# *Global Small Caps provide a rich source of idiosyncratic growth for global equity portfolios*

*"For Professional and Sophisticated Investors Only"*

Foresight Analytics™

## Summary

Despite the high certainty of global small caps out-performing global large caps (aka the 'small cap effect') over the long term, Australian institutional and wholesale investors have been reluctant to allocate equity capital outside the global large caps and global emerging markets. As a matter of fact, we find that there is a greater propensity to allocate capital to global private equity than to global small caps. Our analysis shows that a modest allocation to global small caps can:

- Substantially increase the investment opportunity set and potential for adding alpha,
- Provide demonstrable diversification benefits due to idiosyncratic attributes,
- Offer significant growth advantage over large caps and,
- Offer greater liquidity than global private equity.

Global small cap investing has strong merits for Australian investors, both from return-enhancing and risk-diversification perspectives. 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 outperforming attributes of the asset class with greater certainty.

## Exhibit 1: Vast opportunity set offers high selection breadth for active managers

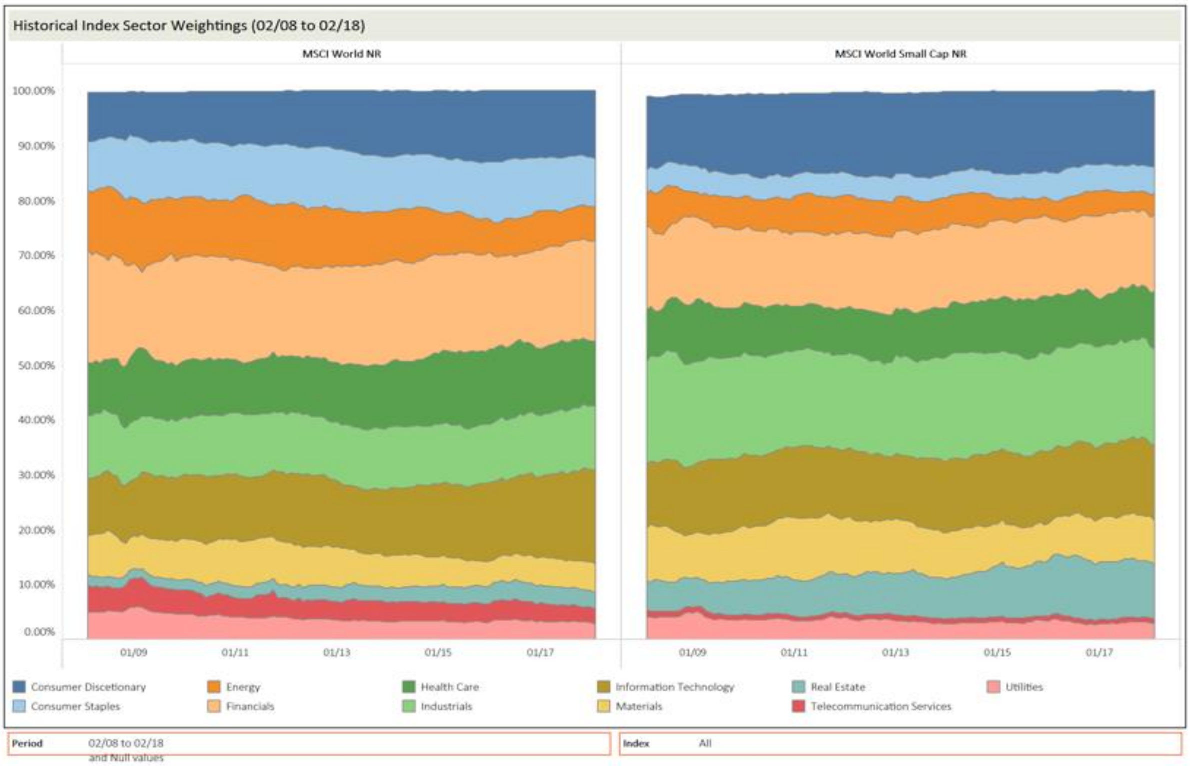
Key Facts on Global Equity Indices (as at 31.01.2018)

