



From the Desk of the Quantitative Equities Team

TD Q US Small-Mid-Cap Equity ETF

By Julien Palardy, CFA, & Michael Formuziewich, CFA, edited by Jitesh Chauhan as of January 7, 2024



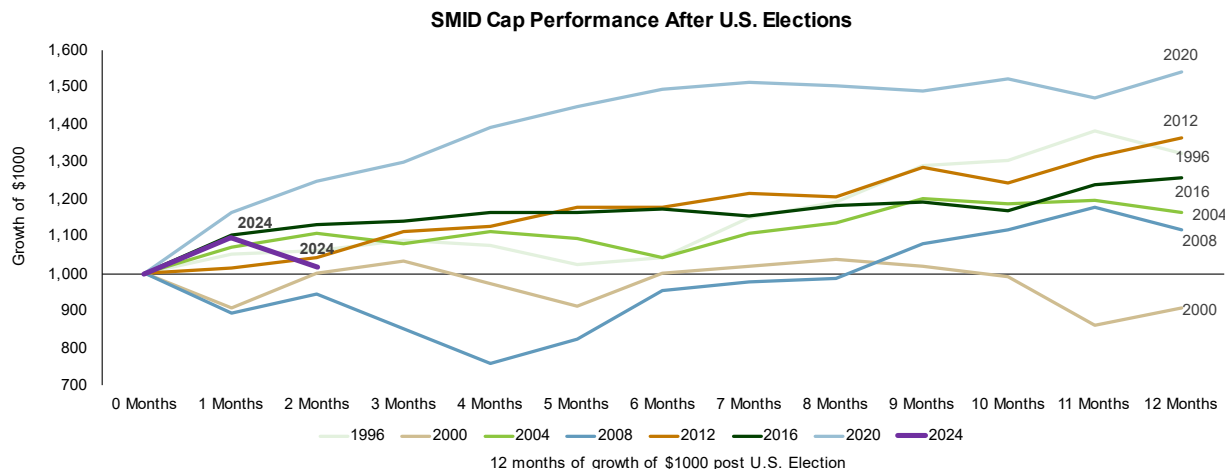
Q1: How have the last 8 election cycles impacted small and mid-cap (SMID) stocks, and what is the outlook for the next 12 months?

In the 12-month period following the last 8 U.S Presidential election cycles, 7 have delivered positive returns for small and mid-cap stocks, with an average return of ~24% (Chart 1), which is very strong performance. These returns reflect the stability and growth that often follow election cycles, with a notable rebound once any political uncertainty clears. The incoming Donald Trump administration is being viewed as beneficial for small and mid-cap stocks, given its focus on onshoring critical industries and deregulation policies. Moving forward, small and mid-cap stocks could continue performing strongly if the U.S. economy remains resilient.

Chart 1:

Small-Mid (SMID) Cap Performance Around U.S. Elections

Historically SMID Cap Stocks Perform Well After Elections



- Average return of SMID stocks 12 months after U.S. Elections is 23.9%

Source: FactSet, TD Asset Management. SMID Cap = 50% S&P SmallCap 600 Index, 50% S&PMidCap 400 Index. As of November 30, 2024

Q2: Given the strong performance of large-cap stocks and since the COVID-19 pandemic, could small and mid-cap stocks outperform in the next 12 months?

In our view, the outlook for small and mid-cap stocks is strong. While large-cap stocks, such as Amazon.com, Inc, Nvidia Corporation. (Nvidia), and Tesla, Inc. had huge rallies, small and mid-cap stocks were adversely affected by factors like high interest rates and a slowing economy. However, small and mid-cap stocks are more exposed to the U.S. domestic economy, have a higher exposure to financial companies than large cap stocks, and they are likely to benefit from a more favourable policy environment under Trump's policies. Trump's pro-deregulation stance is especially advantageous to the Financials sector, benefiting small and mid-cap companies in banking and insurance.

Q3: Could artificial intelligence (AI) drive growth in small and mid-cap stocks?

AI has already benefitted mega-cap companies like Nvidia, who are manufacturing and selling GPUs essential for AI development. Other mega-cap companies have seen their share prices rise on the future potential of AI. However, at this point, AI's broad impact on small and mid-cap stocks has not been fully realized. For AI to be a successful long-term investment theme, it will need to move beyond the promise of future benefits and deliver real productivity gains to industrial, manufacturing and service industries. If AI leads to more widespread productivity gains in the coming months and years, we believe small and mid-cap companies would be significant beneficiaries.

