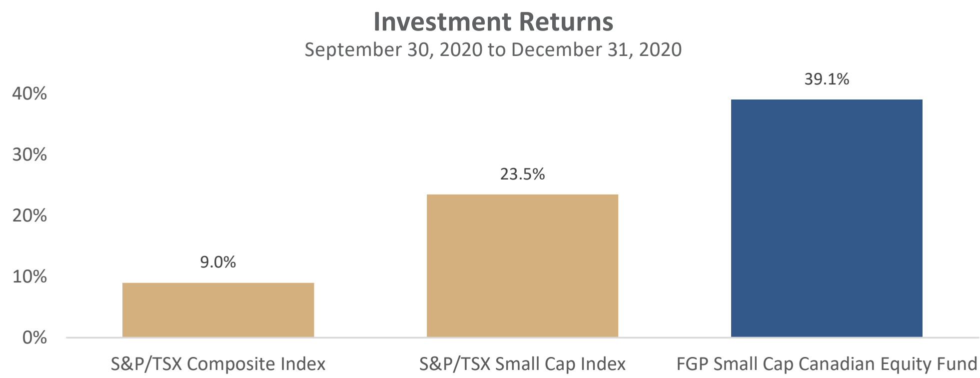
Why Invest in Canadian Small Cap Equities?

Small Caps Tend to Lead the Overall Equity Market

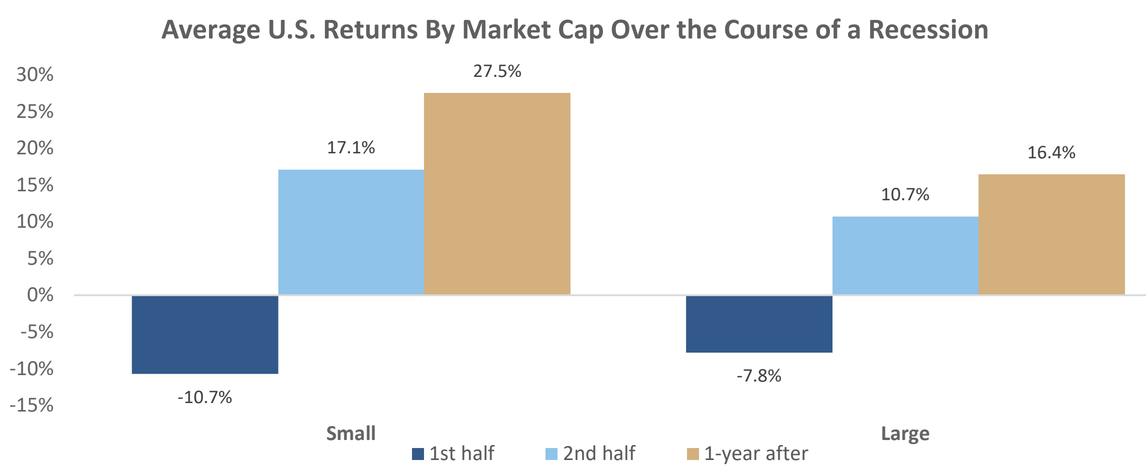
Small cap equities significantly outperformed their large cap peers in the fourth quarter of 2020. But what, if anything, can short term performance tell us about longer term trends? Though less widely followed than their large cap peers, small cap equities can provide valuable insights on the direction that the overall market is headed, as they have a history of leading the market, both on the way down and on the way up.



Source: S&P/TSX and FGP

In the initial phases of an economic crisis, the small cap segment of the equity market tends to underperform the large cap segment. We most recently saw evidence of this during the market downturn in the first quarter of 2020. On the positive side, small caps tend to outperform their large cap peers as the economy progresses through the second half of, and eventually recovers from, a recession. This has been true for nine out of the last ten recessions[1].

So where are small cap equities today? While considerable challenges remain on the path to recovery from the COVID-19 health and economic crisis, given the availability and effectiveness of the vaccines it appears increasingly likely to us that we are now solidly in the second half of the recession (light blue bar in graph below).



Source: Center for Research in Security Prices (CRSP), The University of Chicago Booth School of Business

[1] Steven G. DeSanctis, CFA, Jefferies, "JEF's SMID-Cap Strategy: 1Q20 Recap Slides" April 3, 2020

Valuations Matter - Market Distortions Create Opportunities

The Challenge and the Opportunity

While the current environment tends to be favourable for small cap equity returns, the strong returns for small cap equities this past quarter are a reflection of not only the improving economic outlook, but more significantly a recovery from excessively depressed valuations that pre-dated the COVID-19 crisis, a recovery we firmly believe is now only in its infancy.