| | Number of securities | Total Market Cap | Median Market Cap | Average Market Cap | Max Market Cap | Min Market Cap |
|---|---|---|---|---|---|---|
| Global Developed | 1,649 | US$42,541B | US$11.30B | US$25.80B | US$864.81B | US$1,338M |
| Global Emerging | 846 | US$5,883B | US$3.09B | US$6.95B | US$337.78B | US$558M |
| Global Equities | 2,494 | US$48,424B | US$7.78B | US$19.42B | US$864.81B | US$558M |
| Global Small Caps | 4,320 | US$6,573B | US$0.97B | US$1.52B | US$13.07B | US$13M |

Source: Foresight Analytics and Morningstar

The opportunity set for global smaller companies is vast across global markets as the universe comprises over 4,300 stocks. This compares with 1,600 names for developed large caps and 846 names in emerging markets. The size differential of companies within this universe is quite significant with the maximum market caps for small companies currently standing at US$13.1 billion compared to US$864.8 billion for large caps, whilst the average market cap for smaller companies currently at US$1.5 billion is closer to the smallest company in the large cap index at US$1.4 billion.

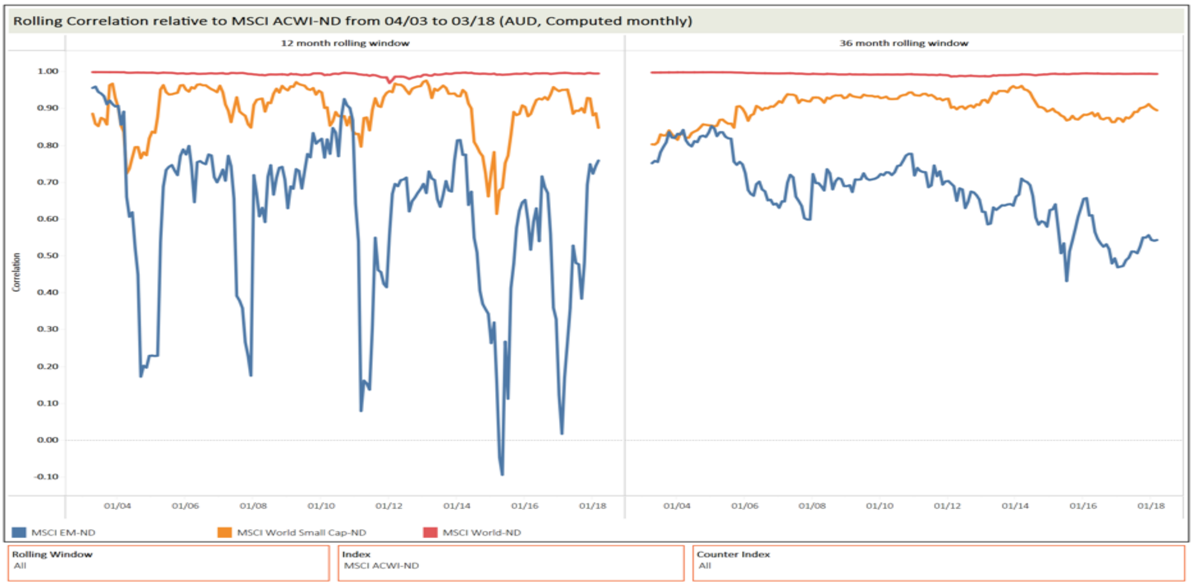
Exhibit 2: Greater sector diversity but across cyclical sectors that add to volatility of the index




Source: Foresight Analytics, Morningstar and Style Research

The larger opportunity set compared to large caps offers diversification benefits not only at the stock level but also at the sector level. However, investors should note that small cap index has higher allocations to cyclical sectors such as consumer cyclical, industrial and financial sectors. While this differentiation adds to the overall diversity, it also adds to higher volatility in the earnings and cashflow streams of the index. It is therefore important to consider active implementation in this asset class. We explore this insight further in future sections of the report.

