

# The Opportunity For Global Small Caps – Part II

## The Opportunity For Global Small Caps Part I – Global Smaller Companies Have Much To Offer Investors

At the index level, global small caps have much to offer investors looking for long term capital growth. From January 2001 to 31 August 2023, the global small caps have generated higher earnings growth, with outperformance of more than 2% p.a. over MSCI large caps and +2.9% p.a. over Australian small caps<sup>1</sup>. Currently many investors are reviewing the opportunity for global small caps given the current relative valuation.

### Small Caps Part II - Active Management Is More Suited To Global Small Caps

In this monthly note we shine a light on the greater ability to pick stocks in smaller companies compared to larger companies. We find the opportunity for outperformance from stocks selection is larger across smaller companies and more likely across global small caps. The economic rationale is simple - smaller companies are less researched resulting in a less efficient information flow to investors and the opportunity for an information advantage. News from small companies is expected to take longer to be fully reflected in share prices which creates a better opportunity for effective stock selection. For investors focusing on this less efficient area of the market, it can offer potential for greater stock picking ability.

### Measuring Stock Selection Ability – The Correlation Coefficient

A commonly accepted measure of a managers ability to pick relative stock performance is to look at the relationship between a manager's stock views and performance. Most managers will develop an investment process that ultimately ranks expected relative stock performance from most favorable to least favorable. To determine if this stock ranking has efficacy to predict stocks returns we can measure if there is any relationship between the stock rankings and subsequent stock returns. The correlation coefficient can be used to measure the average relationship between these ranks and stock returns. It measures how much of the variation in ranks can be explained by the variation in the stock returns to provide a measure on how much they move together. If the scores can explain the next period's return you would expect a positive correlation coefficient.

**Figure 1. Information coefficients – a measure of stock selection ability**

Correlation Coefficient	Interpretation for Stock Selection Skill
Positive	Good - Your stock selection process has some stock selection power
Zero	Neutral - Your stock selection process has no stock selection power
Negative	Bad - Your stock selection process provides negative stock selection insights

Source: State Street Global Advisors

The more powerful the relationship the higher the correlation coefficient and the greater your stock selection capability and expected ability to generate excess returns.



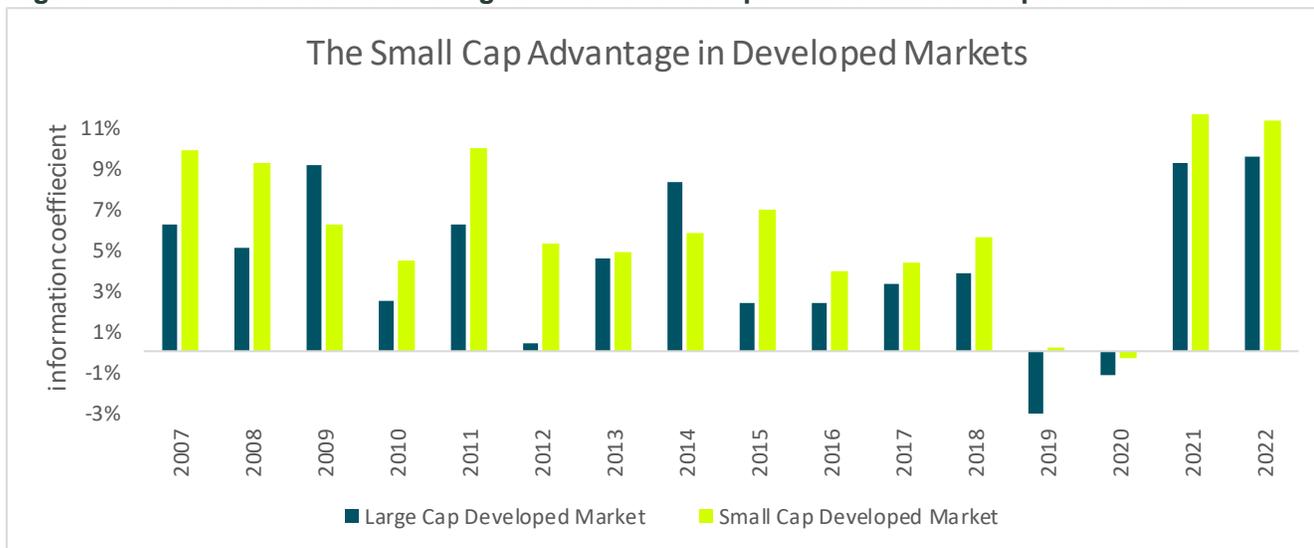
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<sup>1</sup> Source: FactSet, State Street Global Advisors from 31 January 2001 to 31 August 2023. Smaller companies are often in the early stage of their corporate life cycle and can offer potential for above market growth.

## Developed Markets – Better Stock Selection in Small Caps

In Figure 2 below we illustrate the average information coefficient (IC) for large and smaller caps across the developed markets. On average the small cap IC is 6.2% which is 45% higher than the larger cap IC. The result is consistent across most years occurring 88% of the time. In 2009 the year of the global financial crisis, liquidity likely played a big role in smaller companies security movements and may partly explain the lower IC. Interestingly during 2019 the IC for small caps remained positive when it was negative for larger caps. Looking to emerging markets we see even stronger results.

