TD Asset Management

Investor Knowledge 10 Minutes

Focusing on an **overlooked asset class**

At a glance

- The genesis of some of the world's largest companies often start from the U.S. small and mid-capitalization (cap) asset class and have rewarded investors for the additional risk taken over time.
- Today, there are a select few large-cap stocks that are leading the performance in U.S. equity markets. This creates an opportune time for investors to consider an allocation of U.S. small and mid-cap stocks to their portfolios where they can benefit from an improved risk-adjusted return profile.
- To harness the opportunity in the space, TD Q U.S. Small-Mid-Cap Equity ETF ("TQSM", the "ETF") aims to provide exposure to a diversified portfolio of small- and mid-cap U.S. companies. By using a quantitative multi-factor approach, which seeks to optimize exposure to stocks that are expected to outperform the market by emphasizing style factors, TQSM aims to provide strong performance.

Why invest in U.S. small and mid-cap equities?

Smaller U.S. companies are the lifeblood of the U.S. economy. While they don't get the same sort of media exposure as an Apple or Microsoft, these companies span the gamut from agricultural and construction machinery to airplane parts to specialty chemicals and everything in between. These companies also have a bias toward the strong U.S. economy, and they should benefit from the "onshoring"/"reshoring" of U.S. industries.

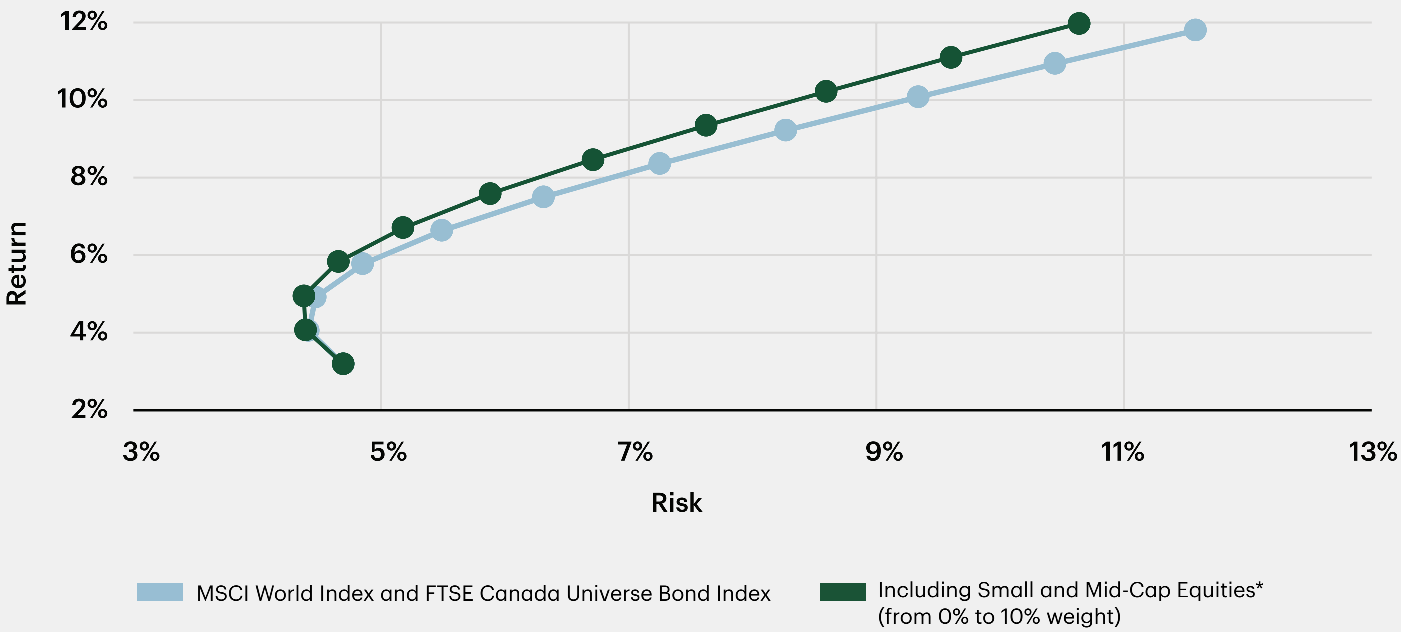
What are the key considerations when investing in small and mid-cap stocks?

The small and mid-cap indices are much more diversified than the large cap S&P 500 Index. The weight of the largest 1% of companies within the S&P 500 Index is about 22%, which dwarfs the benchmarks used by TD's small and mid-cap funds. Similarly, from a sector point of view, the S&P 500 Index is more concentrated in a single sector than the small and mid-cap benchmarks – the largest sector (Information Technology) within the S&P 500 Index makes up about 29% of the overall index. This number jumps to nearly 40% if we include companies like Amazon, Alphabet, Meta and others that were previously classified as Information Technology companies. While the concentration of the S&P 500 Index in just a few companies tends to lead to strong performance when they do well (such as in 2023 with the "magnificent seven"), the index performance can also suffer when they underperform[1].

Adding small and mid-cap stocks to a diversified portfolio can lead to higher returns and lower risk. The graph below shows the efficient frontier for a portfolio consisting of varying weights of the FTSE Canada Universe Bond Index and the MSCI World Index (blue line). Adding in a small allocation of small and mid-cap stocks to this portfolio leads to higher returns and lower risk (green line). For instance, from the chart, a portfolio consisting of 50% FTSE Canada Universe Bond Index and 50% MSCI World Index has a 15-year annualized return of 7.5% and an annualized standard deviation of 6.3%. Adding in a 5% weight of small and mid-cap stocks increases the return to 7.6% and decreases the risk to 5.9%.