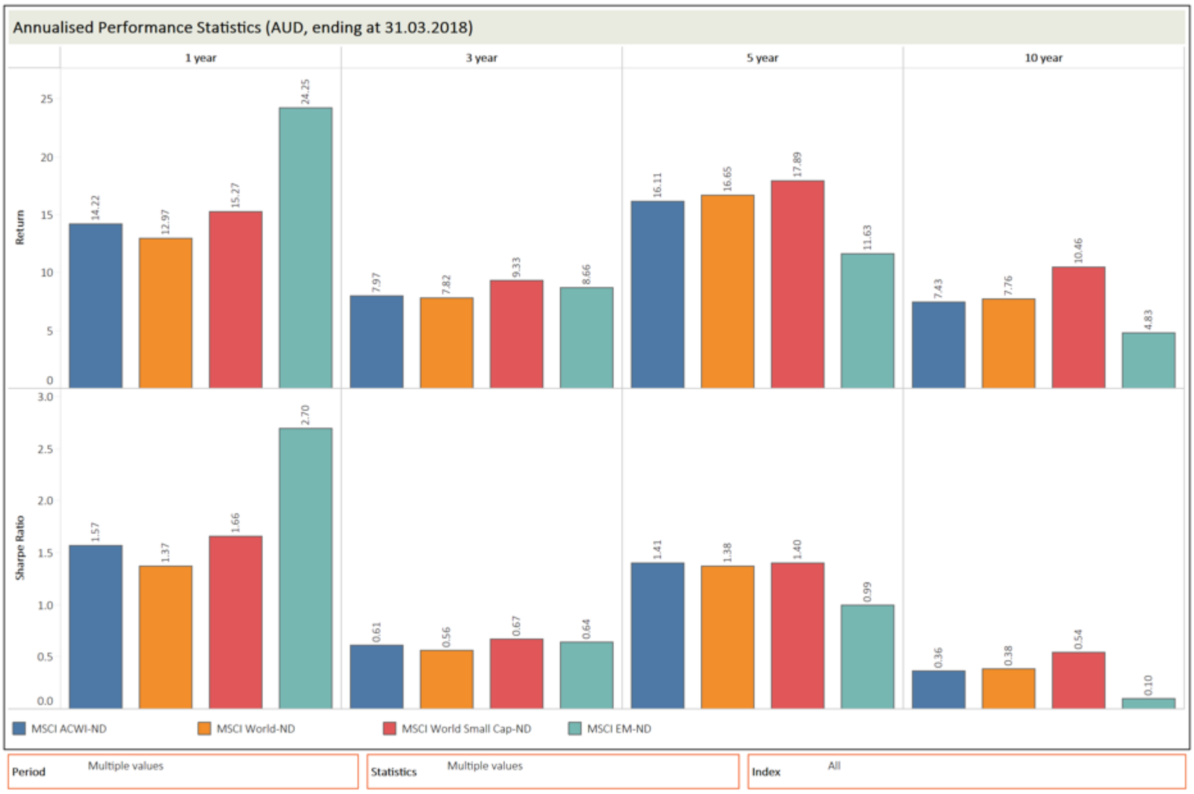
**Exhibit 3: Global Small Caps offer diversification benefits to large and emerging equities**




Source: Foresight Analytics
Data source: eVestment

The diversification benefits that global small caps offers through size, sector, growth and diversity of names are reflected in less than perfect correlation between global small caps and global large caps, which on a rolling 12-month basis, has averaged 0.87 since 2004. This is not surprising given that smaller companies typically operate exclusively in their home market. 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 uncorrelated opportunities not available to portfolios or index funds that are heavily skewed towards larger exporting countries tied to the developed world.

