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The role of global small and mid caps in an Aussie portfolio

There's more to investing internationally than household names and, given the chance, small companies can spell big opportunity.

Facebook, Apple, Tesla and Alibaba, Amazon, Netflix and Alphabet. When you think of international equity stocks, it's generally these companies that first spring to mind.

That's because as Australians' appetite for investing in international equities has grown substantially in recent years, much of their money is being funnelled into the big household names they know and love – much in the same way local investors demonstrate bias toward the companies they've tangibly experienced.

However, where Australian investors are also comfortable owning the lesser known or smaller companies on the ASX, they are significantly more averse when it comes to the much larger world of global small and mid cap stocks, and it could be costing them.

In the United States, from 1927 through to 2015, the return premium earned by investing in small cap companies relative to large cap companies was 3.3%. A similar analysis of European markets stretching from 1982 to 2014 shows an average return premium of 2.7% for small companies.

Fairlight Asset Management portfolio manager Nicholas Cregan[01] describes this return premium as intuitive, as smaller companies are capable of faster growth and have a longer runway to compound growth.

"Less sell-side coverage means that smaller companies exhibit greater mispricing, offering further opportunities to outperform," Cregan explains.

The premium may also be compensative for lower liquidity and less diversified business models, he adds.

The probability of outperformance by smaller companies increases steadily with investment horizon. For long-term investors, the probability of small company outperformance has historically approached 100% [Figure 1].

Still, an idea that large companies are in some way safer is still common among many retail investors, and it's true – small companies are more volatile than their larger counterparts. But Cregan points out that a blend of global large and global small companies does not necessarily have to be more volatile than a pure large cap portfolio.

As the saying goes, diversification is the one free lunch in finance, and the imperfect correlation of small and large caps can serve investors well.

"Both asset classes are driven by slightly different factors. There is a tendency for the large cap market to be driven by global factors, whereas for small and mid cap businesses, they can be driven by more local or idiosyncratic factors," Cregan says.

Therefore, with a blended portfolio, investors can earn some of the historic return premium associated with smaller companies without necessarily taking on more risk; the addition of global small and mid caps moves the efficient frontier of the portfolio upward.

And if investors are concerned about risk, Cregan points them to the realised performance during the Global Financial Crisis where global small and mid caps demonstrated better risk control for unhedged Australian investors than both Aussie large and small cap equities.

"This relative defensiveness comes from the tendency of the Australian dollar to depreciate relative to other developed currencies in times of economic stress," he explains.

Still, risk reduction is key and, in times of volatility, so too is capital preservation. So how does Fairlight's Global Small and Mid Cap Fund protect investors?

Recognising that there has not been a single year in the past 20 years where both the small cap factor and quality factor have underperformed at the same time, the Fairlight team anchors the portfolio in a quality mindset, only seeking companies with a history of generating attractive returns through the cycle.

The fund also only invests in developed markets where there is transparency around accounting and governance, screening out those that are highly leveraged or that have deep cycles, single product or customer businesses. As a signatory to the UN Principles for Responsible Investment, Fairlight also screens out tobacco, armaments, gambling, uranium mining and old growth logging industries.

Once the analysis is complete, what is left is 200-300 companies which Fairlight whittles down to between 30 and 40 to ultimately invest in.

The bulk of the fund's revenue exposure is in North America, followed by Europe. In terms of sectors, the portfolio comprises largely of software and consulting stocks, followed by miscellaneous retail and business services.

Cregan says the Fed pivot in late 2018 and the COVID-19 crisis gave Fairlight the opportunity to stress test this portfolio design, saying its low risk, low volatility approach fared well at the height of the sell-off.

"The portfolio itself performed more like a large cap strategy in its defensive profile, so during those periods of stress it was down the line with the large cap market, but it's tended to outperform during good periods, so more akin to a small cap alpha generation profile," Cregan says.

Going forward, with so much uncertainty still on the cards, Cregan believes the relative valuation opportunity for small and mid caps when compared to large caps remains stark, the small and mid cap market is currently the cheapest it has been versus large caps at any point in the last 10 years.

The reason for this is that while smaller companies tend to outperform larger companies over the long-term, there are sometimes setbacks, Cregan says, including from 2008 to 2010 and the one currently being experienced. "Over the past 14 months small and mid caps have underperformed large caps by about 14%. Interestingly, if you look at the last hundred years in the worst 25 monthly sell-offs during that period, once we go into recovery phase small and mid outperform large caps over one, three, five and 10 year periods," he says.

"While historical returns are no guarantee of future earnings, this looks like a pretty good set up to us." FS

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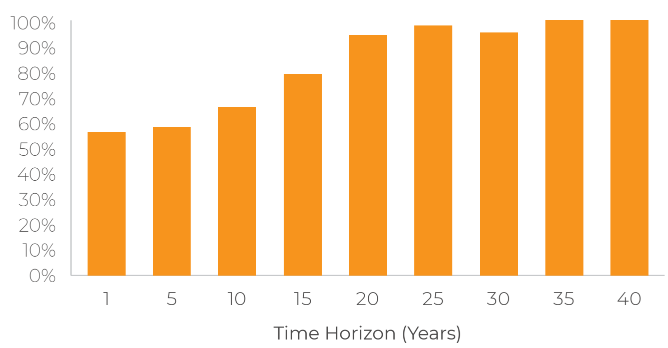
The relative valuation opportunity for small and mid caps when compared to large caps remains stark.

Watch the video on www.fsitv.com

Figure 1. Percent of Time US Small-Cap has Outperformed



Source: Percentage of time small has outperformed large in the U.S. 1926-1996 (Hanna & Chen, 1999)