William Blair

Why Now For Small/Mid U.S. Equities

Setting The Stage

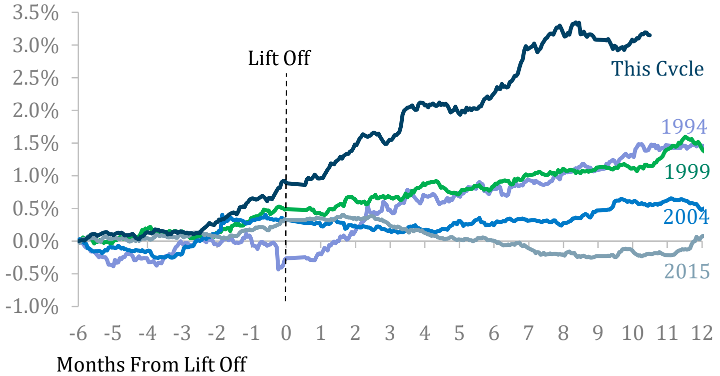
In January 2022, we wrote a piece on *'Why Now for Non-Large U.S Equities'*. The thesis was the following: *"As we enter 2022, the relative case for non-large caps looks exceptionally appealing".* The timing of that article proved reasonable with small-mid caps performing essentially in line with the S&P 500 after more than a decade of relative, and sometimes dramatic, underperformance. Specifically, the Russell 2500 lost 18.4% while the S&P fell 18.1% last year. Further, as we will highlight later, relative performance has not only stabilized in 2022, but there are very early indications that it may have begun reverting to its longer-term median.

What wasn't explicitly spelled out but implied in the earlier paper that we missed was how quality metrics would fail to materially influence performance, particularly given the dramatic absolute market decline this past year. As economies both in the U.S. and globally weaken with tighter monetary policies, corporate earnings are coming under greater pressure. This, in turn, typically leads to multiple contraction and general market volatility as investors seek "safer ground". Historically in such periods, quality metrics provided some measure of positive influence in navigating this market uncertainty. That didn't happen in 2022, but neither estimated or reported earnings decline to the extent one might have expected given the market freefall. As we will discuss below, we believe this dynamic is very likely about to significantly change in 2023 as last year's higher rates begin impacting earnings with a lag.

Why Now?

A lot has changed in the past 12 months, but from a market perspective, the 425-basis point pop in interest rates trumps all other market influences. We remind investors of how different this rate cycle has been relative to recent history in the chart below. Whether taking our "medicine" earlier and more aggressively influences the depth and duration of a U.S. slowdown or recession remains to be seen, but it is worth remembering that the stock market is a leading indicator by 9-12 months and should the U.S. economy bottom in the next 12-18 months, we could witness a material turn in the market during 2023.

Average U.S. Interest Rate Changes In Fed Tightening Cycles

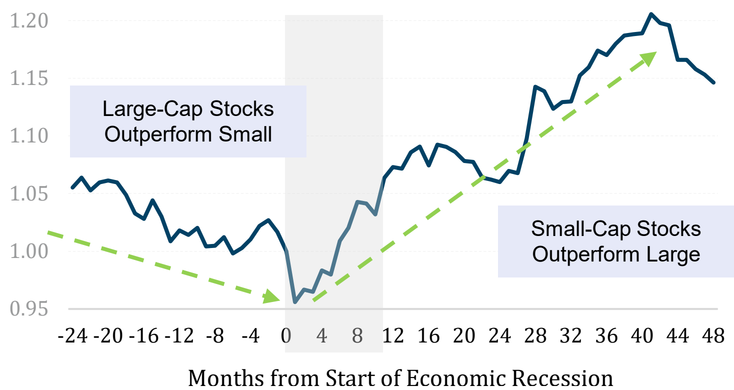


As of December 2022.
Source: Source: Piper Sandler Macro Research, William Blair. The data represents the average interest rate paid by U.S. households, businesses, and governments from six months before Fed liftoff to twelve months after for the past five tightening cycles.

One particularly intriguing chart observes the last six U.S. recessions going back to 1980 and how smaller cap companies performed going into the recession, as well as in the subsequent years. Without exception, in the 24 months prior to a recession, large caps outperformed small caps. However, almost immediately upon entering a recession, smaller caps reversed and outperformed large caps for the next three years, again, without exception.

