap universe remains unprofitable.

Percentage of Companies with Negative Earnings
1994 - 2022



Source: Factset

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This highlights one of the limitations of valuation multiples, like the P/E ratios. When the denominator (earnings) is negative, the P/E calculation ceases to be useful. As such, the aforementioned 11.42 forward P/E of the Russell 2000 Index only reflects the valuations of the small-cap names with positive projected earnings.

Suppose we include companies with negative earnings in the P/E calculation. In that case, the Russell 2000 Index is more expensive than the Russell 1000 Index (22 vs. 17.9), which is more in-line with what we'd expect given the corresponding FCF yield levels of the two indices.

Forward P/E
12/31/22

	Russell 1000 Index	Russell 2000 Index
Excluding Negative	16.68	11.42
Including Negative	17.90	22.00

Source: FactSet

So, based on our findings thus far, from a valuation standpoint, small-caps, as an asset class, do not seem sufficiently cheap enough to be an attractive bet for investors.

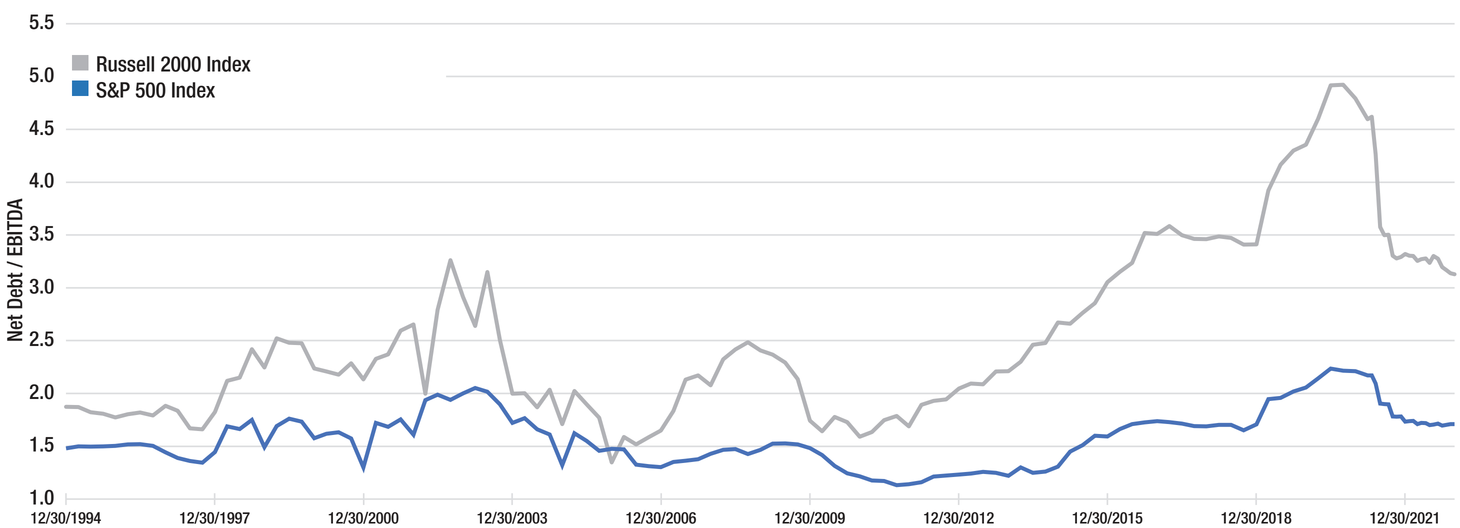
The Small-Caps Leverage Issues

In addition to concerns surrounding the profitability of small-cap stocks, there are other fundamental features which warrant further caution for investors considering an allocation to small-caps.

Small-cap stocks are traditionally more leveraged than their large-cap counterparts. Particularly in the months following the advent of the COVID-19 pandemic, small-cap's Net Debt/EBITDA ratios reached the highest level in history.

