Making the Case for U.S. Small-Cap Stocks…Despite 2022 Volatility

U.S. equity markets have been roiled in 2022 so far by worries about Russia's invasion of Ukraine, soaring oil prices, raging inflation, rising interest rates, slowing global economic growth and persistent pandemic overhangs. The result has been heightened volatility. And U.S. small-cap stocks tend to be riskier than their large-cap counterparts. So, it may seem counterintuitive to suggest an increased allocation to small-cap stocks in your investment portfolio may well be the way to weather these uncertainties and mitigate several of the potential pitfalls facing large-cap stocks. But here are some reasons why.

More Domestically-Focused Small-cap stocks tend to be domestic companies with their revenue generated primarily from the U.S. In turn, they are less impacted by a strong or weak U.S. dollar and tend to be better insulated from international risk and global developments compared to large-cap stocks. Further, if investors believe the U.S. economy may outperform the global economy, then small-cap stock exposure could prove beneficial.

Prime Beneficiary of Healthy Consumer When the COVID-19 pandemic first struck, the Russell 2000 Index, a common measure of U.S. small-cap stocks, significantly underperformed U.S. large-cap equity indices. Investors appeared to view small-cap equities as being more negatively impacted by the lockdowns and more closely tied to U.S. economic conditions than their larger peers. However, during the pandemic, household savings rates, income growth rates, real estate values and asset prices rose, leaving consumer balance sheets strong and better equipped to weather some inflation as a result.

Fundamentals for many small-cap companies remain solid, and since equities rebounded from their mid-March 2020 lows through the end of March 2022, the Russell 2000 Index solidly outperformed the Russell 1000 Index, a broad proxy for U.S. large-cap stocks.

> *"Following the restrictions of the COVID-19 pandemic, the U.S. consumer is financially healthy overall, boding well, in our view, for small-cap companies, which remain the backbone of the U.S. economy."*
> *Robert Stimpson, Co-Chief Investment Officer and*
> *Portfolio Manager of River Oak Discovery Fund*

More Specialized Products/Services Small-cap companies thrive on innovation, typically offering more niche, or specialized, products or services with fewer competitors. Notably, 2021 marked a record year for merger & acquisition activity.[1] Deal activity is expected to remain strong in 2022 with the key factors that drove record activity, including cash-flush corporate balance sheets, still in place. As relatively digestible takeover targets, small-cap companies may well benefit from that trend—either by being acquired themselves or by seeing their valuations rise when competitors, already few in number, are absorbed.

> *"Small-cap companies often get acquired by large-cap companies looking to manage inflation by purchasing economies of scale or solve hiring shortages by buying up rivals. In the nine months ended March 31, 2022, approximately 10% of River Oak Discovery Fund's holdings were acquired, validating our investment approach."*
> *Jeffrey Travis,*
> *Portfolio Manager of River Oak Discovery Fund*

Exposure to Secular Growth Themes Approximately ¾ of high growth companies in the U.S. are small-cap companies, with significant exposure within the Russell 2000 Index to the information technology, health care, industrial and consumer discretionary sectors.[2]

More Agile Smaller companies are generally flexible and their decision-making processes tend to be simple and direct. In turn, they can often adapt to changing conditions, spot and then capitalize on opportunities, and adjust pricing more rapidly than large-cap companies run by centralized managements pressured by long-term mandates and more complex administrative apparatus.

Historical Outperformance Amidst Rising Rates The U.S. Federal Reserve began to tighten monetary policy in mid-March 2022 for the first time since the end of 2018 as it seeks to combat soaring inflation. Most expect several more short-term interest rate increases as the year progresses. U.S. small-cap stocks have outperformed U.S. large-cap stocks in every period of rising interest rates since 2008.[2]

Compelling Diversification Opportunity Adding small-cap stocks to an investment portfolio offers diversification not only from large-cap companies but also from the concentration currently found in the S&P 500 Index. More specifically, more than 20% of the S&P 500 Index is dominated by just five megacap stocks. In contrast, the top five stocks in the Russell 2000 Index account for just 2% of that Index, as measured by weight.[2] Further, in recent years, the Russell 2000 Index has seen broader participation in constituent gains than has the S&P 500 Index.

Attractive Earnings Growth Potential The expectation for earnings growth of Russell 2000 companies in 2022 is 30%, well above the 9% forecast for the S&P 500, another measure of U.S. large-cap stocks.[2]

Beneficiary of Careful Analysis Most smaller companies are not as widely followed by institutions or individuals as larger companies. As a result, stock prices do not always reflect a company's true potential. In-depth research and active, experienced management can provide a significant advantage.

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While past performance is no guarantee of future results, it remains true that over the long term, small-cap stocks have historically outperformed large-cap stocks. So, while we are not suggesting you reduce your exposure to large-cap stocks, we are suggesting you consider investing a portion of your portfolio in a carefully-managed fund of small-cap stocks as a way to add balance, diversification and growth potential, especially if you have at least a five- to 10-year time horizon.

"Despite heightened market volatility and geopolitical tensions, there is reason to believe the U.S. remains in a long-term bull market and a broadly diversified portfolio may be a key factor in participating in its gains. Active portfolio management, with a focus on identifying high quality small-cap companies with a niche focus, can potentially help investors reduce the historic swings within small-cap markets."

Robert Stimpson, Co-Chief Investment Officer and Portfolio Manager of River Oak Discovery Fund

RIVER OAK DISCOVERY FUND

Overall Morningstar Rating™

★★★★

in the small blend category among 600 funds as of March 31, 2022 based on risk-adjusted returns[3,4]

Take a Closer Look at the River Oak Discovery Fund to Help You Gain Access to Small-Cap Stocks

River Oak Discovery Fund invests primarily in the shares of smaller companies across a broad range of economic sectors, favoring companies with specific market expertise, solid fundamentals and a sustainable competitive advantage.

According to Co-Chief Investment Officer and Portfolio Manager Robert Stimpson, "We look for companies with cutting-edge products, visionary management and the ability to bring innovation to new and established industries. Our focus in the Fund is on companies that are rapidly growing and may not yet be fully discovered by Wall Street. And now, against a more positive pandemic backdrop, we believe the time to consider adding small-cap stocks to your portfolio is advantageous, as a widely anticipated increase in spending on both services and capital expenditures could prove positive for domestically-focused smaller companies."

Oak Associates Funds has been specializing in U.S. equity investing for more than 35 years based on an investment philosophy centered on the core tenets of investing for the long term, concentrating in our best ideas and remaining fully invested.

[1]https://www.morganstanley.com/ideas/mergers-and-acquisitions-outlook-2022-continued-strength-after-record
[2]https://www.gsam.com/content/gsam/us/en/institutions/market-insights/gsam-insights/2022/FE-2022-top-equity-ideas.html
[3]Morningstar, Inc. is an investment research and investment management firm headquartered in Chicago, Illinois, United States.
[4]The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. For River Oak Discovery Fund: Five-star rating for 3-year (600 funds) and 5-year (541 funds); two-star rating for 10-year (358 funds); and four-star rating for overall (600 funds) periods ended March 31, 2022. All in the small blend category.

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Investments in lesser-known, small capitalization companies may be more vulnerable than larger, more established organizations.

Past performance is no guarantee of future results. Oak Associates Funds are available to U.S. investors only. To determine if this Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's prospectus, which may be obtained from your investment representative or by calling 888.462.5386. Please read it carefully before you invest or send money.

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