Five Reasons Why You Should Consider Investing in a Global Small Companies Portfolio

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"For Professional and Sophisticated Investors Only"

Key Insights

- Australian investors' propensity to allocate capital into domestic small caps is much greater than global small caps. This is despite the evidence for a superior 'small cap effect' in the global equity markets.

- Global small caps have a number of unique attributes that appear structural in nature, and importantly, offer longer term diversification benefits for Australian investors within a global equity portfolio.

Introduction

The 'small cap effect' - where small capitalisation companies (with a market cap of US$500 million to US$5 billion) outperform the large capitalisation companies over time - is a widely accepted anomaly in global capital markets.

In their seminal paper, Professors Fama and French concluded the out-performance of small caps over large caps (i.e. the 'small cap effect') was due to an element of risk that is unique to small caps. In other words, investors are compensated for undertaking additional risk when investing in companies with a relatively small market capitalisation. Other empirical studies have also demonstrated that smaller companies have higher rate of earnings growth than large caps.

In the most recent decade, the 'small cap effect' has been strongly evident in the global equity markets. Importantly, the presence of the 'small cap effect' is not the result of just one or two outlier years of out-performance.

For example, in the last 10 years and on a rolling one-year basis, global small caps outperformed global large caps 60 percent of the time. Over three and five-year rolling periods, global small caps outperformed global large caps 74 percent and 89 percent of the time, respectively.

Despite the high certainty of global small caps outperforming global large caps over three to five year periods, Australian investors have been reluctant to allocate capital outside the global large caps and global emerging markets within their equities portfolio.

An allocation to global small caps can:

- substantially increase the investment opportunity set and potential for adding alpha,
- complete the 'capitalisation range' of an international portfolio,
- provide demonstrated added diversification benefits, and
- offer relative valuation advantage over large caps.

Thus, we believe Australian investors with longer term horizons should reassess their allocation to global small caps, potentially increasing their weighting to 10%-15% of their total global equity allocation.

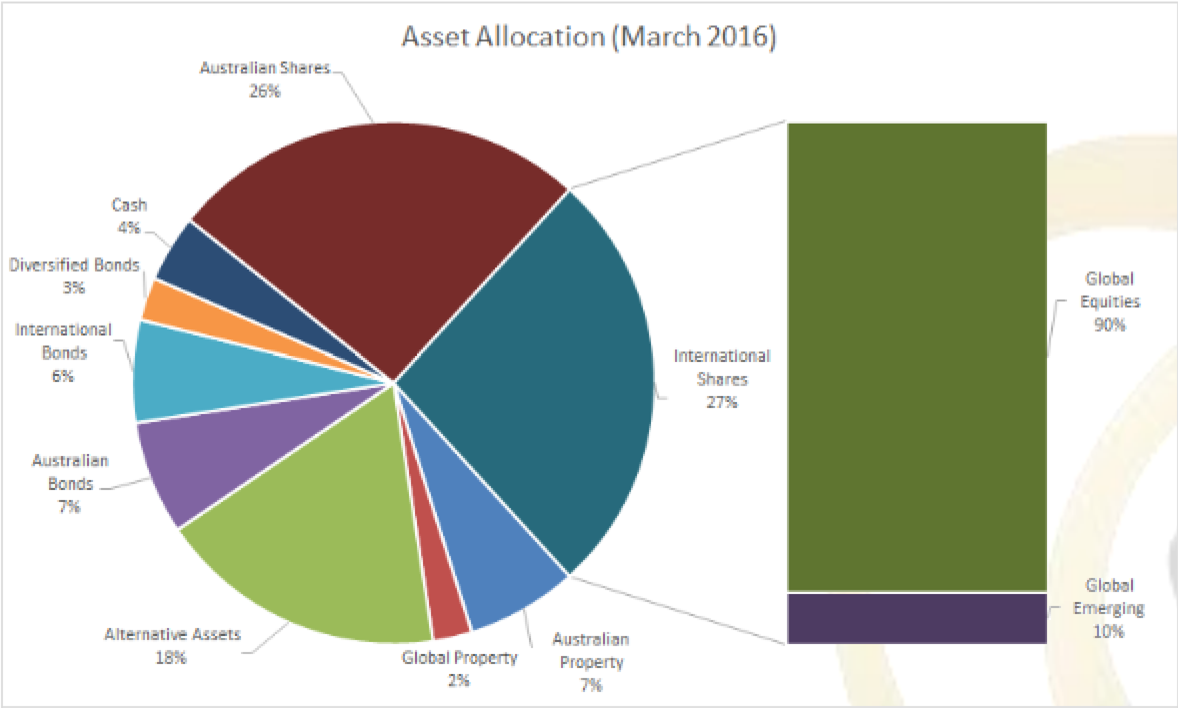
Fact 1: Insufficient diversification in international equity portfolios

We believe investors are missing an opportunity to add further value and increase the diversification of their international equity portfolios by ignoring a large segment of the global equity markets.