This trend reversed by the end of 2022, and small-caps' balance sheets improved as leverage ratios returned to pre-COVID levels . However, the current 3X Net Debt/EBITDA is still higher than the levels following the financial crisis, when interest rates were pushed to almost zero as the result of the Fed's QE program. Now that the Fed fund rate is trending towards 5% following the most aggressive pace of interest rate hikes in history , it is hard to imagine that such highly leveraged companies will fare well in the current environment.

Non-Financials Companies Net Debt/EBITDA
1994 - 2022



Source: Factset

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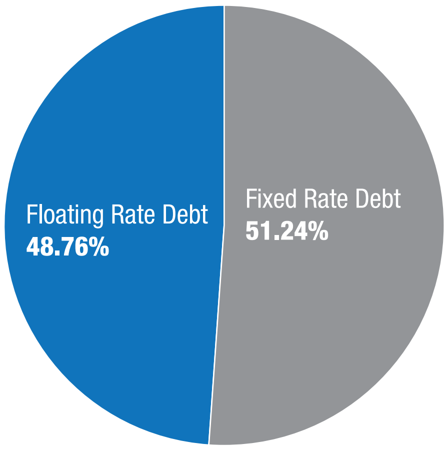
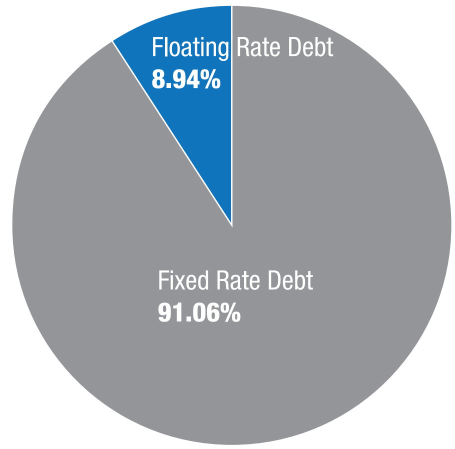
Floating Rate Debt vs Fixed Rate Debt
Russell 2000 as of 12/31/22



Source: Factset

Floating Rate Debt vs Fixed Rate Debt
S&P 500 as of 12/31/22



Source: Factset

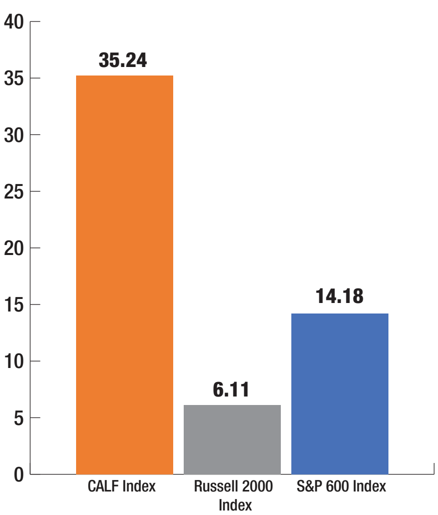
Additionally, floating rate makes up almost half of small-cap companies' debts, thus increasing financing costs and negatively impacting small-cap earnings as rates could potentially remain elevated for the foreseeable future.

Is there a better way to invest in small-caps?

We believe high-quality, value-oriented small-cap companies, particularly those with strong free cash flows and healthy balance sheets, are best positioned for the current environment.

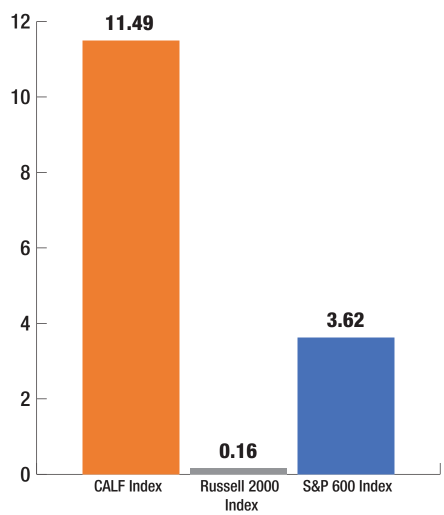
The Pacer US Small Cap Cash Cows Index (CALF Index) consists of 100 small-cap stocks with high free cash flow yields. These companies are more profitable and less leveraged than their broad-based small-cap benchmarks.

