The Case for SMID Cap Equities in ESG Investing

Executive Summary

We believe small and mid capitalization (SMID cap) equities are a particularly compelling asset class for investors looking to align with environmental, social, and governance (ESG) principles. In comparison to their large cap counterparts, SMID cap companies provide:

- **Focused product and service offerings** that enable targeted exposure to environmental or social priorities
- **Less dilution from legacy businesses**, yielding greater impact of ESG-related products and services
- **Significant innovation** around ESG-related themes
- **Greater engagement** opportunities with senior management

Though the SMID cap space presents certain challenges—less formal ESG disclosure, highly variable governance structures, and lower fidelity in third-party ESG rankings—none are insurmountable. Each can be adequately addressed by a pragmatic approach to equity research and mindful portfolio construction, making a SMID cap asset allocation an attractive consideration for ESG investors.

SMID Cap Equities Offer Particular ESG Benefits

ESG investors prioritize exposure to companies involved in solving critical environmental or societal problems. Many are especially drawn to investment theses tied directly to these types of solutions.

Examples of appealing ESG investments could include a firm that increases shareholder value by winning market share because its products are more energy efficient, or a company developing alternative delivery systems in an effort to reduce societal dependence on prescription opioids.

Targeted, prioritized exposures

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We believe that when the bulk of a company’s revenue is generated by a limited number of products or services, the opportunity for investment thesis alignment with ESG objectives becomes much more prevalent. In such cases, the success or failure of the investment is tied directly to the
company’s ability to deliver superior environmental prioritization or an effective solution to a societal problem.

**Less dilution yields greater impact**

The more focused nature of the SMID cap asset class also helps prevent a dilutive effect from legacy product lines, a phenomenon common in larger cap companies. For example:

An investor excited about zero emissions power generation has two investment options. One is a large conglomerate that manufactures wind turbines, though this business represents less than 10% of company revenue. The other is a SMID cap producer of turbine blades, which drive nearly 100% of the firm’s financial performance. If the investor’s expectation for rapid growth in wind power proves accurate, the benefits for the conglomerate would be diluted by its preexisting (legacy) business lines. The smaller supplier, however, would see a pronounced impact on its financials from the broader adoption of this technology.

**More opportunities for ESG innovation**

With less bureaucracy, SMID cap companies are able to act more quickly on a good idea, which is why they tend to be innovation leaders in the domain of ESG-related opportunities.

Although large corporations devote meaningful resources to R&D and product development, market-disrupting products and services are frequently a result of a smaller company’s agility. This ability to nimbly react to innovative concepts is an increasingly attractive characteristic as both consumers and corporations prioritize ESG objectives in their decision-making process. Recent areas where smaller companies have established market-leading positions due to superior innovation include police body cameras, opioid overdose prevention, solar power inverters, and automobile gasoline vapor recovery systems.

**More access to senior leadership**

Senior management teams at SMID cap companies are generally more accessible than their large cap peers, affording institutional investors distinct opportunities for fruitful ESG engagement. Since a key priority of many SMID cap public companies is to increase their visibility to a broadening set of investors, the senior leadership of these businesses (frequently the CEO or CFO) is often willing to
connect directly with investors on a regular basis. At a large cap company, the bulk of such interactions are delegated to an investor relations professional.

Direct access to senior management also provides key benefits for SMID cap ESG portfolio managers and analysts:

1. They can gauge the “tone at the top” of the organization to assess the company’s internal approach and commitment to ESG priorities.
2. For companies with more unique governance frameworks, they can assess practical implications and potential for change via direct interaction at the senior level.
3. They can directly engage leadership on any critical ESG-related opportunities for the company. When included as part of a collaborative discussion about the overall fundamentals of the business, senior management is often receptive to such dialogue.

**Pragmatic Solutions for Unique Challenges**

While SMID cap stocks offer many attractive attributes for ESG investors, the asset class comes with certain challenges that are not as common in larger companies.

- **Less formal ESG disclosure** and fewer comprehensive reports on sustainability or corporate social responsibility tend to be available for smaller companies.
- **A broader range of governance structures** are often found in SMID cap companies, due to their shorter tenure since inception or a less mature corporate profile.
- **Lower fidelity in third-party ESG rankings** can result from the limitations of inflexible testing methodologies.

