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Time is everything

It's about time in the market, not timing the market.

There's an old, oft-repeated adage in investing circles about how time in the market always beats timing the market.

MFS Investment Management says the best example of this can be seen in the performance of small and mid-cap stocks over time. In the 20 years to December 2021, the MSCI ACWI World Small Mid Index saw an annualised return of 9.72%. Over the same period, the MSCI ACWI World Index saw an annualised return of 7.98% and the MSCI World Index returned 8.06%.

While many investors might flee to larger, better known companies in times of uncertainty, institutional portfolio manager Nick Paul believes this is the wrong call. Remember, the Global Financial Crisis and the COVID crash both happened in the last 20 years.

Past performance aside, Paul says there's several reasons small and mid-cap stocks represent a sound investment in tough macroeconomic environments.

Firstly, Paul says to consider these stocks' valuations relative to large caps, which are trading at multi-decade lows. This makes small and mid-caps an attractive prospect, he notes.

Secondly, Paul says consumer confidence is key – though not in the way one might think.

For context, the OECD's Consumer Confidence Index surveys consumers on the outlook for their household finances and ability to save, and their sentiment about the economic environment. An indicator above 100 means consumers are feeling positive, while an indicator below 100 is indicative of a more pessimistic outlook. As per the most recent data, global consumer sentiment currently sits at 96.9, while it's slightly higher – though still low – in Australia at 97.5.

"Historically, if you look at consumer sentiment as a contrarian indicator, it's a good buy indicator; when consumer sentiment is low, that's typically a good opportunity to invest in small and mid-cap stocks," he explains.

Finally, and more importantly, over the last two decades global small and mid-cap stocks have strongly outperformed large stocks, Paul says.

"You really need to be there through market cycles, so it's less about timing the market versus time in the market," he says.

However, as with any conversation about going global, discussing an allocation to global small and mids can be challenging when it comes to Australian clients as they've historically shown a bias to large cap stocks. Adding to the complexity, Paul says, is the fact that clients often don't even realise that they're lacking an allocation to smaller companies.

This is because the standard benchmarks have changed significantly over the past decade, he explains.

"If you went back a decade and looked at the MSCI All Country Index or the MSCI World Index and you looked at the allocation to small and mid-cap stocks, under $30 billion in market cap, you would see that over 40% of those benchmarks actually had an allocation to $30 billion and below," Paul says.

"Fast forward to today and that allocation has been cut in half."

Now, a handful of mega-cap US technology companies like Alphabet, Amazon, Apple, Meta and Tesla dominate those benchmarks.

"Whether you knew it or not, a decade ago you had a fair amount of exposure to small and mid-caps, which again has been a very strong performing asset class over time. But today, you just don't get that allocation in standard benchmarks," Paul says.

"I think having a dedicated allocation to the asset class today makes a lot of sense, even versus a decade ago."

These shifting benchmarks have created gaps in investors' portfolios because, while the indices still include some mid-caps, companies with market capitalisation of over US$300 billion have commandeered much of the historical weighting to smaller stocks; where they once represented less than 2% of the benchmarks, now they acount for over 20%.

Paul elaborates: "As standard benchmarks have changed over time and you get less exposure to those $30 billion and belows, that decrease in exposure has not just come from small caps – it's also come from mids. So, whether they know it or not, investors probably have a gap in their lineup, not just in allocations to small but also to mids."

Paul adds that an allocation also improves liquidity and increases the maturity and quality characteristics within the portfolio as the companies have typically been around a lot longer.

"By expanding your universe for those reasons, that's a positive, and it fills that gap for investors with one portfolio as opposed to having to invest in two separate portfolios," he says.

An allocation also provides obvious diversification benefits, with about 8000 names in the benchmark. However, the sheer size of the asset class means it's extremely inefficient – but that makes it an ideal space for active managers to play, Paul says.

"The number of names in the asset class is astounding," he asserts.

"From a sell side research standpoint, a lot of those names are thinly covered."

As such, MFS has a global research platform and analysts on the ground in almost all the markets its MFS Global New Discovery Trust invests in, meeting with its investee companies.

"We believe the lack of analyst coverage in the small and mid-cap universe brings great opportunities for active managers like MFS," Paul says.

The MFS Global New Discovery Trust is currently overweight Europe and the UK. It's not because of any top-down, macro calls though – it's about valuations.

"If you look back, historically over time as US stocks have become relatively expensive compared to their counterparts in Europe and the UK, we've become more underweight the US and more exposed to that area of the market as we're finding better opportunities," Paul says.

"From our standpoint, as we try to look across the globe for opportunities, those better opportunities include both underlying fundamentals as well as valuation."

Paul says the team isn't focused on making big, top-down calls on sectors or regions. Rather, they like to focus on bottom-up security selection to drive performance over time. That's what drives both the process, and the alpha MFS is looking to generate over time, he explains. **FS**

The quote

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