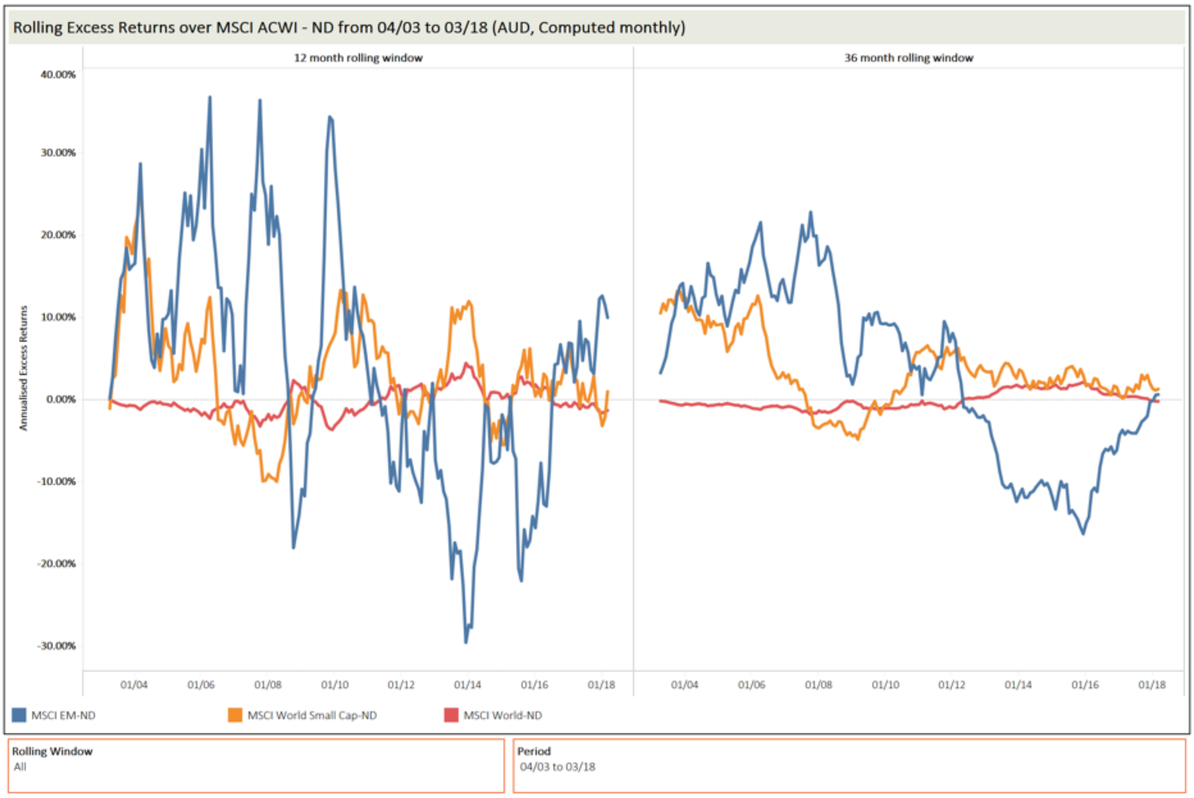
## Exhibit 4 & 5: Global small cap effect is highly pervasive in AUD




Source: Foresight Analytics
Data source: eVestment

The 'small cap effect' has been quite pervasive in global equity markets. Over the past 3 years, 5 years and 10 years, global small caps have outperformed global large caps by a significant margin. While global small caps are more volatile than the global large caps and global all caps, the return premium observed is persistently higher. This point is evident from a Sharpe Ratio analysis that adjusts returns for the risk-free rate and volatility. The data shows 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.