Relative Performance Around Recessions: Small vs. Large Russell 2000/S&P 500

Average Relative Performance For Last 6 Recessions: 1980 to 2022



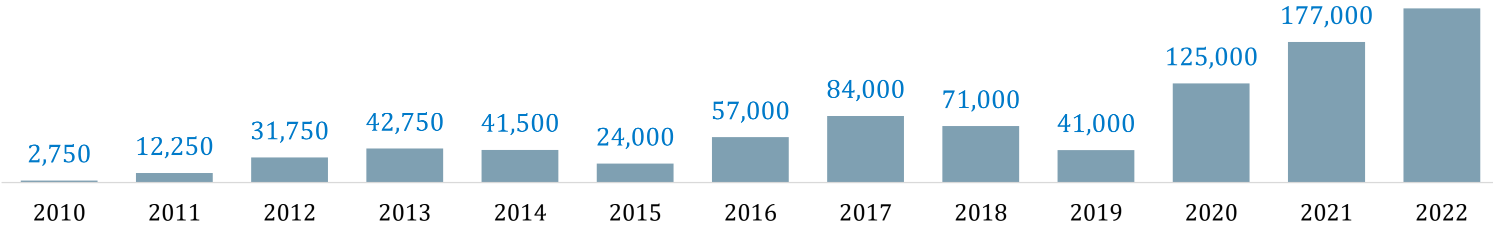
As of June 2022.
Source: William Blair, Bloomberg.
Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

Why Now?

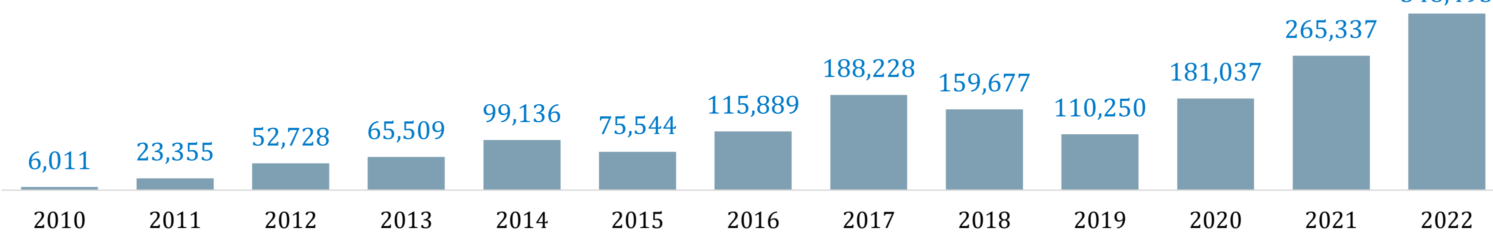
Another factor that has not received sufficient media and investor attention is the secular trend of "on or near-shoring" that is a distinct tailwind for more U.S. centric companies. This trend creates jobs back in the U.S. for companies that operate primarily in that market, a clear benefit for U.S. small-mid caps. For multi-nationals with significant exposure to overseas markets, they are more likely to face weaker end markets in 2023 and be penalized by a relatively strong U.S. Dollar.

U.S. Job Growth Tied To Reshoring Activities Surging

U.S. Manufacturing Jobs From Reshoring Activities



U.S. Manufacturing Jobs From Reshoring & FDI Activities



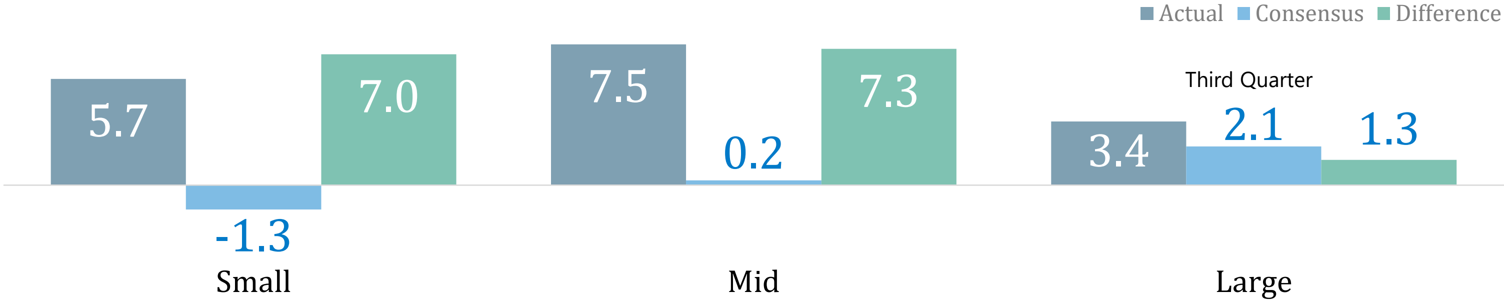
As of September 2022. December numbers are projected. Source: Reshoring Initiative®, BofA Global Research, William Blair. FDI refers to foreign direct investment.