When you consider the current asset allocation of a typical balanced fund (Exhibit 1), the global equity exposure is heavily dominated (as much as 90 percent) by global equities (as proxied by the MSCI World Index) and global emerging market equities (as proxied by MSCI Global Emerging Markets Index).

Both these indices only capture a narrow part of the global opportunity set, both in terms of the number of securities and market cap range.

Exhibit 1: Asset allocation profile of a typical balanced fund (31.3.2016)



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The average market cap of global large cap companies is almost US$20 billion. For global emerging markets, it is US$4.8 billion, while for global small caps, it is US$1.2 billion. By allocating part of the global equity portfolio to global small caps, investors can expand their potential investible universe from approximately 2,500 companies to 6,800 companies (Exhibit 2).

Exhibit 2: Complementary opportunity set (31.8.2016)

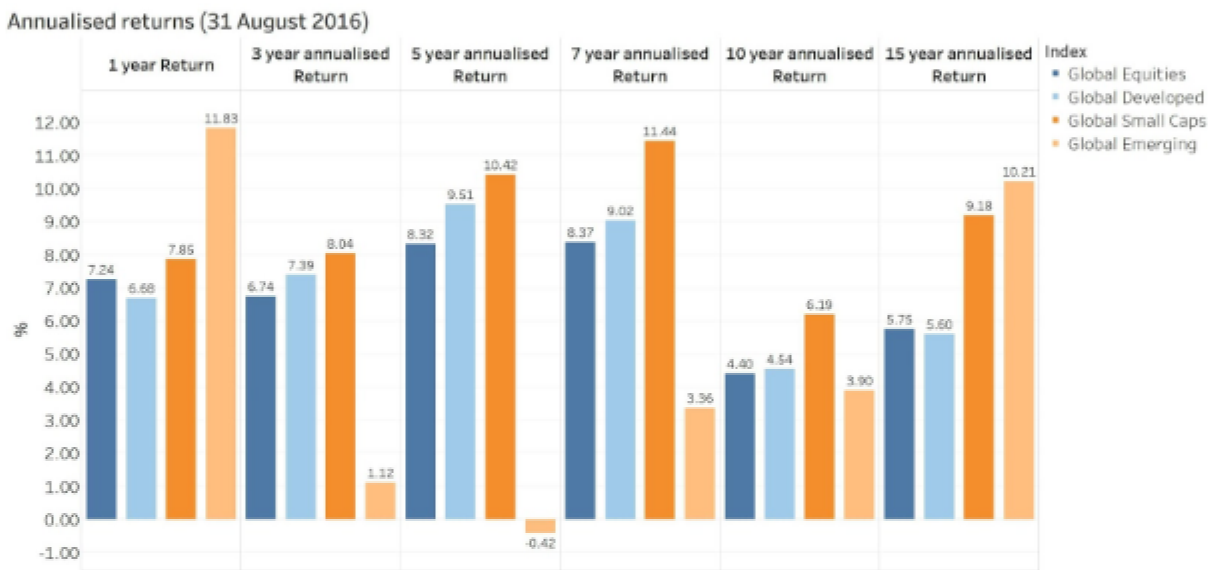
Unique opportunity set (31 August 2016)

Index	Total Market Cap	Number of securities	Average Market Cap	Largest Market Cap	Smallest Market Cap	Median Market Cap
Global Developed	US$ 33,244.85B	1,641	US$ 20,259M	US$ 619,223M	US$ 800M	US$ 8,999M
Global Small Caps	US$ 5,192.47B	4,298	US$ 1,208M	US$ 7,887M	US$ 15M	US$ 784M
Global Emerging	US$ 4,011.46B	834	US$ 4,810M	US$ 155,011M	US$ 406M	US$ 2,399M

Fact 2: The 'small cap effect' is highly pervasive

The 'small cap effect' has been quite pervasive in global equity markets. Over the past 5 years, 7 years, 10 years and 15 years, global small caps have outperformed the global large caps by a significant margin. Despite this persistent anomaly, investors' propensity to allocate into global small caps has been much less than the case with domestic small caps. Australian Investors with longer time horizons are missing on the opportunity to capture this premium.

