The Case for Investing in Global Smaller Companies

With global equity markets trading at historically high valuations, we believe smaller companies have an increasingly important role to play in the search for value-added returns. There are several compelling reasons investors should consider an allocation to smaller companies. These companies are less widely followed by sell-side research analysts and have a less concentrated investment universe, thus providing active managers with a greater opportunity to generate value-added returns for clients. Furthermore, global smaller companies have historically offered superior risk-adjusted return characteristics relative to broader global equity universes.

Global Equity Index Peformance
Annualized to June 30, 2021

Global Equity Index	1 Year	3 Years	5 Years	7 Years	10 Years	20 Years
MSCI ACWI Small Cap	54.07	12.20	14.13	9.37	9.90	8.74
MSCI ACWI SMID Cap	48.50	12.28	13.65	9.09	9.55	8.03
MSCI ACWI	39.26	14.57	14.61	9.75	9.90	5.78
MSCI EM	40.90	11.27	13.03	6.35	4.28	8.02
MSCI World	39.04	14.99	14.83	10.16	10.65	5.76

Source: eVestment. Quarterly data in US$.

Superior risk-adjusted returns

Smaller companies have historically enjoyed superior risk-adjusted returns relative to broader global equity benchmarks. The table below shows the performance and risk characteristics of global equity markets over the past 20 years. During that time, the MSCI ACWI Small Cap Index and the MSCI ACWI SMID Cap Index[1] outperformed broader global equity benchmarks like the MSCI ACWI Index, the MSCI World Index and the MSCI EM Index[2]. It should be noted that the higher absolute returns are often accompanied by the risk of a higher level of volatility, as measured by standard deviation. However, on a risk-adjusted basis, the small and SMID cap benchmarks delivered the best (highest) reward to risk ratio compared with broader global equity benchmarks over the past 20 years. As the table below shows, since 2000 the small cap and SMID cap indexes also had the best batting averages, having outperformed the MSCI ACWI Index 62% of the time.

Global Equity Return and Risk Characteristics
July 2000 to June 2021

Global Equity Index	Returns	Std Deviation	Reward to Risk Ratio	Tracking Error	Information Ratio	Batting Average
MSCI ACWI Small Cap	8.74	21.39	0.41	5.91	0.50	0.62
MSCI ACWI SMID Cap	8.03	20.53	0.39	4.60	0.49	0.62
MSCI ACWI	5.78	17.95	0.32	---	---	---
MSCI EM	8.02	23.96	0.33	11.08	0.20	0.55
MSCI World	5.76	17.62	0.33	1.10	-0.01	0.45

Source: eVestment. Quarterly data in US$. Performance metrics are calculated against the MSCI ACWI.

[1] ACWI = All Country World Index; SMID = small- and mid-cap companies
[2] EM = emerging markets

Good relative performance in both up and down markets

It should not come as a surprise that smaller companies have historically performed better than large-cap companies in strong up markets. This phenomenon occurs because smaller companies tend to grow at a faster rate than their more mature large-cap peers since they are often in a sweet spot in their business life cycle: they have proven business models, improving balance sheets, strong cash flow generation, and a long runway of future growth – factors which can enable them to deliver above-average revenue and earnings growth over time. Strong upside market capture often comes at the expense of underperformance in down markets. The table below shows the performance of global equity markets in both up and down markets over the past 20 years. While the small cap and SMID cap benchmarks modestly lagged the MSCI ACWI return in down markets, they significantly outperformed in up markets. The incremental upside market return for smaller companies exceeds the incremental downside market return.

Global Equity Returns in Up and Down Markets
July 2000 to June 2021

Global Equity Index	Upside Market Capture	Upside Market Return	Downside Market Capture	Downside Market Return
MSCI ACWI Small Cap	126.37	34.96	107.78	-32.84
MSCI ACWI SMID Cap	119.99	33.19	105.98	-32.29
MSCI ACWI	100.00	27.66	100.00	-30.47
MSCI EM	125.69	34.77	111.82	-34.07
MSCI World	98.58	27.27	98.53	-30.02

Source: eVestment. Quarterly data in US$. Performance metrics are calculated against the MSCI ACWI.

Inefficiencies create opportunity for active managers

Smaller companies tend to be less widely followed by sell-side research analysts thus creating more opportunities for active managers to generate value-added returns. On average, for every three sell-side research analysts following a developed market large-cap company, there is only one sell-side research analyst following a developed market small-cap company. With fewer research analysts following smaller companies, the market tends to be less efficient, increasing the likelihood of market mispricing. Astute active managers can take advantage of pricing discrepancies to purchase great companies at a discount to their intrinsic value and sell companies that are trading at a premium to their intrinsic value.

Analyst Coverage By Market Capitalization
Developed Market Listed Companies

Market Cap Size	Mkt Cap (billions, US$)	# of stocks	Avg # of analysts
Large	>$48.4	323	25
Medium	$16.3-48.4	628	19
Small	1.0-16.3	4,683	10
Micro	0.1-1.0	8,361	2

Source: Bloomberg (via EQS stock screener).

Furthermore, returns for smaller cap indices tend to be less concentrated than returns for broader equity indices, which are increasingly dominated by a few large companies. The MSCI World Index gained 39% in U.S. dollars in the one-year period ended June 30, 2021, yet the top five companies by market value – Apple, Microsoft, Amazon, Alphabet (Google's parent) and Facebook, representing approximately 14% of the index – were up by 52% on average. Active large-cap managers can materially underperform their benchmarks by not owning or being underweight the largest companies in their universe. It is a similar situation in emerging markets, where returns for the MSCI EM Index are dominated by the top four companies by market value: Samsung, Tencent, Alibaba and Taiwan Semiconductor, which we collectively refer to as STAT.

By contrast, smaller cap universes are much more diversified. The top 10 companies by market value in the MSCI ACWI Small Cap Index and the MSCI ACWI SMID Cap Index represent just 1.4% and 1.8% of their respective indexes overall. Building an active position in a company that has a 5% weight in an index could lead to a lack of portfolio diversification. A more fragmented universe gives active managers more flexibility to build meaningful positions in companies they believe offer the highest potential return, while assuming relatively less concentration risk.

Conclusion

There are several compelling reasons why we find global smaller companies attractive and believe investors should consider an allocation to this asset class. Compared to larger companies, smaller companies can potentially provide:

- Greater reward per unit of risk
- Outperformance in strong up markets
- Less volatility in down markets than emerging markets
- Strong diversification benefits relative to a large-cap equity portfolio
- Greater opportunities for active managers to take advantage of market inefficiencies

These factors create an environment that is ripe with opportunity for active managers to generate value-added returns for clients.

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