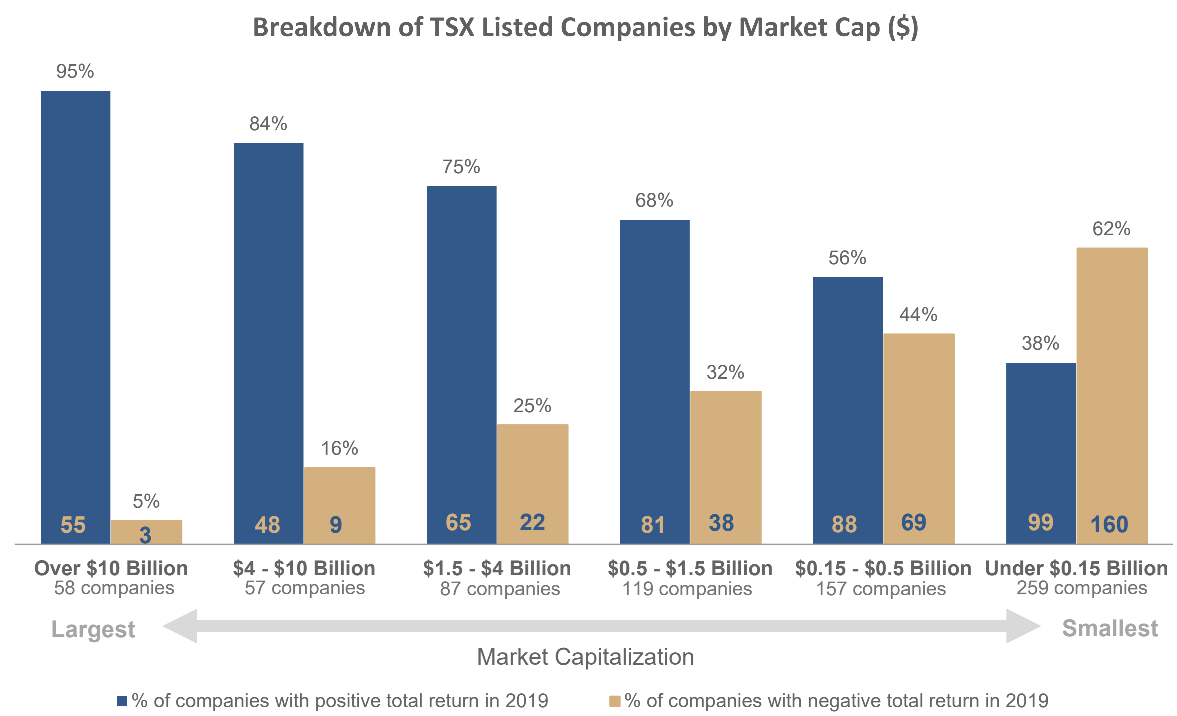
Prior to the market correction in the first quarter of 2020, small cap equity valuations were already at multi-decade lows relative to their large cap peers. This bifurcation in returns was created primarily by considerable net selling pressure on small cap companies, with Canadian equities, and companies with traditional value characteristics, being the hardest hit.

This phenomenon had many drivers. Among them:

- An acceleration in the shift away from actively managed portfolios (including mutual funds) that are often overweight smaller cap companies.
- Crowding into passive investment products that are typically biased towards the largest publicly listed companies (as is the case with the most popular ETFs).
- Ongoing waves of pension plan de-risking where the prime targets were asset classes with above-average risk and below-average liquidity: Canadian small caps by their very nature broadly lag on both metrics.
- Significantly compounding the effect, we found many small cap managers and investors proactively reduced their small cap exposure in order to get out of the way of a materially underperforming market segment.

The consequence of this vicious cycle was a significant and widening valuation gap between the largest and smallest companies to record levels in many instances by the close of 2019 - by far the worst period in this multi-year 'perfect storm'.

The effects wrought on the small cap segment of the market in 2019 were severe, and the damage done is perhaps best illustrated by relative returns by market cap:



Source: Bloomberg

- In what was generally considered to be a good year for Canadian equities (S&P/TSX Composite was up 22.9% in 2019), 55 of 58 TSX-listed companies with market caps over $10 billion had positive returns.
- But as we move down market cap, the number of companies with positive returns drops off dramatically: of the 157 TSX-listed companies with market caps between $150 million and $500 million, only 56% recorded a positive total return for the year.
- Among the 259 companies with market caps below $150 million, 62% were down in 2019 - a dramatically different outcome for smaller companies operating in the same country and market environment.

From a simple statistical perspective, the substantial underperformance of smaller companies relative to their larger cap peers in 2019 was an outlier, and we felt it highly unlikely that such a large group of small companies could suddenly become inherently inferior to a large group of the very largest companies from a fundamental standpoint. We concluded that the market distortion had reached unsustainable levels.