ROE (Return on Equity) as of 12/31/22



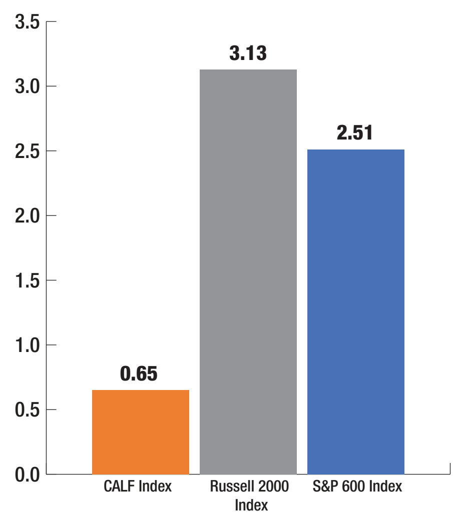
Source: Factset

FCF Margin (Median) as of 12/31/22



Source: Factset

Net Debt/EBITDA as of 12/31/22



Source: Factset

Also, these names more accurately reflect the current narrative that "a lot of bad news has been priced in".

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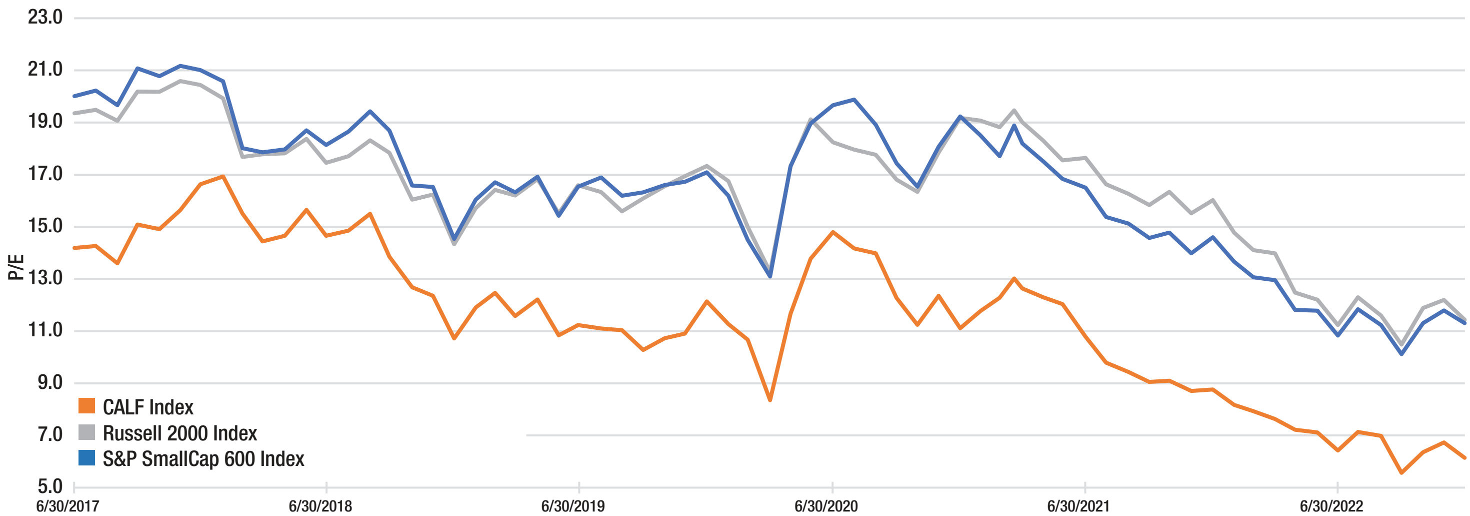
Companies in the CALF Index not only trade at a significant discount relative to its small-cap benchmarks, but also recently reached the lowest forward P/E since 2017. The record FCF yield premium over the Russell 2000 Index and the S&P 600 Index further confirms the attractive valuation discount of companies in the CALF Index, which could offer great potential for price appreciation in the event of a macroeconomic recovery.