**Figure 2: Information coefficients higher in smaller companies across developed markets**

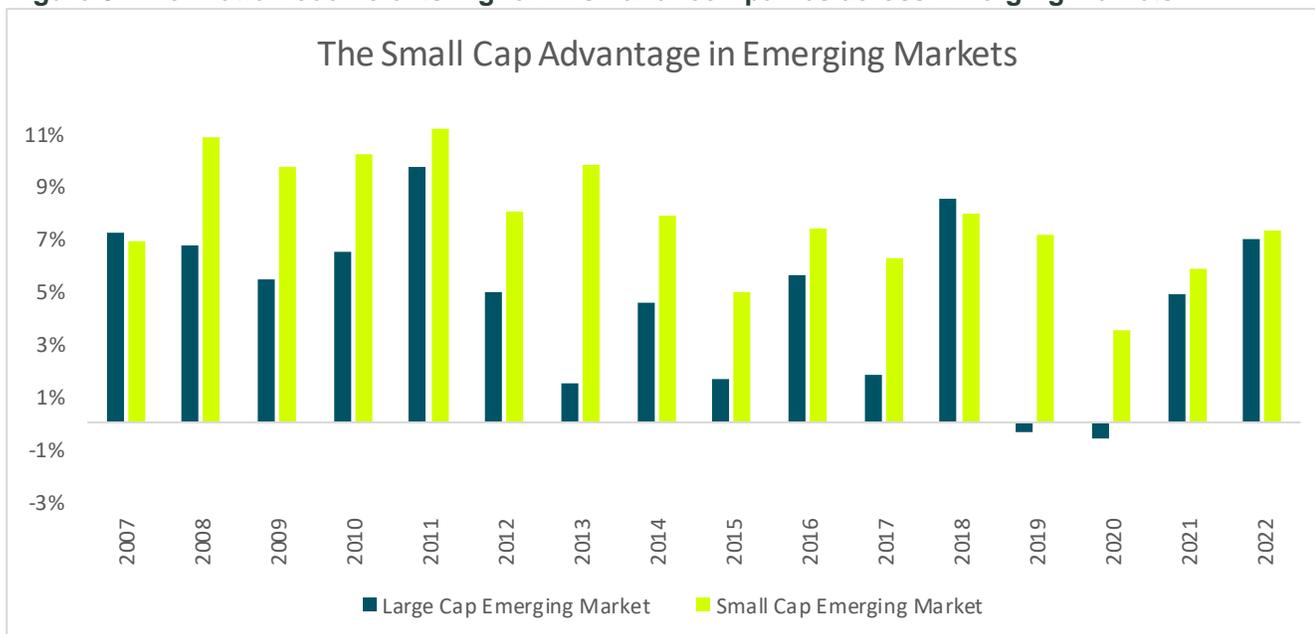


Source, State Street Global Advisors from 31 January 2007 to December 2022. Each month we calculate the information coefficient between the stock rankings and the next month's returns. The annual number represent the average over the year. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

## Emerging Markets – Better Stock Selection In Small Caps

In Figure 3 below we highlight the average information coefficient (IC) for large and small caps across emerging markets. On average the IC for EM small caps is 7.8% which is 66% higher than large caps across the emerging markets universe. Again, it is broadly consistent across years occurring in 88% of the 16 years. During the difficult years in 2019 and 2020 the small cap IC's were positive. There were no negative years for small cap IC's in Emerging markets.

**Figure 3: Information coefficients higher in smaller companies across Emerging Markets**



Source, State Street Global Advisors from 31 January 2007 to December 2022. Each month we calculate the information coefficient between the stock rankings and the next month's returns. The annual number represent the average over the year. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

## Breadth, Liquidity And Market Impact

Small cap stock selection as measured by the information coefficient is consistently higher across Developed and Emerging Markets. The effective number of securities and the opportunity for higher breadth is also greater in the smaller company universes.

**Figure 4: Effective number of names across Large and small cap universes**

Universe	Herfindal-Hirschman Index (HHI)	Effective number of securities ~ 1/HHI
Developed Market Large Cap	0.73%	136
Developed Market Small Cap	0.05%	2021
Emerging Market Large Cap	0.96%	104
Emerging Market Small Cap	0.09%	1142

Source: State Street Global Advisors as at 30 September 2023. Herfindal-Hirschman Index was designed to measure industry concentration and is applied to an equity index. Lower values are less concentrated. 1/HHI provides an approximation to the effective number of securities in an index. We have calculated the 1/HHI for Developed Market Large Cap, Developed Market Small Cap, Emerging Market Large Cap and Emerging Market Small Cap. The information contained above is for illustrative purposes only.

The opportunity for a large number of independent active positions further builds conviction in an active global small caps approach. The main caveat is market impact. Bid ask spreads are larger in smaller companies and trading volumes are lower increasing trading costs. Limiting capacity and managing market impact would need to be key to translating better stock selection capability into higher active returns for investors.

## **The Bottom Line**

Active management would appear to have an advantage in smaller company universes. We find the information coefficients are consistently higher for smaller companies across both developed and emerging markets and across most time periods. Active managers should be able to provide greater excess returns in smaller companies provided they limit capacity and manage market impact.

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