Relative Fundamentals

Turning to Earnings Fundamentals, the most recent reported quarter provides insights into the strength of earnings growth across all market caps relative to Wall Street expectations and the expectations for future growth. Looking first at the light blue bars in the chart, these were Wall Street's expectations ahead of the calendar third quarter reporting season. The dark blue bars are the actual earnings results, and the dark green bars are the difference between what was expected and what was actually achieved. Note that when averaging the two green bars together, the small-mid caps represent nearly 5x the growth of large cap. The point: small-mid cap earnings are considerably stronger than expected in comparison to large caps.

Third Quarter 2022 Absolute Earning Growth: Actual vs. Estimates

Relative to large caps, small/mid caps are seeing stronger absolute earning growth with a wider gap between actual and consensus estimates



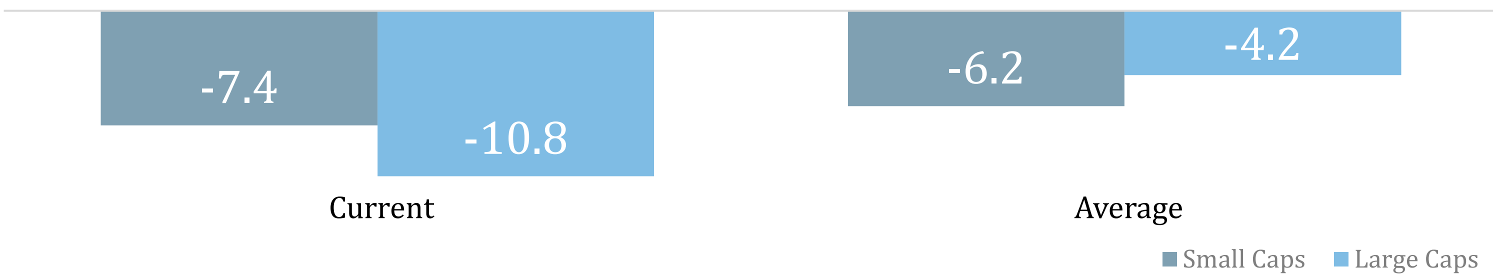
As of December 2022. Source: William Blair, Standard & Poor's, Jefferies.
Actual data represents third quarter year-over-year earnings growth, while consensus data reflects earnings estimates for the same period.
Earnings growth for small, mid and large cap companies are defined by the S&P 600, 400 and 500, respectively.
A direct investment in an unmanaged index is not possible.

Relative Fundamentals

Taking the fundamental differences a step further, focus first on the two bars on the right side of the chart. Historically, when smaller caps miss sales and earnings expectations, they are punished more severely than large caps. But as you will note on the left side, the opposite was true in the most recently reported quarter. The reason is straightforward: estimates for smaller caps are already estimated to be down 15% from their next twelve-month peak while large cap estimates have not materially moved. It therefore should not surprise investors that large caps are more vulnerable when a miss occurs as the chart portrays. This also begs the question of "what's embedded" in the stock from an earnings standpoint. It is one thing for Wall Street analysts to create earnings estimates, but it is far more important to know what investors are expecting and reflecting in the current stock price. While this chart only represents one quarter, today investor expectations are lower for the smaller cap companies relative to large caps. This is also reflected in valuations, where we would argue non-large stocks should have better valuation support given the extreme divergence in relative valuations of large vs. non large (more on this point shortly).