Forward P/E

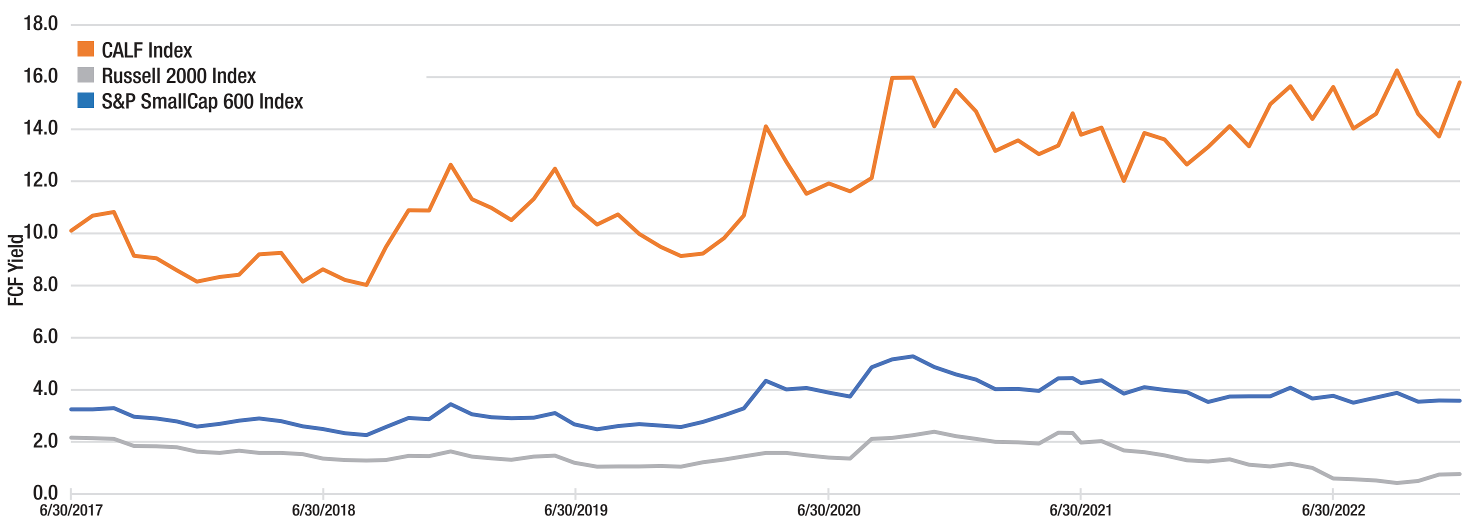
6/30/2017 - 12/31/2022



Source: Factset

Free Cash Flow Yield

6/30/2017 - 12/31/2022



Source: Factset

The post-COVID bear market recovery offered a live example: In the 12 months after the market bottomed in March 2020, the CALF Index posted a 158% return, outperforming the Russell 2000 Index and the S&P 600 Index by more than 38%.

