STATE STREET GLOBAL ADVISORS

State Street Australian Equity Fund
Smaller companies disappoint in a rising market

- Smaller companies exhibit greater volatility post the Global Financial Crisis (GFC)
- Smaller companies miss lofty growth expectations post GFC

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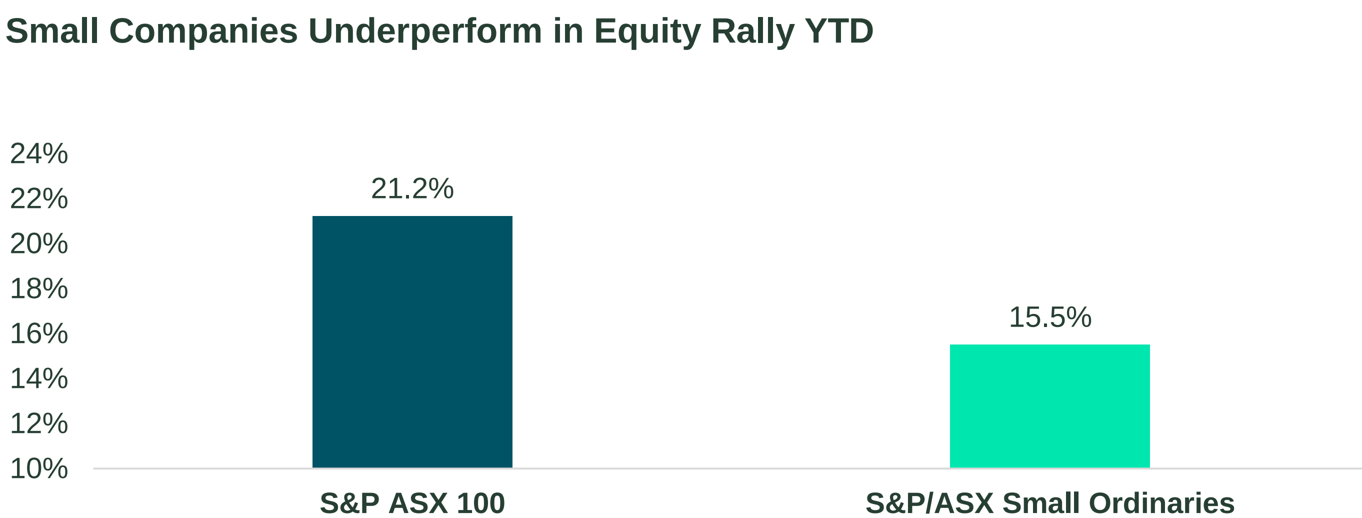
Smaller companies continue to underperform despite a bullish market environment

The Australian equity market has generated above average returns in the last 12 months with the S&P ASX 300 Index up +20.5%. The larger capitalised stocks represented by the S&P ASX 100 outperformed up +21.2% and the S&P/ASX Small Ordinaries Index[1] were only up +15.5%[2]. The underperformance of the smaller companies may seem somewhat surprising. Don't smaller companies usually outperform in up markets?

Figure 1. **The 12 month performance of the S&P ASX Small ordinaries Index and the S&P/ASX 100 Index**