Companies That Missed Third Quarter 2022: Earning & Sales (Based on Subsequent 5-Days)

Small caps have performed better than large caps among companies that have missed earnings and sales, with a narrower gap when compared to the historical average

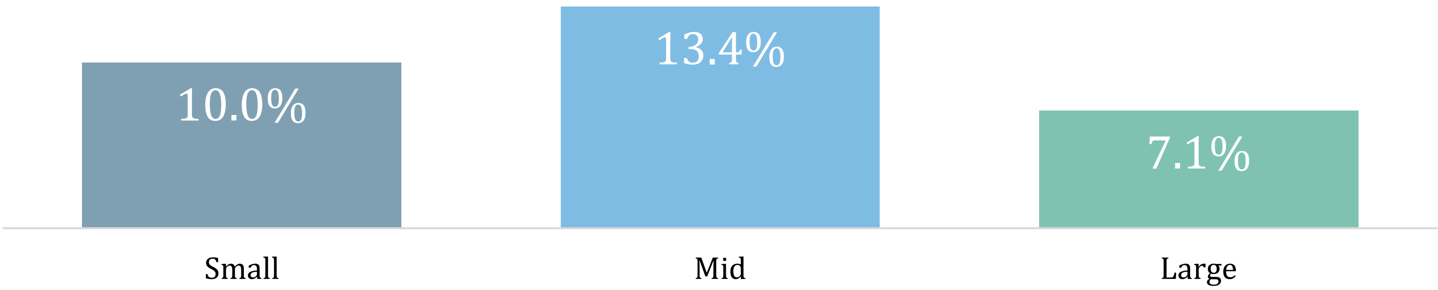


As of December 2022. Source: William Blair, Standard & Poor's, Jefferies.
Data represents relative performance of small and large cap companies that have missed earnings & sales expectations in the subsequent five days after reporting. Small and large cap companies are defined by the S&P 600 and 500, respectively. Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

The last chart on earnings fundamentals below looks at Wall Street's expectation for the next twelve months by market cap. If we combine the small and mid earnings growth estimates compared to large caps, the ratio is approximately 67% faster growth. Historically the non-large caps have seen expected growth approximately 30% higher, suggesting Wall Street believes relative earnings growth will above average in the non-large space. While all three market caps will likely experience deteriorating earnings expectations as we move through 2023, we can conclude that the fundamental strength and expectations of the small-mid caps appears superior to large caps today.

Earnings Growth Estimates: Small vs. Large

Relative to large caps, small/mid caps are seeing stronger absolute earning growth

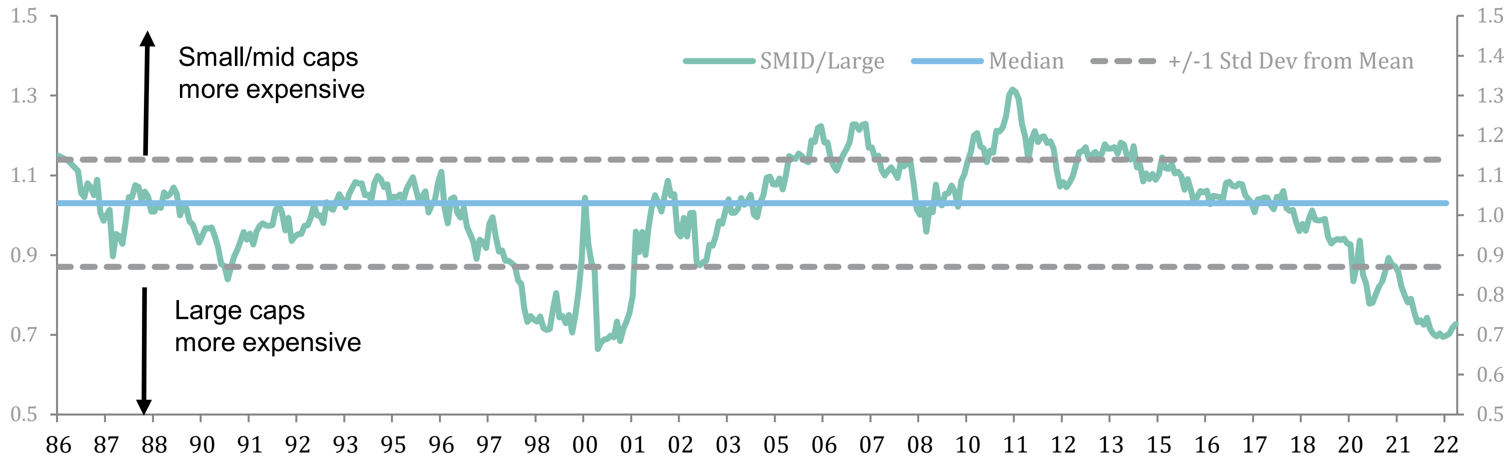


As of December 2022.
Source: William Blair, Standard & Poor's, Jefferies. Data reflects next twelve months' earnings estimates.
Earnings growth for small, mid and large cap companies are defined by the S&P 600, 400 and 500, respectively.
A direct investment in an unmanaged index is not possible.