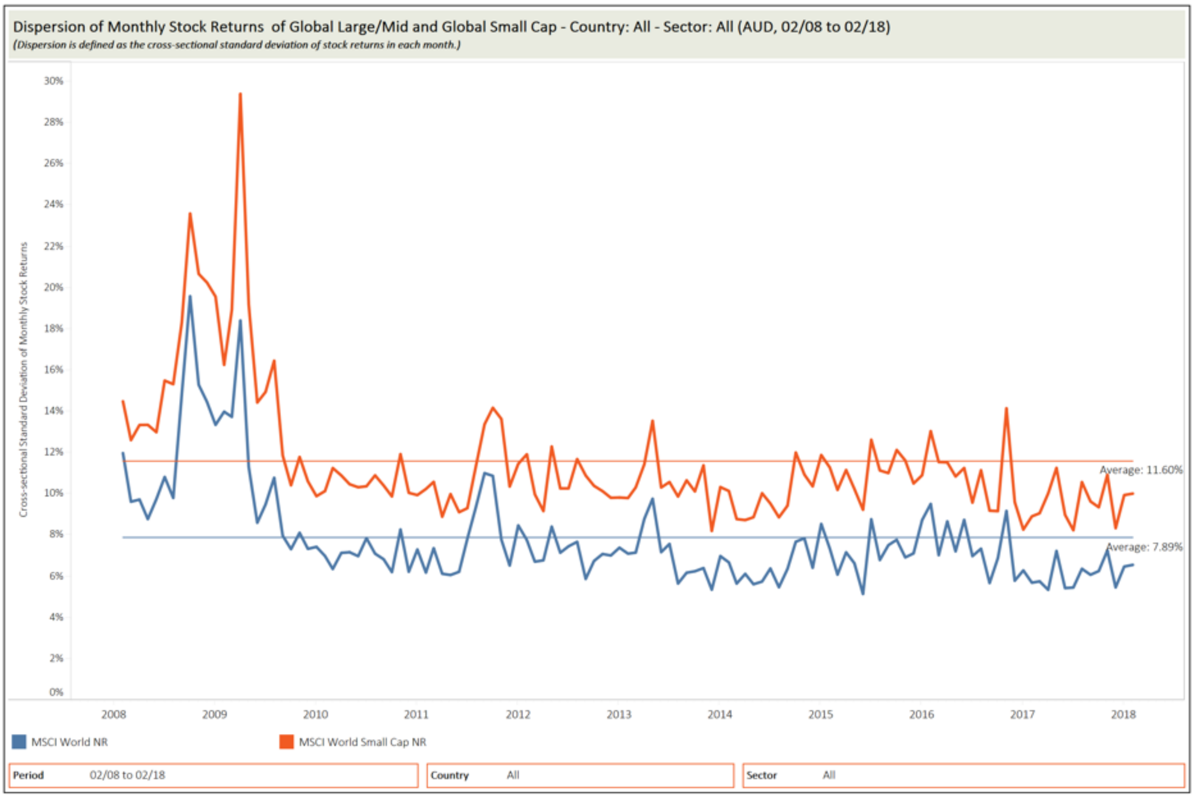
## Exhibit 6: Higher cross-sectional dispersion of returns offers opportunity for stock pickers.




Source: Foresight Analytics
Data source: eVestment

Whilst there is a higher degree of risk and uncertainty in smaller company investing, the 'small-cap effect' is not driven by one or two outlier periods in the data sample. Our analysis of the historical returns shows that there is a high level of persistence in this premium over the medium and longer time periods. The data further shows that it pays for investors to hold smaller companies for a longer investment period to smooth out the effect of higher volatility in the shorter term.