These challenges can be adequately addressed by an appropriate investment approach that combines rigorous, labor-intensive research with thoughtful portfolio construction.

**Closing the disclosure gap**

Since the vast majority of corporate ESG-related disclosure is voluntary, the range of available company-provided data varies widely. Although many SMID cap companies have taken meaningful steps toward increased depth of reporting, disclosure variability is more pronounced among smaller companies than their larger peers.

To illustrate how disclosure profiles can vary by company size, constituents of the S&P 500® Index were compared to those of the Russell 2500™ Index. A significantly greater percentage of companies in the S&P 500® were found to
offer some form of ESG disclosure than their smaller counterparts in the Russell 2500™. Additionally, the percentage of S&P 500® companies providing a robust set of metrics for their quantifiable ESG measurements was more than three times higher.

There are actions that can be taken to address this disclosure disparity. A thorough research process involving the capture of available data from third-party sources can bring valuable insight on a company's ESG metrics. For instance, Glassdoor reviews from current and former employees can provide a glimpse of a corporation's culture. So can publications that focus on diversity, ethics, and environmental impact.

Model-based analysis (for example, to gauge a company's carbon emissions) has also proven to be an effective assessment tool. Engaging with company leaders—who are often easier to access in the SMID cap asset class—can help bridge any disclosure gaps.

**Engaging management to assess governance**

Direct interaction with company management is also the primary solution to addressing the variability in governance frameworks that can be present among SMID cap companies. Understanding the history and practical significance of a company's dual share classes or staggered board of directors can help inform investment decisions. The companies themselves can also benefit from this engagement.

Companies that are still early in their life-cycle frequently look for shareholder input as they assess appropriate ways to gradually transition away from a governance structure that favors a founder's control or influence. This communication can also lead to improvements in other areas, such as board structure, diversity, and management compensation.

**Understanding the flaws of third-party ESG rankings**

SMID cap companies are often unduly penalized by third-party ESG rating systems that rely on corporate responsiveness to surveys and other forms of disclosure. Because smaller companies often have a lean corporate staff, less mature reporting structures, and a lower overhead profile, they may not be in a position to devote the resources required to comprehensively respond to multiple information requests on a regular basis.

This can yield falsely unfavorable ESG scores, particularly when some ratings providers are unable to take a practical view of the business because of an inflexible scoring approach.

Though unintended, rigid scoring mechanisms meant to promote comparability can result in biased outcomes that favor the sometimes arbitrary characteristics of the rating system. For example, a company in the industrial sector may be given
less credit for clean technology development than a company classified as a technology firm. It is also important to recognize that third-party ESG rating systems endeavor to make summary comparisons between companies based on incomplete data. These imperfections in data accumulation and calculation mean that ESG rankings may not always assess the true impact of a company's products or services on ESG objectives.

To Sum Up

We believe that the SMID cap equity space has many inherent qualities that align with ESG investor priorities. Though assessing the ESG performance of SMID cap companies can pose some difficulties, a pragmatic portfolio construction approach combined with a robust research effort can overcome these unique challenges.

Engaging with SMID cap company management, understanding how to best leverage available data, and properly assessing a business's ESG metrics can yield ESG outcomes that are in many ways superior to other asset classes.

The SMID cap asset class is compelling for ESG investing.

- Small enough for ESG differentiators to truly “move the needle”
- Mature enough to have governance and corporate responsibility systems in place
- Early innovators
- Superior access to senior management
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The Russell 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as “smid” cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small to mid-cap opportunity set.

The Russell 2500™ Index is used as the benchmark. The Index is unmanaged and represents total returns including reinvestment of dividends. The benchmark is used for comparative purposes only and generally reflects the comparable risk or investment style of the Firm’s strategy. The investment portfolios underlying the Index are different from the investments in the portfolios managed by the Firm.

S&P 500® Index - Widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although S&P 500 focuses on the large-cap segment of the market, with about 75% coverage of U.S. equities, it is also an ideal proxy for the total market.