Relative Valuation & Style Parity

Pivoting to Valuation, Merrill Lynch has plotted a relative valuation below for the last 36 years, going back to 1986, for the Russell 2500 (U.S. small-mid caps) in comparison to the Russell Top 200 (a large cap proxy). For more than a decade, large caps have dominated, leading to an unprecedented relative valuation only seen briefly during the internet bubble. The conclusion is straightforward: ***there is an unmistakable, undisputable and somewhat unprecedented valuation disparity that exists today between market capitalizations, which favors small and mid-caps.*** Finally note the most recent data point on this chart suggests not only has this valuation disparity stabilized in 2022, but it has potentially begun to revert toward the long-term median.

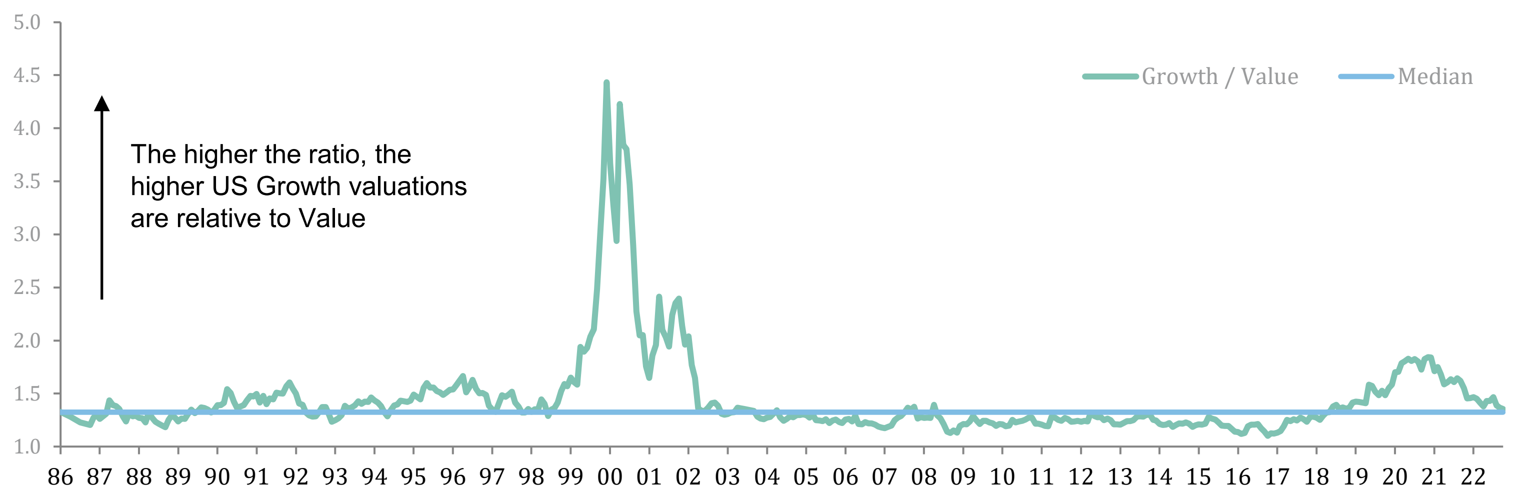
Relative Forward P/E: Small-Mid vs. Large
Russell 2500/Russell Top 200



As of December 31, 2022. Source: Bank of America Merrill Lynch.
Valuation methodology excludes unprofitable companies. A direct investment in an unmanaged index is not possible.

Because there is often a question of style attractiveness at any point in time, we have included the chart below, which also looks back at the last 36 years. From 2017 through 2020, Russell 2500 Growth valuations expanded meaningfully relative to Russell 2500 Value valuations, but this reversed in 2021 and today the style differences are effectively at valuation parity relative to the longer-term median. While styles can, and do, come in and out of favor, we believe investors are increasingly likely to focus on quality, whether it be in a growth, core or value-style portfolios.

Relative Forward P/E: Growth vs. Value
Russell 2500 Growth/Russell 2500 Value



As of December 31, 2022. Source: Bank of America Merrill Lynch.
Valuation methodology excludes unprofitable companies. Growth and value are represented by the Russell 2500 Growth and Russell 2500 Value, respectively.
A direct investment in an unmanaged index is not possible.

