

The Opportunity For Global Small Caps

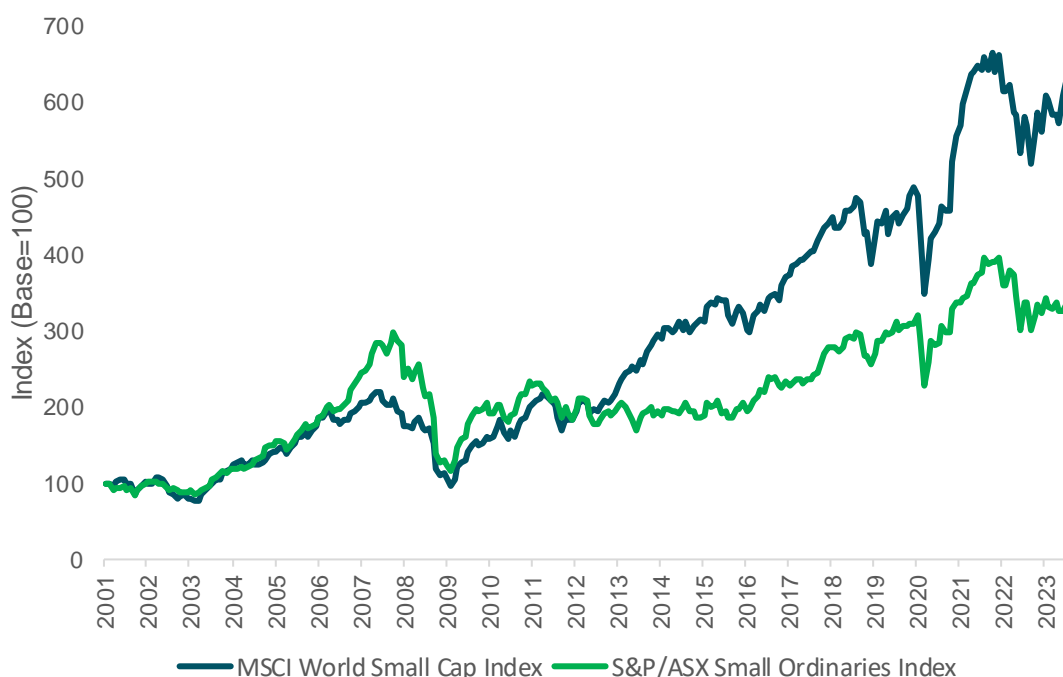
The opportunity for smaller companies is a hot topic amongst investors at the moment. Smaller companies are often in the early stage of their corporate life cycle and can offer potential for above market growth. Further, they are typically less researched and offer potential for a valuation uplift as investors come to appreciate their business models. In this monthly note we compare the opportunity for Australian smaller companies compared to Global smaller companies.



Bruce Apted
Head of Portfolio Management Australia, Systematic Equity - Active

Global Small Caps Outperform Australian Small Caps

Figure 1: Accumulated Performance of MSCI World Small Cap Index and the S&P/ASX Small Ordinaries Index



Source: FactSet, State Street Global Advisors from 31 January 2001 to 31 August 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

In the last 22+ years, Global smaller companies have outshone Australian smaller companies. Figure 2 provides some key statistics. The MSCI World Small Caps Index has generated 8.39% p.a. and has outperformed the Australian smaller companies index by +2.90% p.a. and outperformed the MSCI World Index by 2.16% p.a. The Global small cap index has been associated with the highest earnings growth of 5.9% and lower volatility. In contrast, Australian smaller companies have delivered the lowest annualised returns, negative earnings growth (-1.3%) and been the most volatile.