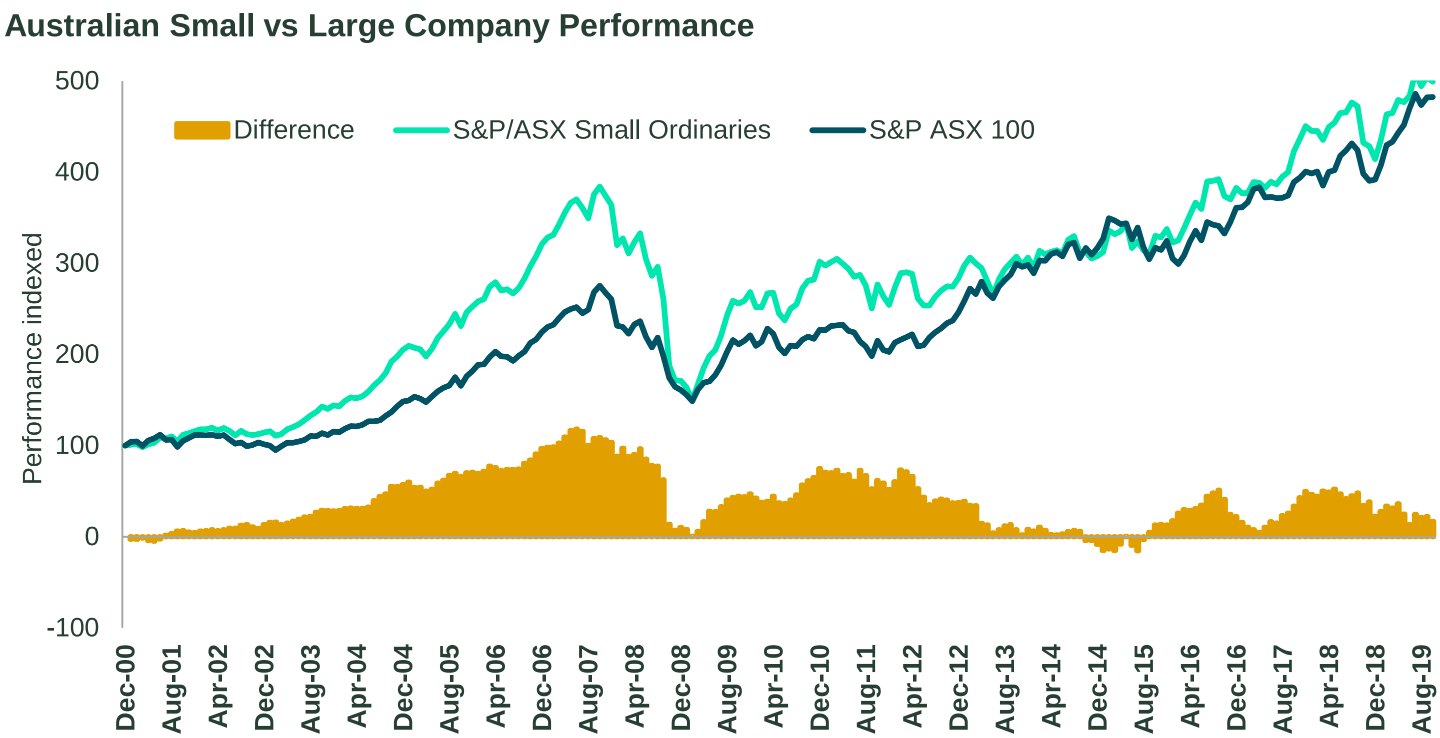


Source: Thomson Reuters, SSGA as at 31 October 2019.
Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

[1] Companies included in the S&P/ASX 300, but not in the S&P/ASX 100.
[2] Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

In this monthly note we take a closer look at the longer term performance and characteristics of the small and larger capitalised companies from within the S&P ASX 300 Index.

Figure 2. **The performance of the S&P ASX Small Ordinaries Index and the S&P/ASX 100 Index**



Source: Thomson Reuters, SSGA as at 30 October 2019.
Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Figure 3. **The performance characteristics of the S&P ASX Small Ordinaries Index and the S&P/ASX 100 Index**

	Pre GFC (Dec 2000 to Oct 2007)			GFC (Oct 2007 to Feb 2009)			Post GFC (Feb 2009 to Oct 2019)		
Statistic	**Small***	**Large****	**Difference**	**Small***	**Large****	**Difference**	**Small***	**Large****	**Difference**
Return p.a.	21.8%	16.0%	5.8%	-50.7%	-37.0%	-13.8%	12.0%	11.6%	0.4%
Volatility (STD pa)	10.0%	11.0%	-0.4%	28.0%	17.0%	10.8%	14.0%	12.0%	2.4%
Beta vs ASX 300	1.2	1.0	0.2	1.4	1.1	0.4	1.2	1.0	0.1
Avg PE	15.2	15.0	0.2	11.6	12.0	-0.4	14.8	14.3	0.5
Avg Dividend Yield	3.9	3.7	0.2	5.8	5.1	0.7	4.0	4.5	-0.5