Why Quality Should Matter in 2023

As we observed early in this article, quality surprised us in 2022. One of the interesting aspects of 2022 was the apparent unwillingness of investors to recognize the potential benefits of quality as earnings begin to weaken. If one looked at the last four earnings downturns since 2000, there is a 100% correlation with positive factor performance for metrics deemed to reflect quality. In 2022, despite the initial earnings declines across all market caps, quality metrics either hurt performance or contributed a below average contribution relative to history.

As we look forward to 2023, there are indications that higher quality investments should fare better in the coming year. Investors expect interest rates to continue to rise, albeit at a slower pace than in 2022, assuming inflation continues to moderate. We believe the majority of multiple compression from rising interest rates should already be embedded in stocks. In contrast to 2022, we believe market performance in 2023 will likely be tied more closely to fundamentals than valuation differences.

Given the lagged impact, the effects of interest rate increases will likely have a more meaningful impact on the U.S. economy in 2023. A slowing economy and generally weaker demand relative to this past year may necessitate costs come into equilibrium with slower revenue growth. This implies risk to corporate earnings. Moreover, as an era of near-zero rates ends, capital sources for more speculative equities are likely to diminish, focusing more on near-term fundamentals.

We believe quality companies, which have the financial independence to continue to invest in their operations and the business model flexibility to adjust quickly in a dynamic environment, have become increasingly attractive investment opportunities against this backdrop. Pricing flexibility, for example, will be critical if inflationary pressures from labor and materials persist and overall demand weakens. This scenario would likely cause pressure on margins and earnings disappointments for the average company. Companies with strong management teams, superior business models and solid financials would likely be in a better position to navigate such headwinds. In addition, higher quality investments did not materially outperform during the sell-off in 2022, resulting in compelling valuations for these businesses as we look ahead.

If you conclude as we do that the small-mid-cap asset class is extremely attractive, an active manager with small-mid cap expertise is critical. William Blair’s 86-year history is rooted in quality small-mid cap investing. It is who we are and what we do, and we do it well. We focus on what we know has worked well and what we believe will continue to win over time: sustained superior fundamentals combined with a valuation discipline that identifies attractive risk/rewards.

William Blair Small & Mid-Cap Expertise

Small-Mid Cap Growth Fund (Class I: WSMDX)

- Investment team seeks to invest in small- and mid-cap companies that can sustain a higher level of growth for a longer period of time than the market expects
- Fund seeks to outperform over the long term with lower levels of risk
- Fund has a Morningstar overall rating of 4 stars in the Morningstar Mid-Cap Growth Category as of 12/31/22

MORNINGSTAR RATINGS AND RANKINGS*

	Overall	1 Y	3 Y	5 Y	10 Y
Class I Rating	★★★★	--	★★★	★★★	★★★★
Class N Rating	★★★★	--	★★★	★★★	★★★★
Class I Percentile Ranking		21	63	49	19
Class N Percentile Ranking		22	67	67	88
# of Funds in Category		586	534	499	389

Small-Mid Cap Core Fund (Class I: WBCIX)

- Investment team seeks to invest in small- and mid-cap quality companies across a broad universe that can achieve more durable returns on capital than the market expects
- Fund seeks to outperform over the long term with lower levels of risk
- Fund has a Morningstar overall rating of 5 stars in the Morningstar Small Blend Category as of 12/31/22

MORNINGSTAR RATINGS AND RANKINGS*

	Overall	1 Y	3 Y	5 Y	10 Y
Class I Rating	★★★★★	--	★★★★★	--	--
Class I Percentile Ranking		59	11	--	--
# of Funds in Category		611	585	--	--

Small Cap Growth Fund (Class I: WBSIX)

- Investment team seeks to invest in small-cap companies that can sustain a higher level of growth for a longer period of time than the market expects
- Fund offers a differentiated approach to small cap investing, given the team's focus on investing in quality growth companies at attractive valuations and emphasis on uncovering companies with growth opportunities that other investors do not fully appreciate
- Fund has a Morningstar overall rating of 5 stars in the Morningstar Small Growth Category as of 12/31/22

MORNINGSTAR RATINGS AND RANKINGS*

	Overall	1 Y	3 Y	5 Y	10 Y
Class I Rating	★★★★★	--	★★★★	★★★★	★★★★★
Class N Rating	★★★★★	--	★★★★	★★★★	★★★★★
Class I Percentile Ranking		18	19	23	6
Class N Percentile Ranking		19	21	27	8
# of Funds in Category		604	576	530	399

