

understanding investing in small caps

INTRODUCTION

The small cap sector is usually seen as a source of higher return compared to the large caps. The small cap “sector” is best defined as the 200 stocks between the S&P/ASX100 and the S&P/ASX300. Beyond this, there is a long tail of micro cap stocks with extremely low turnover. We discuss some of the factors driving the small cap sector in general and how small cap funds might be used in a portfolio.

WHY USE A SMALL CAPS FUND?

Small caps should be used as an enhancement to a core equities portfolio. There are a number of reasons for this:

- Small caps may be under-represented in most large cap Australian share funds. This is because fund managers manage their portfolios to align with the S&P/ASX 200 Index. Most of their portfolios are thus invested in the top 50 stocks. The Dimensional Strategic Trust is an exception to this, in that it has an in-built tilt towards small caps, with a lower than index weight in the larger cap stocks.
- Small caps can provide greater exposure to certain sectors, e.g. resources, as well as to companies that are in a growth or start-up phase, or in new industries.
- Small caps can offer periodic exceptional returns. The emphasis is on the word periodic. Investors should note that over the longer term, annualised performance of the small cap index has lagged the Australian large caps by around 20%. It needs a lot of skilled active management to make that up.

Small caps are not a simple high growth substitute for a “normal” share fund, but should be viewed as a distinct investment that has to be justified on normal risk / return and portfolio diversification measures.

THE SMALL CAP SECTOR IS LESS EFFICIENT

The market is inefficient in pricing small companies and hence they have more volatile share prices. This is particularly pronounced in companies where market capitalisation is less than \$500 million and even more so in the microcaps. This size effect is due to the following correlated factors:

- Lack of or poor dissemination of information. There is little research coverage of smaller companies by brokers and no research at all on a large part of the small cap market.

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- The quality of broker research is lower. Small cap analysts tend to be young and inexperienced!
- The periodic flight to quality to “safe” large caps leaves some good small companies unrecognised.
- Low liquidity. Even if information is there, most large fund managers can’t fully act on it because of their portfolio size. Anecdotal evidence from a number of fund managers

indicates that there are limits on how much money can be managed in a small cap fund, if their ability to generate good returns is not to be degraded. Evidence shows that the larger small cap funds with over \$1 billion in FUM have struggled to outperform their smaller peers. This encourages small cap managers to close their funds to new money when they reach around \$800m under management.

- The lack of track record and transparency in start-up companies or new technologies.
- Because of their size, single product focus and lack of management depth, small companies tend to have more unstable earnings and therefore greater vulnerability to business failure.



This article by Patrick Bennett (above), Head of Research.

SMALL CAPS ARE MORE STRUCTURALLY DIVERSIFIED

In the large cap sector, the top 20 stocks account for around 70% of the large cap market capitalization. In contrast, the top 20 small cap stocks account for only 24% of the small cap index.

These differences mean small cap fund managers can pay less attention to company index weights when constructing small cap portfolios. For example, if a manager chooses not to buy the largest company in the Small Ords, the portfolio will be only 3.0% underweight that stock. If a large cap

manager excludes the largest stock in the ASX100, this will be a massive bet that will impact on the risk profile of the portfolio.

PERFORMANCE CHARACTERISTICS

One of the key things to note from Graph 1 is the difference in volatility compared to the large caps. Small caps tend to be consistently more volatile, at times considerably so.

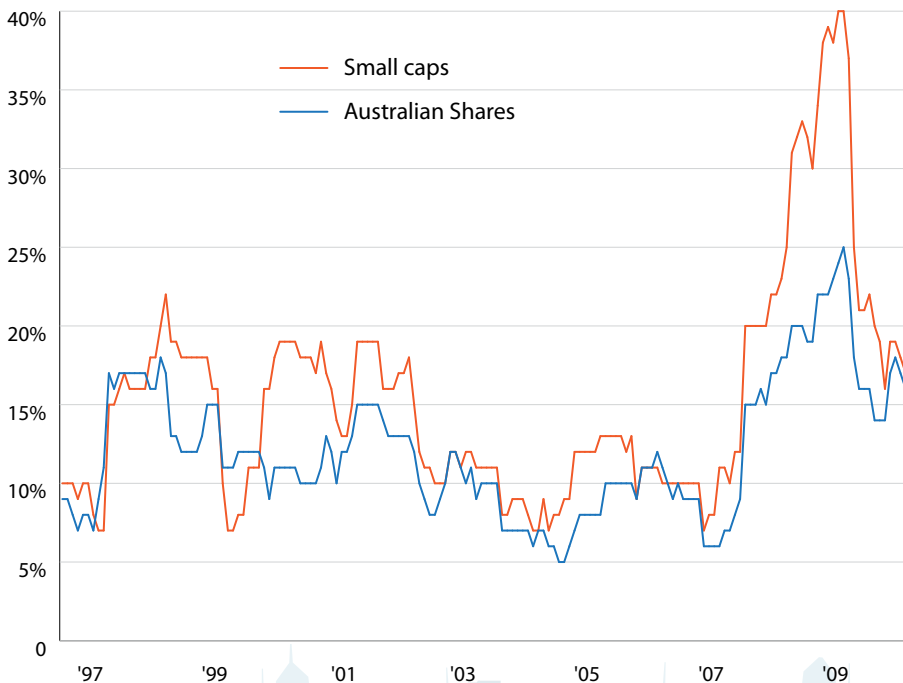
Small caps are highly correlated to large caps, at around 90%. Small caps therefore do not provide much diversification benefit in an equity portfolio.

RISK MANAGEMENT CONSIDERATIONS

We believe it is better to think of small cap risk in terms of its contribution to overall portfolio volatility and capital loss. Because small caps are typically included as an enhancement, rather than as the core equity exposure, they are there to provide an absolute rather than a relative return to the portfolio and therefore the risk and return should be assessed in absolute terms.

Before using a small cap fund, it is important to properly assess the impact the fund will have on the overall risk / return profile of your portfolio. A small cap fund may add significantly to the overall volatility of the portfolio but not necessarily deliver the expected return benefits in the short term.

Graph 1: Volatility (% standard deviation)



CONCLUSIONS

Small caps have a high correlation with large caps, so should not be considered to be a diversifier within an Australian shares portfolio.

Small caps will contribute a lot of volatility to a portfolio. They are typically 20-30% more volatile than large caps.

Because investors only allocate a nominal amount of their portfolio into specialised asset classes, we would suggest one small cap manager would be sufficient. It is therefore better to select a style neutral small cap manager to avoid the periodic underperformance that comes with strong style biases. However, investors should be prepared to switch more often if FUM capacity or staff quality begins to affect the manager's performance. The opportunity cost of remaining invested in a mediocre small cap manager can be high.



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