[1]Source: FactSet, Bloomberg Finance L.P. Data as of Dec 31, 2023.

Adding small and mid-cap equities to a diversified portfolio can lead to higher returns and lower risk

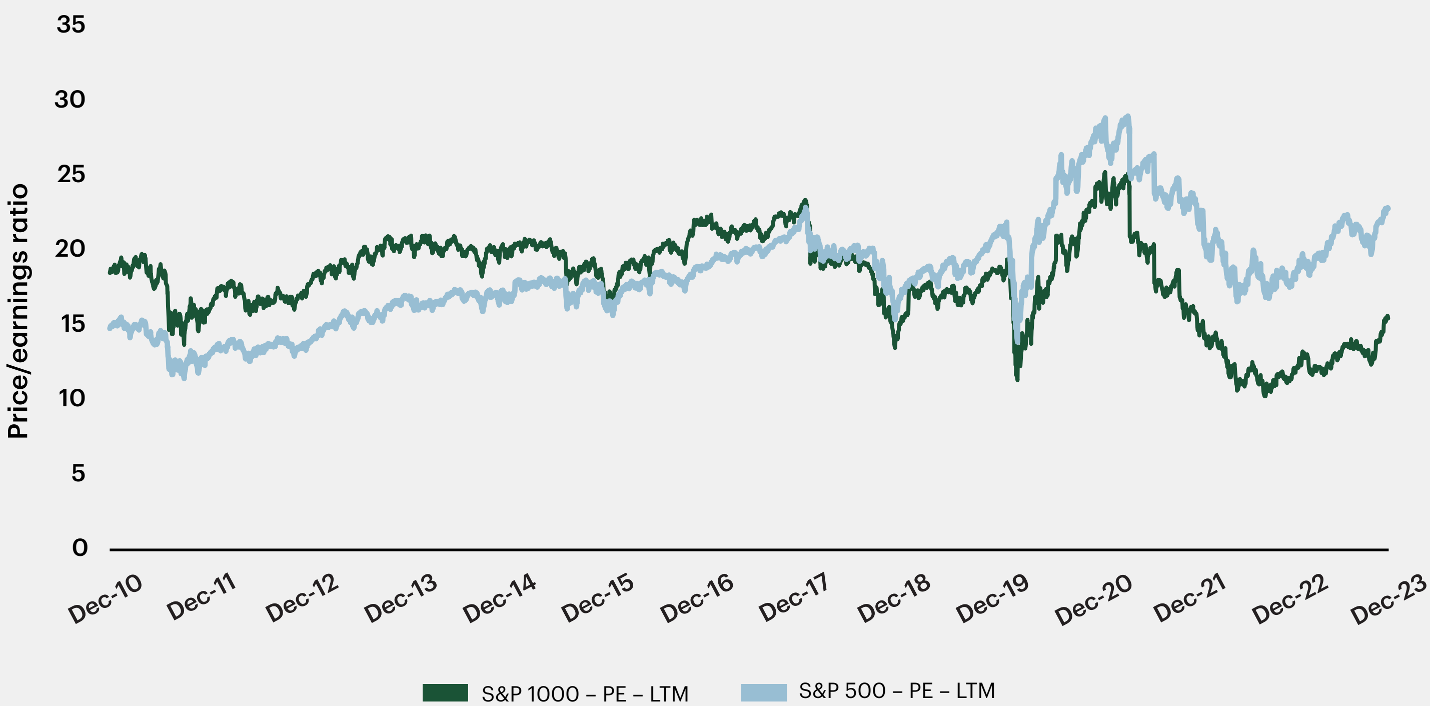


Source: Bloomberg Finance L.P. Data as of December 31, 2023
* 50% S&P MidCap 400 Index (Total Return) 50% S&P SmallCap 600 Index (Total Return).

How are valuations today compared to historical trends?

Valuations for small and mid-cap equities tend to be attractive. Historically, small and mid-cap equities traded at a premium to large-cap equities reflecting their higher risk/return profile. However, since 2017 the large-cap index has become more expensive and the gap in valuations between large-cap equities and smaller cap stocks has been increasing (chart below), indicating that smaller stocks are attractively valued compared to their larger peers. Moreover, small and mid-cap stocks are trading cheaper than their own historical multiples.

S&P 500 Index vs S&P 1000 Index Price/Earnings Ratio



Source: TD Asset Management Inc. Factset. Data as of December 31, 2023

Solutions from TD Asset Management Inc.

TQSM aims to provide exposure to a diversified portfolio of small and mid-cap U.S. companies. By using a quantitative multi-factor approach, which seeks to optimize exposure to stocks that are expected to outperform the market by emphasizing style factors, TQSM aims to provide strong performance.

Currently, TQSM's largest factor exposures are to companies with conservative leverage and low-price volatility, companies with profitable and efficient business models and value with a reasonable quality factor. TQSM is also taking a cautious stance on credit risk. TQSM has performed well within this market environment, with returns for all periods up to 3 years above benchmark[2]. With less concentration risk and lower valuations than the S&P 500 Index along with higher returns and lower volatility than the benchmark, investors could consider adding TQSM to their U.S. equity allocation.

Performance as at January 31, 2024	3 months	YTD	1 year	2 years	3 years	Since Inception[1]
TD Q U.S. Small-Mid-Cap Equity ETF (TQSM)	10.36%	10.35%	12.77%	12.58%	14.44%	9.50%
Benchmark[2]	12.26%	-1.54%	3.46%	4.55%	6.94%	8.97%

Source: TD Asset Management. As of January 31, 2024.
[1]November 20, 2019.
[2]50% S&P Mid Cap 400 Total Return Index (C$), 50% SmallCap 600 Total Return Index (C$).

Focus

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