Small Cap Value Fund (Class I: ICSCX)[1]

- Investment team seeks to invest in undervalued, quality small-cap companies that it believes possess solid balance sheets and free cash flow generation along with management teams that are strong stewards of capital allocation
- Our process combines the focused knowledge of individual career sector analysts with the collective experience of the team to find companies that we believe can outperform the broader market over time
- Fund has a Morningstar overall rating of 4 stars in the Morningstar Small Value Category as of 12/31/22

MORNINGSTAR RATINGS AND RANKINGS*

	Overall	1 Y	3 Y	5 Y	10 Y
Class I Rating	★★★★	--	★★★	★★★	★★★★
Class I Percentile Ranking	--	53	65	43	21
# of Funds in Category	--	481	453	426	322

[1]See Important Disclosures for information on the fund reorganization and history.

The Morningstar Mid-Cap Growth, Small Blend, and Small Growth, and Small Value Categories represent the average annual composite performance of all mutual funds listed in each respective Category by Morningstar.

*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. Morningstar Percentile Rankings are based on the Fund's total return (excluding sales charge) relative to all the funds in the same Morningstar category, where 1 is the highest and 100 is the lowest percentile rank. Ratings and rankings are one measure of performance. Some of our Funds have experienced negative performance for the time periods shown. Morningstar Quartile Rankings are based on Morningstar Percentile Ranking in Morningstar Category, where 1% - 25% = first quartile (1); 26% - 50% = second quartile (2); 51% - 75% = third quartile (3); and 76% - 100% = fourth quartile (4). The Morningstar Percentile Ranking compares a Fund's Morningstar risk and return scores with all the Funds in the same Category, where 1% = Best and 100% = Worst. Morningstar Ranking / # of Funds in Category displays the fund's actual rank within its Morningstar Category based on average annual total return and number of Funds in that Category.

William Blair Morningstar Highlights

William Blair Small & Mid-Cap Expertise

Small-Mid Cap Growth Fund

INVESTMENT PERFORMANCE (AS OF 12/31/22)

	QTR	YTD	1 Y	3 Y	5 Y	10 Y
Class I (SI: 12/29/03)	8.97%	-22.92%	-22.92%	3.46%	7.24%	12.16%
Class N (SI: 12/29/03)	8.92%	-23.11%	-23.11%	3.20%	6.97%	11.87%
Russell 2500™ Growth Index[3]	4.72%	-26.21%	-26.21%	2.88%	5.97%	10.62%
Morningstar Mid-Cap Growth Category[4]	5.07%	-27.79%	-27.79%	4.14%	7.09%	10.67%

EXPENSE RATIOS

	Gross Expense	Net Expense
Class I	1.16%	1.10%
Class N	1.43%	1.35%

Small-Mid Cap Core Fund

INVESTMENT PERFORMANCE (AS OF 12/31/22)

	QTR	YTD	1 Y	3 Y	5 Y	Since Incep.
Class I (SI: 10/1/19)	9.12%	-17.11%	-17.11%	8.18%	--	9.74%
Russell 2500™ Index[3]	7.43%	-18.37%	-18.37%	5.00%	--	7.27%
Morningstar Small Blend Category[4]	9.05%	-16.24%	-16.24%	5.17%	--	--

EXPENSE RATIOS

	Gross Expense	Net Expense
Class I	1.25%	0.95%

Small Cap Growth Fund

INVESTMENT PERFORMANCE (AS OF 12/31/22)

	QTR	YTD	1 Y	3 Y	5 Y	10 Y
Class I (SI: 12/27/99)	8.51%	-21.39%	-21.39%	7.27%	8.21%	12.98%
Class N (SI: 12/27/99)	8.42%	-21.59%	-21.59%	6.99%	7.94%	12.70%
Russell 2000® Growth Index[3]	4.13%	-26.36%	-26.36%	0.65%	3.51%	9.20%
Morningstar Small Growth Category[4]	4.18%	-27.77%	-27.77%	4.05%	6.60%	10.20%

EXPENSE RATIOS

	Gross Expense	Net Expense
Class I	1.25%	--
Class N	1.56%	1.50%

Small Cap Value Fund[1]

INVESTMENT PERFORMANCE (AS OF 12/31/22)

	Qtr	YTD	1 Y	3 Y	5 Y	10 Y	Since Incep.
Class I (SI: 04/19/89)	10.70%	-11.12%	-11.12%	5.76%	5.13%	9.97%	--
Class N (SI: 07/19/21)	10.61%	-11.36%	-11.36%	--	--	--	-2.59%
Russell 2000® Value Index[3]	8.42%	-14.48%	-14.48%	4.70%	4.13%	8.48%	-5.69%
Morningstar Small Value Category[4]	11.20%	-10.16%	-10.16%	7.06%	4.77%	8.67%	--

EXPENSE RATIOS

	Gross Expense	Net Expense
Class I	0.82%	--
Class N	1.26%	1.15%

[1]See Important Disclosures for information on the fund reorganization and history.