Figure 2: Global Small Caps Outperforms Australian Small Caps With Higher Growth And Lower Volatility

	Return p.a.	Volatility p.a.	Beta	Earnings Growth p.a.	Dividend Yield (Median)
MSCI World Small Cap Index	8.39%	17%	1.09	5.9%	2.2
MSCI World Index	6.22%	15%	1	5.2%	2.6
S&P/ASX 100 Index	8.21%	13%	1	4.1%	4.6
S&P/ASX Small Ordinaries Index	5.48%	18%	1.15	-1.3%	3.8

Source: FactSet, State Street Global Advisors from 31 January 2001 to 31 August 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Valuations Support Global Smaller Companies

Figure 3 provides a perspective on the relative valuation multiples for large and small companies, both overseas and in Australia. **The key observation is global smaller companies are cheapest in absolute terms, and relative to history.** Since 2001, global smaller companies are trading on a multiple of 15.3x well below historical averages at the 31st percentile. Compare this to the MSCI World Index trading at 16.8x or the 83rd percentile. **Australian smaller companies are in fact the most expensive sitting at the 90th percentile since 2001.**

Figure 3: Global Small Caps Offer The Greatest Valuation Opportunity, Australian Small Caps The Least

	Price Earnings (Current NTM)	Price Earnings Percentile since 2001
MSCI World Small Cap Index	15.3	31%
MSCI World Index	16.8	83%
S&P/ASX 100 Index	15.6	70%
S&P/ASX Small Ordinaries Index	18.4	90%

Source: FactSet, State Street Global Advisors from 31 January 2001 to 31 August 2023. Past performance is not a reliable indicator of future performance. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Active Management Can Benefit From Larger Breadth

The MSCI World Small Cap Index has 4,313 constituents, compared to the S&P/ASX Small Ordinaries Index with only 198 constituents as at 31 August 2023. **This is important as the opportunity for active portfolio management is greater in larger universes.** A fundamental principle in active management implies that an active managers ability to generate risk adjusted excess returns (information ratio), is directly related to their stock picking ability (no surprise there) but also directly proportional to the number of independent active positions (perhaps some surprise here). The number of independent active positions is often referred to as breadth, and can be approximated by the square root of the number of independent positions. The formula for information ratio is described below:

Information Ratio \propto Information Coefficient \times Breadth

Where:

- Information ratio is a measure of risk adjusted excess return
- Information coefficient = stock picking ability
- Breadth = the $\sqrt{\text{number of independent positions}}$ or (\sqrt{n})

Figure 4 highlights the potential for higher information ratio with larger breadth. For a constant level of stock picking ability, the risk adjusted excess return is expected to improve significantly with larger universes that offer larger breadth.

Figure 4: Theoretical Information Ratios At Various Levels Of Market Breadth

	Number of Independent Active Positions		
	300	1,500	3,000
Information Ratio	1.0	2.3	3.3

Source: State Street Global Advisors. A constant information coefficient of 6% is assumed. The information contained above is for illustrative purposes only.

The Bottom Line

Since 2001, global smaller companies have outperformed Australian smaller companies while also delivering higher growth with less volatility. Currently, global smaller companies also offer better absolute and relative value. A variety of approaches are available for investors to access opportunities in global smaller companies, including active management which should benefit from the larger breadth found in this universe.

Important Disclosures

Issued by State Street Global Advisors, Australia, Limited (AFSL Number 238276, ABN 42 003 914 225) ("SSGA Australia"). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia · Telephone: +612 9240-7600 · Web: ssga.com.

The views expressed in this material are the views of Bruce Apted, Head of Portfolio Management Australia, Systematic Equity - Active Team through the period ended 20 September 2023 and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Investing involves risk including the risk of loss of principal.

Equity securities may fluctuate in value and can decline significantly in response to the activities of individual companies and general market and economic conditions. Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment. Because of their narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

This document may contain certain statements deemed to be forward-looking statements. All statements, other than historical facts, contained within this document that address activities, events or developments that SSGA expects, believes or anticipates will or may occur in the future are forward-looking statements. These statements are based on certain assumptions and analyses made by SSGA in light of its experience and perception of historical trends, current conditions, expected future developments and other factors it believes are appropriate in the circumstances, many of which are detailed herein. Such statements are subject to a number of assumptions, risks, uncertainties, many of which are beyond SSGA's control. Please note that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.

This material is general information only and does not take into account your individual objectives, financial situation or needs and you should consider whether it is appropriate for you.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA Australia's express written consent.

© 2023 State Street Corporation. All Rights Reserved.

5966693.1.1.ANZ.RTL

Expiry Date: 30/09/2024