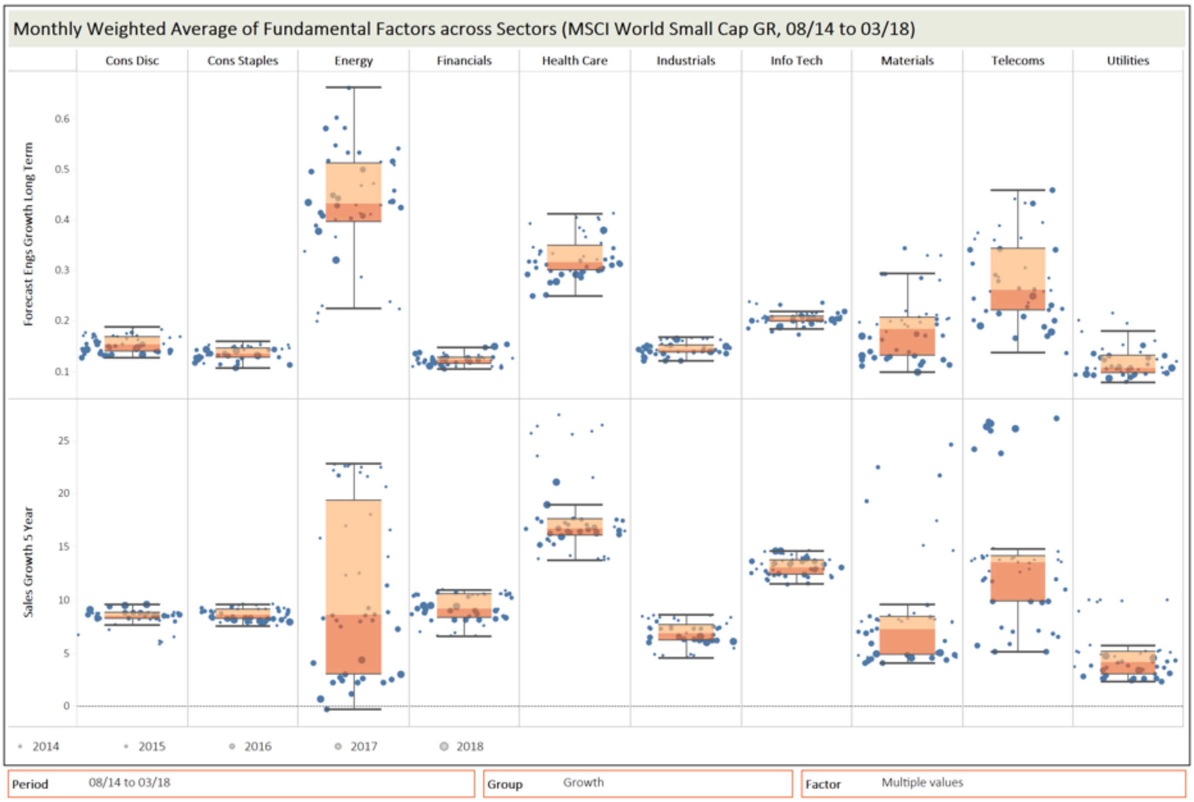
Exhibit 6: Higher cross-sectional dispersion of returns offers opportunity for stock pickers.




Source: Foresight Analytics
Data Source: Morningstar and Style Research

It is highly evident that the average stock dispersion is consistently higher for Global Small Cap (11.6%) than the Global Large caps (7.89%). Higher levels of stock return dispersion as experienced by the Global Small Caps indicate greater investment breadth and therefore, superior stock picking opportunities for active managers. Conversely, below average levels of cross-sectional volatility indicate lower market breadth and lower selection opportunities for active managers.