Our Response

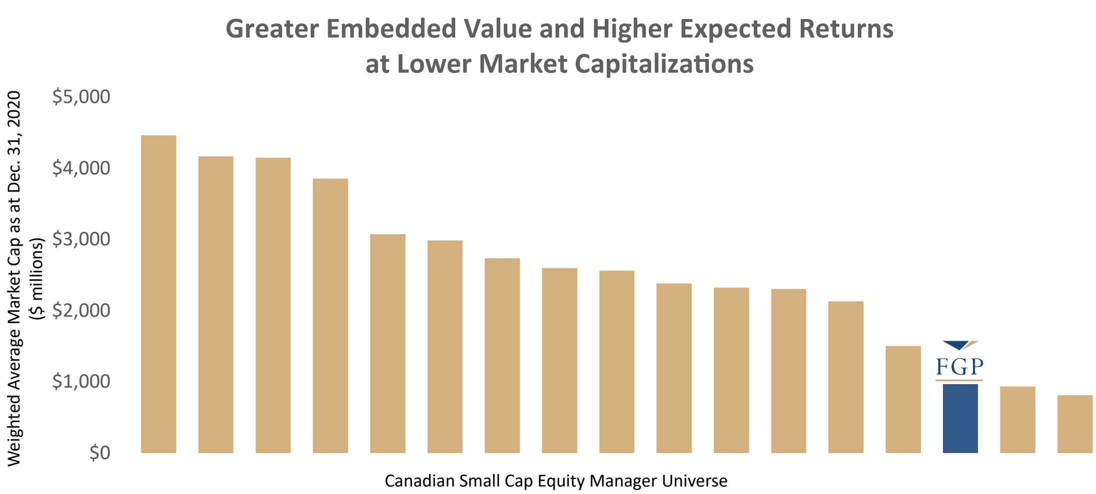
As value investors, valuation is the beating heart of our philosophy and process. Disciplined active managers do not shy away from widening valuation discounts.

Our response was to welcome the above challenges as a rare opportunity to deepen the value attributes of the portfolio by identifying those businesses where our analysis indicated the embedded value and expected return were the highest.

We concluded that the best way to approach the dislocation we were seeing was to increase the pace at which we reinvested our clients' capital in the relatively smaller cap companies where we observed the most severe pricing distortions, and where we determined the embedded value and return potential to be highest within our investable universe. This involved both adding new companies to the portfolio and increasing our portfolio weights in existing smaller portfolio companies that were caught up in the multiple compression phenomenon. These are companies we already knew well, and the investment team's depth of knowledge and experience from years of analysis were, as always, instrumental in our process. Throughout, we remained focused on bottom-up fundamental analysis, relying on the full complement of tools in our value investor toolbox.

While our strategy remains sector agnostic, a number of patterns emerged that led us to gravitate towards certain areas of the market that were significantly more out of favour than others - none more so than energy services - and so we increased our overweight exposure relative to the benchmark weight.

One category of the small cap universe that provided compelling valuations was companies that had been removed from broad-based indices, including the S&P/TSX Composite and MSCI Small Cap indices, resulting in selling pressure from passive ETFs that were forced to sell given the mechanical nature of these investment products.



Source: eVestment

Small Cap Equities Are an Essential Part of a Well-Diversified Investment Strategy

The small cap equity market provides investors with exposure to companies that offer faster growth coming out of a recession, good risk-adjusted returns and relatively low correlation to the large cap universe. Yet many investors are underinvested in this segment of the equity market. In today's market, investors are more inclined, perhaps than ever before, to favour the very largest and best-known companies, which are often perceived as being lower risk. However, the greater inefficiencies in the smaller cap market provide ample grounds for successful active managers to generate strong risk-adjusted returns.

While the small cap Canadian equity market returned 23.5% in the fourth quarter of 2020 (and 12.9% for the full year), we believe we are still in the early stages of a rotation into the value segment of the small cap market and that active managers positioned further downmarket cap will be best positioned for higher expected returns over the long-term.

Why an Active Management Approach?

The small cap equity market presents significant opportunities for active managers to outperform. Relative to the large cap universe, there are more companies to choose from, considerably less research coverage, and, increasingly, lower institutional ownership. These factors breed inefficiencies that create more opportunities for mispricing. While inefficient markets present opportunities to generate outsized returns, it is critical to understand that the internal risk/reward profiles of individual small cap companies can vary considerably, even between companies in the same industry. Therefore, we believe small cap investing favours a disciplined active management approach that is firmly rooted in fundamental analysis.

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