

Global Small Caps: why you should hire specialists

Investing in active Global Small-Cap funds is attractive. From an asset allocation point of view, historical data suggest there is a premium to be made by investing in Small-Caps.

In the USA, **US Small-Caps averaged an annualized premium of more than 1% since the 1940's**. Global Small-Cap equity investing is a newer asset class, and the results are promising. The MSCI Global Small Cap Index generated an annualized return of 8.0% since the millennium compared to 4.7% for the large-cap heavy MSCI World Index*.

The most cited reason for the existence of the small-cap premium is **lower liquidity** of the shares, the so-called liquidity premium.

Other research suggests that **outperformance** is also driven by the fact that smaller companies are:

- Attractive take-over candidates.
- Active as market leaders in niches which grow fast.
- Have a strong alignment of interest, evidenced by operational focus and management/founders having substantial skin in the game (ownership).

Apart from performance there are also several qualitative reasons why investors would do well to choose for active management in Global Small-Caps.



INVESTMENT UNIVERSE

To start with the first one, the MSCI World Small-Cap Index consists of around 4200 stocks. A large investment universe has a few advantages for managers as there are more companies to pick from and it is easier to run a high active share.



RESEARCH

Most smaller companies are being followed by only a handful of sell-side analysts. Hundreds of stocks have no coverage at all. This creates inefficiencies which can be exploited by portfolio managers and analysts who are willing to go the extra mile to analyze companies in-depth. It makes for instance less sense to spend weeks analyzing Apple as analyst number 60 as that view would probably not materially differ from the consensus view.



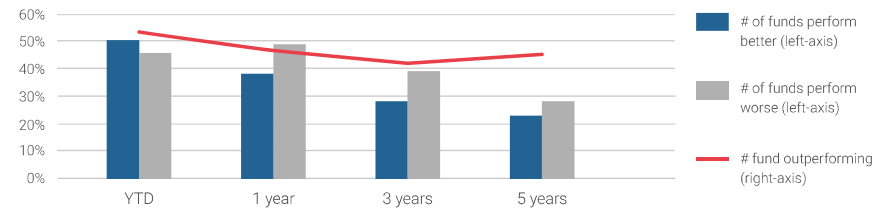
DISPERSION

Differences in quality, balance sheets and earnings tend to lead to larger valuation differences within Small-Caps. This dispersion leads to overreaction either way and creates opportunities for active managers.



Pieter Laan
Head of external manager selection at IBS Capital Allies

So, we have an asset class that could earn a premium, but why should we exploit this via active management? The answer is two-fold. First, the percentage of active managers that outperform the index is high (see graph). Morningstar analysis shows that long-term, around 40-45% of the Global active Small-Cap managers outperform their index. In 2020 that number is above 50%, which shows that many managers are navigating their portfolios well through the COVID-19 storm. Second, the availability of passive solutions is limited. Most Small-Cap indices consist of several thousand stocks (the tail being very illiquid) which makes it a costly exercise to replicate.



Source: Morningstar, YTD* as of end of June

Given the attractive characteristics of Global Small-Cap Funds, why are they not more popular than they are now? That probably has to do with the fact that there is no such thing as a free lunch, also not in Small-Caps. **The main caveats of Small-Caps are volatility and illiquidity.** During strong downturns, Small-Caps suffer more, and liquidity dampens. This is YTD also the case as Small-Caps lag their larger counterparts. As long-term investors we acknowledge these negative characteristics yet remain invested to realize the long-term premium the asset class possesses.

At IBS Capital Allies, **we conducted a Global Small-Cap search about 18 months ago for our fiduciary (advisory) clients.** During the search we met 22 fund managers. What we noticed is that most of the fund managers are fundamental bottom-up stock pickers with a focus on quality and growth characteristics. The number of quant- and value managers in the universe is low. We have selected the following three funds for our clients: **Silvercross Global Small-Cap Fund** (managed by a team that works in another IBS subsidiary), **Columbia Threadneedle Global Smaller Companies Fund** and **Baillie Gifford Worldwide Discovery Fund.**

Each of these funds has a very strong long-term track record. All three have a quality growth bias and at first sight may look similar. But when analyzing the underlying philosophy and portfolios, we notice clear differences between the strategies which regards to concentration, turnover and sector allocation. The overlap in holdings between the three funds is limited.

- **SilverCross** runs the most concentrated portfolio with around **30 stocks**. The PMs running the strategy are seasoned investors. They are not trying to time the market. Their goal is to build a buy-and-hold portfolio of high-quality companies that generate attractive long-term returns. The team includes a native Japanese analyst, which is differentiating factor as a lot of Japanese companies still do not report their numbers in English.

- **Baillie Gifford** (50-70 stocks) has a focus on initially immature, entrepreneurial companies that can disrupt/transform the niche they are active in (the Large-Caps of tomorrow). Internally the team speaks about 'transformational growth investing'. 1/3 of the portfolio consists of companies that are pre-profitable/close to break-even (50% is Health-care related, FDA approval is not a requirement). This is a clear differentiating factor compared to most peers that shy away from these types of companies to avoid blow-ups. The turnover in the strategy (approx. 10%) is extremely low.
- **Columbia Threadneedle** tends to have the most diversified portfolio of around **70 to 80 stocks**. Their investment process is purely bottom-up. Dynamic sector and regional weightings reflect bottom-up opportunities, rather than a top down view. The team has an emphasis on understanding the industry structure and the company's business model to assess the existence of a strong moat. The size of the investment team is a strong differentiator. Most Small-Cap funds are managed by three to five PMs/analysts. The investment team of Columbia Threadneedle is composed of 10 investment professionals split over four regional teams (Europe, US, UK & Japan).

We currently monitor around 80 Global Small-Cap funds with the help of our external data provider (Morningstar). All selected funds currently score first quartile on a 1-, 3- and 5-year basis. In line with our expectations we saw that the asset class as a group is struggling in terms of absolute performance YTD due to the COVID-19 crisis. It is comforting to notice that all three managers we selected are outperforming the index by a wide margin (>10%). This is also the proof in the pudding that hiring specialists within Global Small-Caps makes perfect sense.

*Data from 01/01/2000 till 30/06/2020, measured in USD.