Performance cited represents past performance. Past performance does not guarantee future results and current performance may be lower or higher than the data quoted. Performance is shown in U.S. dollar unless otherwise noted. Returns for periods greater than one year are annualized. Returns shown assume reinvestment of dividends and capital gains. Investment returns and principal will fluctuate with market and economic conditions and you may have a gain or loss when you sell shares. For the most current month-end performance information, please call +1 800 742 7272, or visit our Web site at www.williamblairfunds.com. Class N shares are available to the general public without a sales load. Class I shares are available only to investors who meet certain eligibility requirements.

Expenses shown are as of the most recent prospectus. Net expense ratios reflect a contractual agreement by the Fund's Adviser to waive fees and/or reimburse expenses to limit fund operating expenses until 4/30/23.

[3]The Russell 2500 Growth Index measures the performance of those Russell 2,500 companies with above average price-to-book ratios and forecasted growth rates. The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, which represents approximately 19% of the total market capitalization of the Russell 3000 Index. The Russell 2000 Growth Index consists of small-capitalization companies with above average price-to-book ratios and forecasted growth rates. The Russell 2000 Value Index consists of small-capitalization companies with below average price-to-book ratios and forecasted growth rates. It is not possible to directly invest in an unmanaged index.

[4]The Morningstar Mid-Cap Growth, Small Blend, and Small Growth, and Small Value Categories represent the average annual composite performance of all mutual funds listed in each respective Category by Morningstar.

William Blair Morningstar Highlights

Important Disclosures

Please carefully consider the Fund's investment objectives, risks, charges, and expenses before investing. This and other information is contained in the Fund's prospectus and summary prospectus, which you may obtain by calling +1 800 742 7272. Read the prospectus and summary prospectus carefully before investing. Investing includes the risk of loss.

Risks: Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. Investing in small and medium capitalization companies involves special risks, including higher volatility and lower liquidity. Small and mid-cap stocks are also more sensitive to purchase/sale transactions and changes in the issuer's financial condition. Different investment styles tend to shift in and out of favor depending on market conditions and investor sentiment. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result. Diversification does not ensure against loss.

Indices: The Russell 2000 Index is a market capitalization-weighted index designed to represent the small cap segment of the U.S. equity universe. The Russell 2500 Index is a market capitalization-weighted index designed to represent the small to mid-cap segment of the U.S. equity universe. The Russell 2500 Growth Index measures the performance of those Russell 2500 companies with above average price-to-book ratios and forecasted growth rates. The Russell 2500 Value Index measures the performance of those Russell 2500 companies with lower price-to-book ratios and forecasted growth rates. The Russell 2000 Value Index consists of small-capitalization companies with below average price-to-book ratios and forecasted growth rates. The Russell Top 200 Index is a market capitalization-weighted index designed to represent the largest cap segment of the U.S. equity universe. The S&P 5oo Index is widely regarded as the best single gauge of large-cap U.S. equities. The S&P SmallCap 600 Index seeks to measure the small-cap segment of the U.S. equity market. The S&P MidCap 400 Index provides investors with a benchmark for mid-sized companies. The S&P 1000 Index combines the S&P SmallCap 600 and S&P MidCap 400 to form a benchmark for the mid- to small-cap segment of the U.S. equity market. Indices are unmanaged and do not incur fees or expenses. It is not possible to directly invest in an unmanaged index.

[1]Effective July 19, 2021, the ICM Small Company Portfolio (the "Predecessor Fund") was reorganized into the William Blair Small Cap Value Fund. The Predecessor Fund's (Institutional Class shares) performance and financial history has been adopted by the William Blair Small Cap Value Fund (Class I shares). The Predecessor Fund had a different fee structure and performance would have been different if the fund's current fee structure had been in place during the period.

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