Source: Thomson Reuters, SSGA from 30 December 2000 to 30 October 2019.
Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.
*Small = S&P ASX Small Ordinaries Index
** Large = S&P/ASX 100 Index

Outperformance prior to the Global Financial Crisis (GFC) (Dec 2000 to Oct 2007)

In the pre GFC period from 30 December 2000 to 30 October 2007 the small companies index significantly outperformed. The small companies index (S&P ASX Small Ordinaries Index) generated +21.8% p.a. (284% in total) compared to the large companies index (S&P/ASX 100 Index) of +16.0% p.a. or (175% total return). From 2003 Australian smaller companies benefitted from strong global growth and the resources boom. The Small companies were favoured by many investors for their promise of future growth and during this period they were able to deliver on strong earnings growth and outperformance. The smaller companies also exhibited lower volatility during this period.

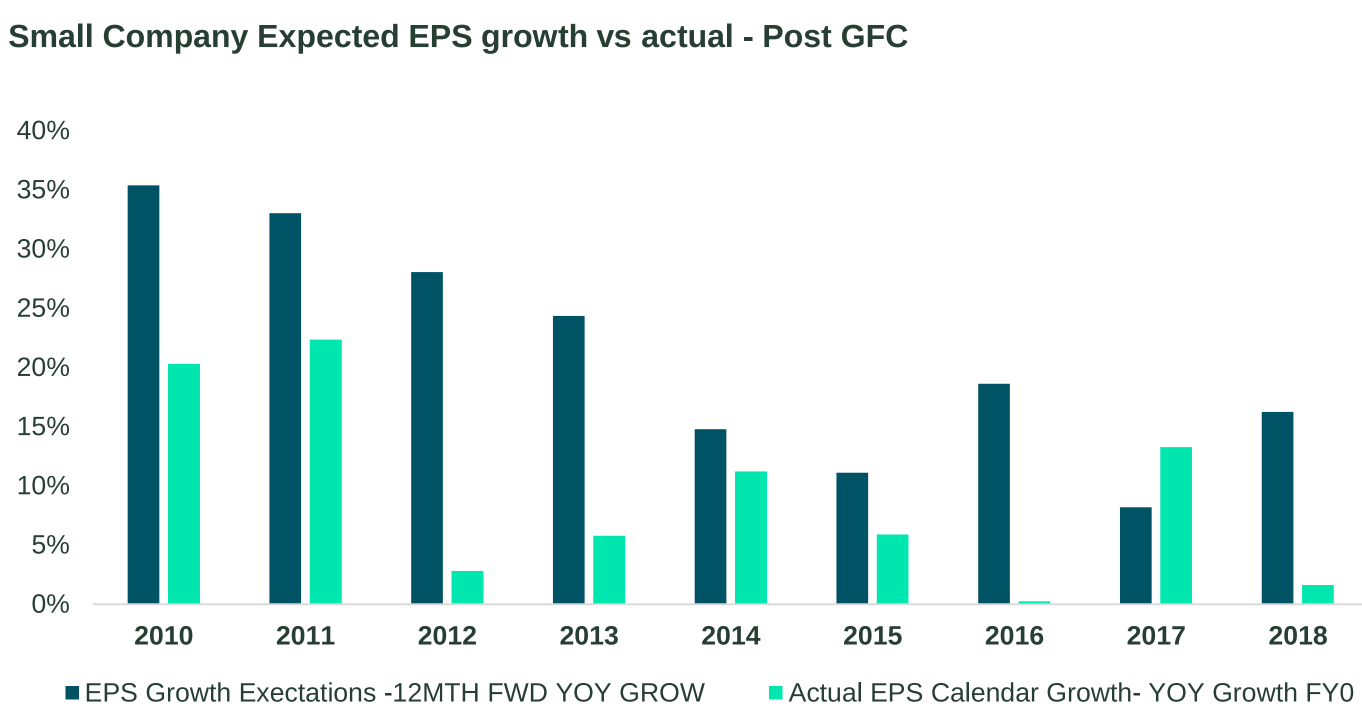
Underperformance during the Global Financial Crisis (GFC) (Oct 2007 to Feb 2009)