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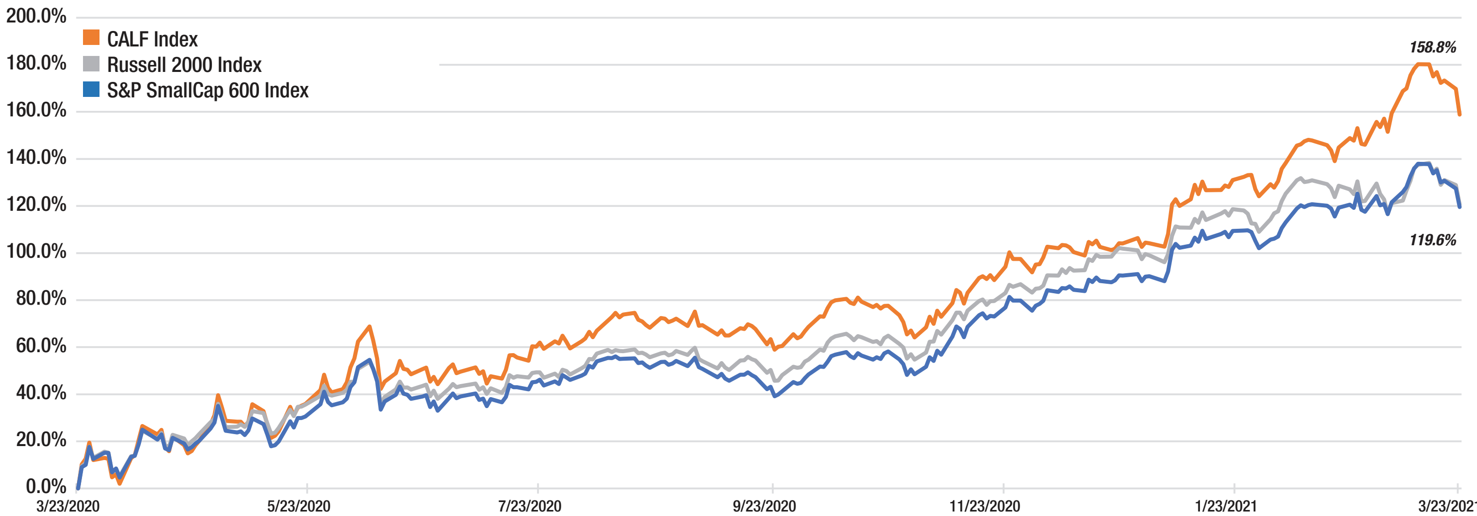
12-Month Performance Since Market Bottom in 2020
3/23/2020 - 3/23/2021



Source: Factset

The Pacer US Small Cap Cash Cows 100 ETF (CALF) tracks the Pacer US Small Cap Cash Cows Index, investing in the top 100 highest free cash flow yielding companies within the S&P 600 Index. It aims to offer investors a way to gain exposure to high-quality companies with high free cash flow and strong balance sheets. Additionally, CALF's current relative valuation discount is amongst the steepest in history, which may offer great potential once economic conditions improve.

CALF

PACER CASH COWS INDEX® ETF SERIES

Pacer US Small Cap Cash Cows 100 ETF

Russell 1000 Index: The Russell 1000 Index is a stock market index used as a benchmark by investors. It is a subset of the larger Russell 3000 Index and represents the 1000 top companies by market capitalization in the United States.
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 600 Index: The S&P 600 is an index of small-cap stocks managed by Standard & Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. This is determined by specific metrics such as public float, market capitalization, and financial viability, among other factors.
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.
P/E: Price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).
Forward P/E: Forward price-to-earnings is a version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation.
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.

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Performance
as of 12/31/22

	Ticker	Total Expenses	Fund Inception		Total Returns (%) as of 12/31/22: 1 Month	3 Month	YTD	Total Returns (%) as of 12/31/22: 1 Year	3 Year	5 Year	Since Fund Inception
Pacer US Small Cap Cash Cows 100 ETF	CALF	0.59%	6/16/17	NAV	-8.44	10.77	-15.18	-15.18	11.50	8.21	8.44
				Market Price	-8.47	10.96	-15.20	-15.20	11.57	8.09	8.42
Pacer US Small Cap Cash Cows Index					-8.47	11.02	-14.50	-14.50	12.10	8.59	8.83

Returns less than 1 year are cumulative. Returns greater than 1 year are annualized.
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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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The Pacer US Small Cap Cash Cows Index was released on 5/29/17.

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