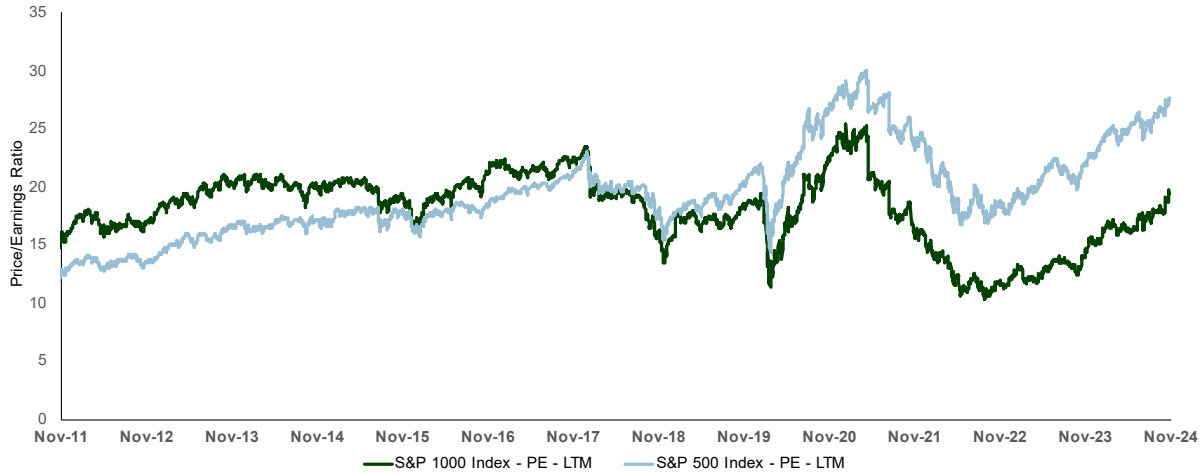
Q4: Should small and mid-cap stocks trade at a discount compared to large-cap stocks?

There is no reason for small and mid-cap stocks to be inherently cheaper than large-cap stocks. Although small and mid-cap stocks earnings contracted during the COVID-19 pandemic, they rebounded strongly in 2021-2022, with their earnings growth outpacing large-cap stocks. Despite their cyclical nature and some earnings deceleration due to higher interest rates, small and mid-cap stocks continue to show impressive growth. The expectation is that small and mid-cap stocks should not trade at a discount to large cap stocks if they continue to demonstrate faster earnings growth over the long-term.

Chart 2:

Valuation Spread

Small/Mid Cap Stocks Much Cheaper Than S&P 500



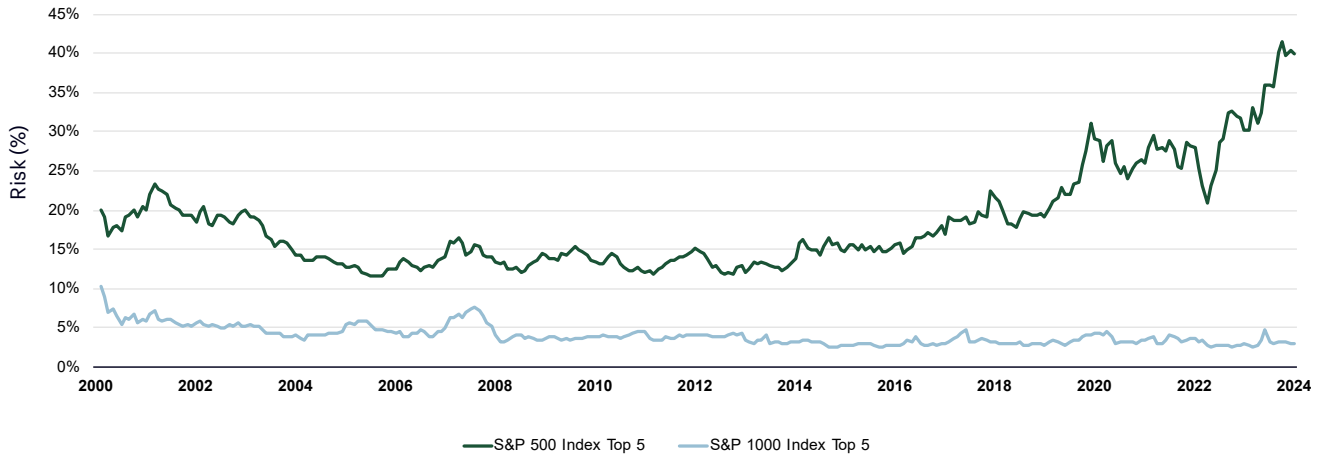
Source: TD Asset Management, FactSet. As of November 30, 2024