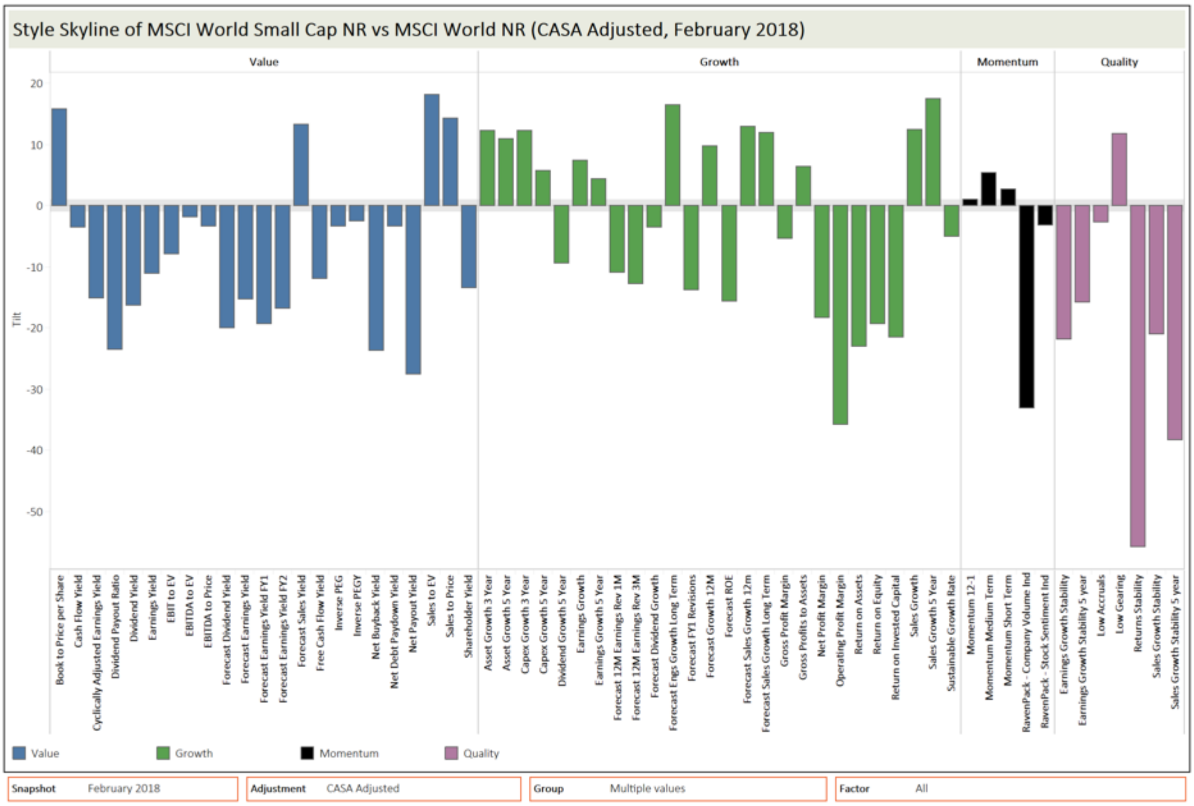
Exhibit 7: Higher fundamental factor dispersion offers opportunity for active management




Source: Foresight Analytics
Data source: Morningstar and Style Research

The differences in sectoral composition, operating strategies and business fundamentals can be measured using fundamental factors that are of interest to active managers. This can provide a further layer of evidence around the breadth of investment opportunities available to investors. The data presented in Exhibit 7 shows that the level of sales/ earnings growth and dispersion there-off is high for small caps across most sectors. A high dispersion as observed is not surprising given smaller companies'-focused business models are applied to niche market segments to generate superior earnings and sales opportunities. This is a structural advantage that small caps offer to active stock pickers and it can increase opportunity for outperformance within the portfolio. It should also be noted that more cyclical sectors such as resources, technology and energy sectors will have greater dispersion in fundamentals than defensive sectors.

**Exhibit 8: Global Small Caps is a good source of growth for investor portfolio**




Source: Foresight Analytics, Morningstar and Style Research

A range of fundamental factors from balance-sheet, profit and loss and cash-flow statements can be used to identify some of the structural differences between large and smaller company returns, by looking at the factor tilts across a range of fundamentals of the MSCI World Small Cap index relative to the MSCI World Large/Mid Cap index. The tilts for each factor is presented as a standardised score where scores between +/- 0.5 standard deviation signifies 'statistically observable' tilt while those outside +/- 1.0 standard deviation signifies 'statistically significant' tilt. The data presented shows that all the factors of Global Small Caps are highly statistically significant in comparison to Large Caps highlighting that the markets are vastly different and the drivers of returns for one cannot be replicated by the other.

The reader should note that the graph only shows the factor tilts as at end February 2018 and this is not a historical representation of the Index. The data-set presented here shows that Small Caps offer differentiated exposure to Large Caps across a range of Value, Growth, Momentum and Quality factors.

That said, growth factors are far more superior than the large caps, particularly across factors such as the Long-Term Forecast Earnings Growth, Sales Growth 5Y and Asset Growth 3Y. On the other hand, there is a significant tilt away from profitability and capital efficiency measures such as Net Profit Margin, Return on Equity and Return on Invested Capital (ROIC). Value factors point to smaller companies being more expensive than larger companies, with price to book, Sales to EV and Sales to Price being exceptions. Quality is generally lower than the large caps at the index level, hence further supporting our view that active management is the most appropriate strategy to invest in this asset class.

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