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Not too big, not too small

The Goldilocks of global equities

We all know the classic tale of Goldilocks and the Three Bears; a young girl named Goldilocks invites herself into the home of a family of bears and helps herself to their freshly served porridge. One bowl of porridge is much too hot, the next is much too cold, but the final bowl hits the spot.

From the popular fairytale emerged the Goldilocks principle – the concept in which things are "just right" or whereby a sweet spot is identified.

But is there a sweet spot for investing in global opportunities? Fidelity International portfolio manager Maroun Younes certainly believes so, and it's in the small and mid-cap space.

His primary reasoning for this is that while the last 10 years have been dominated by large caps, if you look back over a long period of time, the small and mid-cap space has outperformed both in terms of returns and risk-adjusted returns.

"When you think about Sharpe ratio, you've been able to achieve superior Sharpe ratios and therefore superior risk-adjusted returns by investing in the small and mid-cap space over the long-term.," Younes explains.

There's also more potential for generating alpha when investing in these companies, he says.

"As you go further down the market cap spectrum, there's generally less people looking at these stocks. So that increases the likelihood there could be a mispricing and therefore scope to generate some positive alpha," he says.

And, as we all know, diversification is everything in investing – while some investors may believe their global equities portfolios to be well diversified across companies and sectors, there's a good chance the investment mix isn't as broad as they think. This is because, in the last five to 10 years, there's been an increase in concentration among some of the larger companies in the world. For example, this is particularly evident when looking at the US technology and communications services sectors.

"One of the things clients say to me is, 'We get our exposure to this segment via a broad cap or large cap mandate'," Younes says.

However, Fidelity has reviewed some of the more popular products sold here and found there is very little correlation or overlap with the Fidelity Global Future Leaders Fund, of which Younes is co-portfolio manager. This demonstrates that a lot of these popular mandates aren't as active in small and mid-cap space, he says.

This is also partly because, given the concentration of the large cap segment, its dominance of indices, and therefore its influence on the return profile, a large cap manager must spend a lot of time, effort, and resources researching those names.

In contrast, Younes and his co-portfolio manager James Abela are solely focused on small and mid-caps, and the process they use is well tested; it's modelled on the process Abela has been employing for years in investing in local small and mid-caps.

Younes describes the process as balanced in terms of its exposure to various styles, with the fund invested according to four different style biases. At the core is a quality bucket, filled with high-quality, compounding stocks, which is surrounded by a value bucket of unloved or out of favour stocks; a transition bucket for companies experiencing corporate change; and a momentum bucket for the stock exhibiting positive earnings and share price momentum.

With this approach, Younes says the fund has delivered consistent outperformance against the index.

"For instance, over the last three years we've had markets going up and down, rates going down and then up, we've had risk on, risk off, and all throughout we've been able to deliver steady, reliable outperformance irrespective of what's going on in the overall macro," he says.

Driving this is Younes and Abela's ability to pick from a very broad, well researched universe. Younes says he and his team receive a constant stream of attractive investment opportunities because of the roughly 20,000 company meetings the global Fidelity team has each year.

As an example, the fund is invested in a company called Tractor Supply, a US company that is similar to Bunnings but with a much more niche clientele in farmers and ranchers. It's an 85-year-old company that's been listed on the New York Stock Exchange since 1959.

"Over the last 30 years, the company has grown its revenue each and every year, including during the Global Financial Crisis, by an average of about 14% per annum, and it's grown its earnings per share by close to 19% per annum over that same period," Younes explains.

"They generate plenty of free cash which they use to pay a dividend, which has grown at about 30% per annum since it was introduced in 2010. They buy back some of their stock, and they generate really attractive returns – in the realm of 40-50% - so it's very profitable.

"At the moment they have 2200 stores across the US and management has a target of 3000 stores. Every time they open a store there's a short payback period, usually about two to three years. We think the combination of new stores plus existing sales growth can drive earnings growth over the next decade or so, in the realm of high single digits."

It's a strong performer that certainly bodes well for an uncertain outlook. Younes says that while many believe the Federal Reserve is going to engineer a soft landing and avoid a US recession, Fidelity is slightly more cautious. He's not convinced the risks of a recession have completely disappeared, noting the sustained inversion of the yield curve.

"The last time we saw a big divergence between what the bond markets were sending out versus the signals in the equity markets was in 2007 and ultimately the bond market was proven to be correct. Now, I don't think a repeat of the GFC is on the cards, but I do think there are potentially some clouds on the horizon," he says.

What he and Abela have done is stock the fund with high-quality businesses that are recession resilient, either because they're mission critical or have some kind of pricing power, and have a strong balance sheet. This allows you to weather any period of soft economic activity, while also giving you an advantage in the event a vulnerable competitor doesn't fare so well in such an environment.

"Nobody wants a recession, but I do think if there were anything to eventuate in the next six to 12 months, the portfolio is in a good position to withstand the volatility," Younes says.

And given the performance of small and mid-caps in previous downturns, he's likely not wrong, adding: "If you think that the small and mid-cap space can continue to generate superior returns going forward, which we do, then it makes sense to have a manager that's dedicated to this segment of the market." **FS**

The quote

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Watch the video on www.fsitv.com

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