During the GFC the significant underperformance of the smaller companies index was somewhat expected. The higher beta worked in reverse and combined with a risk averse environment resulted in significant underperformance from smaller companies. The curse of a high growth company is pain when the growth expectations are revised lower. Figure 3 highlights the significant underperformance of the smaller companies index during the GFC and the high volatility.

Disappointing performance since the Global Financial Crisis (GFC) partly explained by disappointing earnings growth (Feb 2009 to Oct 2019)

What has been more surprising has been the more muted performance from the small companies since the GFC. Despite a period of above average equity market returns the smaller companies index (S&P ASX Small Ordinaries Index) has lagged expectations generating only 12.0% p.a. compared to 11.6% p.a. for the larger companies index (S&P/ASX 100 Index). Figure 4 below compares the expectations for earnings growth to the actual earnings growth. Post the GFC the expected growth averaged 21% but actual came in at only 9.3%[3]. Post the GFC the smaller companies have not lived up to the expectations of higher growth. Volatility has also been higher than the larger capitalised companies. In contrast the S&P ASX 100 index has not had the same expectations for lofty growth but equally has been more consistent in delivery on that growth. Interestingly in recent years the growth expectations have been reduced, lowering the bar for beating expectations.

Figure 4**. Small companies have disappointed more post GFC (Feb 2009 to Oct 2019)**



Source: Thomson Reuters, SSGA as at 30 October 2019.

[3] From 2001 to 2007 the average expected growth for the smaller companies was 21% while actual was 15.8%.

The State Street Australian Equity Fund is benchmark unaware with flexibility to invest across the full S&P ASX 300 universe. As investment managers that focus on quality, value, improving outlook and lower volatility we tend to invest in less volatile companies that have not been priced for excessive growth. That does not mean we will not invest in smaller companies if they provide the right mix of return for risk. Indeed as Figure 5 highlights we currently own many companies outside the top 20 but within the top 200.

Figure 5**. State Street Australian Equity Fund weights in different size segments compared to the S&P/ASX 300 Index**

	Fund (%)	Benchmark^ (%)	Difference (%)
Mega Cap (0-20)	26.39	56.96	-30.58
Large Cap (21-50)	36.41	20.16	16.24
Mid Cap (51-200)	35.42	20.28	15.14
Small (ex 200)	1.79	2.60	-0.81

Source: SSGA, Factset, as at 31/10/2019.
Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.
^ S&P/ASX 300 Index

Portfolio positioning and performance[4]

The Australian equity market fell in October, slightly lagging global equities. While a strong AUD has played a part in the underperformance, the greater drag has emanated from weakness in Banks and Mining through the course of October. This slippage has seen September's Value rally peter out during the month. A +7.6% gain in Healthcare saw the sector lead the performance table, and compounded the underperformance of Value. IT was the weakest sector falling 3.9%.

The State Street Australian Equity Fund outperformed its benchmark during October. Our structurally lower weight to financials was the key contributor; as the big 4 banks continue to face margin headwinds from lower cash rates, remediation charges and competitive pressures in the mortgage space. Good stock picking within Discretionary and Gold also added value. On the other hand, negative stock selection within Industrials and Health Care were key detractors from relative performance.

[4]Bloomberg Finance, L.P. SSGA. As at 31 October 2019. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Disclosure

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Volatility management techniques may result in periods of loss and underperformance, may limit the Fund's ability to participate in rising markets and may increase transaction costs.

Actively managed funds do not seek to replicate the performance of a specified index

The fund is actively managed and may underperform its benchmarks. An investment in the Fund is not appropriate for all investors and is not intended to be a complete investment program. Investing in the Fund involves risks, including the risk that investors may receive little or no return on the investment or that investors may lose part or even all of the investment.

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