Exhibit 3: Annualised returns in USD (31.8.2016)



While global small caps are more volatile than the global large caps and global all caps, the return premium observed is persistently higher. This can be seen when assessing the risk-adjusted returns using popular measures such as the Sharpe Ratio that adjusts returns for the risk-free rate and volatility. It is quite evident from this analysis that while investors take high volatility risk when allocating to the asset class, they are well compensated for taking that risk over the longer time horizons.

Exhibit 4: Annualised Sharpe Ratio (31.8.2016)

The 'small cap effect' is not driven by one or two outlier periods in the data sample. When analysing the rolling three-year excess return premium over the global equity market return or the large cap return, there is a high level of persistence in this premium (Exhibit 5). The probability of a positive small cap premium occurring in markets is 74 percent when an investor's investment horizon is at least three years.

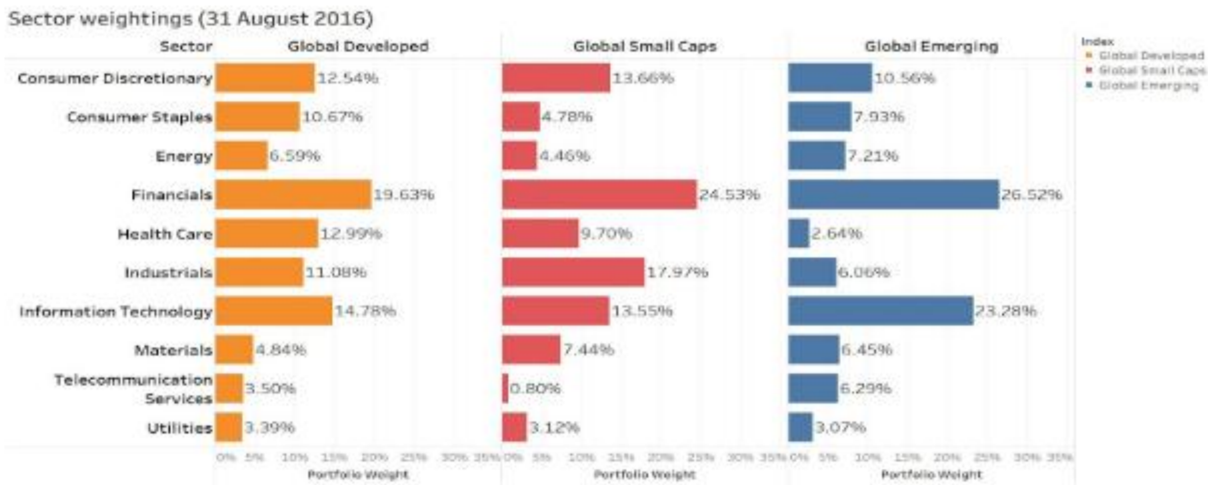
Exhibit 5: Rolling excess returns over global equities (31.8.2006 - 31.8.2016)

Fact 3: A unique opportunity

Our analysis shows that global small caps are underpinned by unique fundamental drivers that are structural in nature. Importantly, this fundamental insight means long-term investors can rely on the critical attributes of the sector with greater certainty.

While company-specific risks can be high, a global small cap portfolio of many stocks can offer multiple levels of diversification, which can potentially enhance risk-adjusted returns. The first level of diversification is sector diversification. Global small caps (Exhibit 6) offer significant exposures to sectors like Consumer Discretionary and Industrials, compared to global equities and global emerging markets.