Q5: How does the concentration risk in the S&P 500 Index affect investors, and should they be concerned?

The S&P 500 Index is highly concentrated, with the top 5 stocks contributing around 40% of the risk (Chart 3). This concentration is a concern because it leaves the entire index vulnerable to the performance of just a few large companies. For example, one stock—Nvidia—accounts for 20% of the total risk in the S&P 500 Index. Investors need to remember that risk matters and concentrating investments in just a few stocks can expose them to greater volatility. Diversification, especially through small and mid-cap stocks, can help mitigate this risk. With small and mid-cap stocks, the risk is spread across a broader range of companies, reducing exposure to a few high-risk names.

Chart 3:

Proportion of Risk Explained by Top Five Risk Contributors



Source: TD Asset Management Inc., S&P Global Inc. As of Sep 30, 2024.

Diversification within the small and mid-cap sector helps investors better manage risk by spreading investments across a wider variety of companies, industries, and sectors. This reduces the impact of any single event affecting the broader market or individual companies. By including small and mid-cap stocks in a portfolio, investors can improve their Sharpe ratio—meaning they can achieve a better return for the amount of risk they are taking on. For example, adding 10% small and mid-cap stocks to a portfolio of large-cap stocks can reduce the overall risk by up to 1-2% without sacrificing return.

Q6: What were the key challenges faced by the TD Q U.S. Small-Mid-Cap Equity ETF in 2024, and how did they perform?

Despite an overall strong performance for small and mid-cap stocks in recent years, the ETF's performance saw a dip in December. This was largely due to the impact of higher mortgage rates, which specifically affected sectors like homebuilders. However, prior to this, the TD Q U.S. Small-Mid-Cap Equity ETF was outperforming its benchmark and showing positive performance. The challenges in December were largely due to a specific sector impact, and the outlook remains positive for 2025 as economic conditions stabilize and President-elect Trump introduces measures which are seen as positive for small and mid-cap stocks.

Due to the success of the TD Q U.S. Small-Mid-Cap Equity ETF and requests for a US\$ version of this ETF, we have launched TQSM.U on January 14, 2025.

Returns as of December 31, 2024	Annualized Returns							Risk	
	3 mths	YTD	1 Yrs	2 Yrs	3 Yrs	4 Yrs	5 Yrs	Since Nov 20-19	Since Nov 20-19
TD Q US Small-Mid-Cap Equity ETF	5.04%	20.65%	20.65%	19.56%	12.93%	15.68%	12.17%	11.69%	15.51%
Benchmark ¹	6.34%	21.45%	21.45%	17.24%	7.99%	11.97%	11.68%	11.80%	18.81%
Difference	-1.30%	-0.80%	-0.80%	2.32%	4.94%	3.71%	0.49%	-0.11%	-3.30%
Morningstar® percentile rank²	28	21	33	6	1	4	9		

¹ 50% S&P MidCap 400 Total Return (CAD), 50% S&P SmallCap 600 Total Return (CAD) ² TD Q US Small-Mid-Cap Equity ETF listed under the US Small/Mid Cap Equity category. This category contains 292 funds as at November 30, 2024. Each series of a fund is counted separately. Percentile data taken from Morningstar® for the period November 30, 2019 to November 30, 2024. This Morningstar® Percentile Rank is the funds total-return percentile rank relative to all funds that have the same Morningstar Category. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. The top-performing fund in a category will always receive a rank of 1.

Note: Returns for periods over one year are annualized; net of expenses. Numbers may not add due to rounding.

Source: TD Asset Management Inc., Morningstar.

**For further information,
please contact your investment professional.**



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