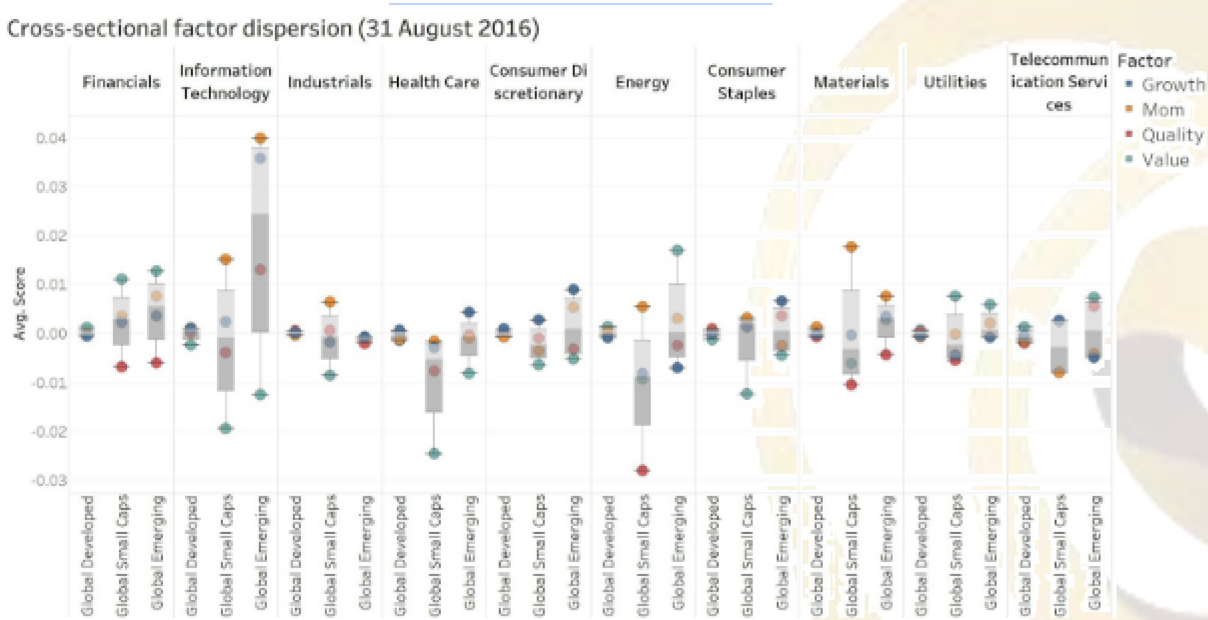
Exhibit 6: Index sector weightings (31.8.2016)



- Strong factor dispersion

When analysing typical fundamental style factors like value, growth, momentum and quality, it's clear that global small caps offer substantially greater dispersion, and therefore opportunity for selectivity. This observation is highly pervasive across all sectors, particularly relative to the global developed markets. While the observation is not surprising given smaller companies focused business models applied to niche market segments, it bodes well for active management within global small caps.

Exhibit 7: Cross-sectional factor dispersion (31.8.2016)



Fact 4: A great source of diversification

Global small caps provide useful portfolio diversification. Exhibit 8 shows rolling 12-month correlation of total returns for the global small caps and the global all caps. The average correlation is about 0.87 since 2000. This is not surprising given that small companies, no matter their location, typically operate exclusively in their home market. Consequently, these stocks offer a pure play on an economy; a Japanese retail chain relies on Japanese shoppers, for instance.

Companies with a domestic demand drivers tend to be less sensitive to global macroeconomic factors, and more dependent upon developments within their home countries. Accordingly, extensive geographic diversification may provide global small cap investors with risk benefits not available to portfolios or index funds that are heavily skewed towards larger exporting countries tied to the developed world.

Small companies, by their very description, have the potential to grow faster than large ones. Smaller businesses can be nimble and responsive to customer needs. The most successful small companies possess characteristics such as new products, new services, new markets and innovative delivery systems that allow the companies to rapidly increase sales, market share and profitable earnings.

Exhibit 8: Rolling correlation (31.1.2000 - 31.8.2016)

Fact 5: Divergent fundamentals

Valuation measures such as the price to book ratio suggest global small caps have more attractive valuation than the large caps. However, this valuation discount has widened more recently and is certainly higher than the average for the last 15 years. This is an interesting observation particularly at a time when global small caps offer greater earnings growth potential than large caps.

When assessing the dividend yields of the global equity markets, global small caps clearly have lower dividend yields than large caps. Not surprisingly, global small caps are often seen as a source of growth for investor portfolios, and that growth is driven by lower dividend payouts and greater reinvestment of capital into the business compared to large caps.

Exhibit 9: Rolling Price-To-Book Ratio (31.8.2006 - 31.8.2016)

Exhibit 10: Rolling dividend yield (31.8.2006 - 31.8.2016)

Valuation - Dividend yield from January 2006 to August 2016 (12-month moving windows, computed monthly)

Concluding points

In this article we make a case for global small caps allocation within the international equity component of an Australian investor's portfolio. We highlight that there are many advantages of investing in global small caps.

Many of these attractive qualities are highly persistent through time, which means investors can allocate into this asset class with greater level of certainty. Global small caps do come with risks such as volatility, currency and liquidity.

However, for long-term investors, this risk is worth taking as the certainty of achieving superior risk-adjusted returns is very high.

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