NICOLA WEALTH

# Why Invest in Global Small-Cap Equities?

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# Introduction

The asset class of global small-cap public equities is often overlooked. Over several years, both institutional and individual investors have allocated only minimal amounts towards global small-cap public equities in their long-term investment portfolios. This oversight may translate into a missed opportunity to maximize potential returns. Empirical data suggests that investors can increase their long-term portfolio growth and yield higher returns by simply increasing their allocation to global small-cap equities.

# Small-Cap Effect and Academic Studies

Academics have extensively researched and documented the anticipated return premium linked to global small-cap equities over the years. Some of these scholarly studies date back 40 years, with Rolf Banz's "The Relationship Between Return and Market Value of Common Stocks" published in 1981 in the Journal of Financial Economics being among the earliest. Another well-known paper is Eugene Fama and Kenneth French's "The Cross-Section of Expected Stock Returns" published in The Journal of Finance in 1992. While numerous academic studies have examined this subject, they ultimately arrive at the same conclusion: global small-cap equities generate higher expected returns than their large-cap counterparts, known as the small-cap effect.

# Higher Returns

Global small-cap equities have produced significantly superior returns compared to large-cap equities over the long term. For instance, over the past 23 years, global small-caps have outperformed global large-caps by 240 basis points annually (from March 24, 2000, to February 28, 2023). The selection of March 2000 as the starting point was intentional, as it coincided with the dot-com bubble's peak, enabling the inclusion of four global bear markets in the analysis (The Dot-Com bubble, Great Financial Crisis, Covid-19, and 2022). Alternatively, examining small-cap outperformance from a regional perspective, we observed that it ranged from 100 to 340 basis points annually, as measured from each respective local regional index inception. Please refer to charts 1 and 2 for further details.

Historical Long-Term Global Small-Cap Equity Outperformance (7.0% vs 4.6%)

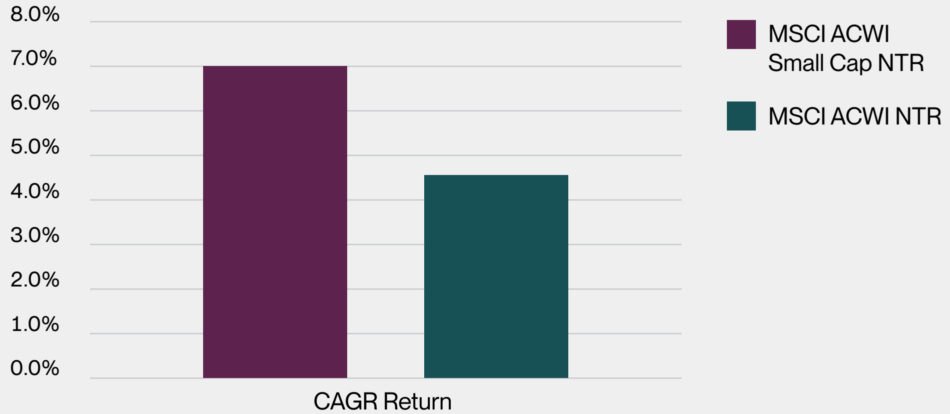


*Chart 1 | Source: Bloomberg (March 24, 2000, to February 28, 2023)*

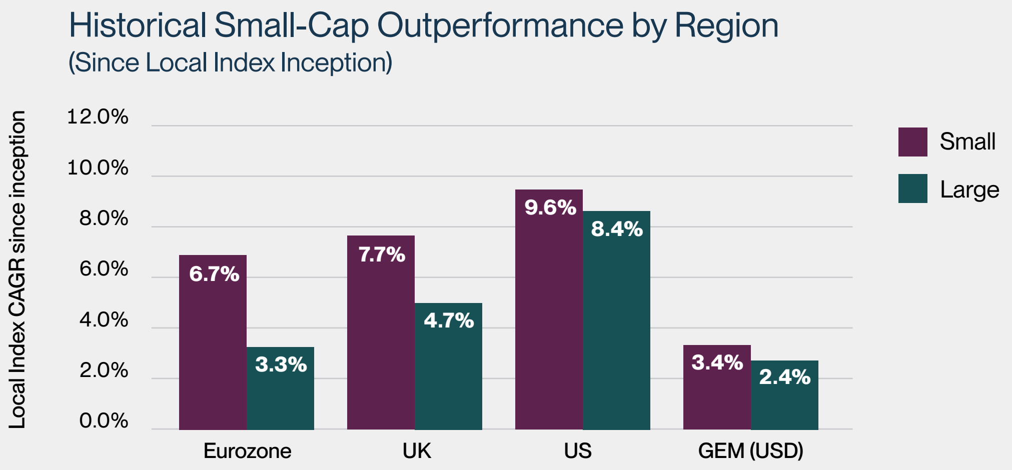

*Chart 2 | Source: JP Morgan, Bloomberg, FactSet, 2022*

## Why Are Expected Returns Higher?

### Benefits of an Inefficient Asset Class

Inefficiency is a great starting point for outperformance, and few asset classes are as inefficient as global small-cap equities. In fact, it is precisely this characteristic of inefficiency that creates the alpha opportunity in global small-cap equities.

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### Reasons for Inefficiency

#### Often Overlooked

Investors, both institutional and individual, frequently disregard global small-cap stocks, perhaps due to the perceived higher risk and the asset class's labor-intensive and skill-intensive nature. This translates into fewer investors analyzing global small-cap stocks, increasing the possibility of market mispricing. Consequently, stocks that are inaccurately underpriced provide alpha opportunities to investors who have the willingness and capability to discover them.

#### Less Sell-Side (Wall Street) Coverage ... Way Less

Global small-cap companies are not adequately covered by sell-side analysts, with only 18% of stocks being appropriately analyzed, and merely 6% having more than ten analysts covering them. Our definition of adequacy, in this context, requires more than five sell-side analysts covering the stock. In contrast, 87% of large-cap stocks have sufficient sell-side coverage, with only 4% having no analyst coverage. Approximately 47% of small-cap stocks are not covered by any analyst, while 35% have only 1-5 analysts covering them. The disparity in coverage is even more pronounced for the most significant and most popular stocks in the world, such as the FAANG stocks, each with an average of 54 Wall Street analysts following them closely.

The lack of sell-side coverage for small-cap companies makes it difficult for them to communicate their story to potential investors via conferences, site tours, company and industry background reports, and road shows. As a result, there is a higher chance that small-cap stocks will be mispriced in comparison to their fundamental value, providing an alpha opportunity. In my experience, this coverage gap is amplified by sell-side analysts publishing reports less frequently for small-cap stocks than they do for large-cap stocks.

Figure 12: Global Large-Caps by Coverage (# of Brokers) – % of Stocks

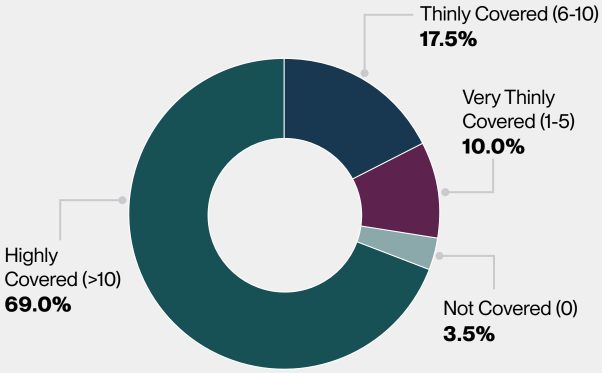


Figure 13: Global Large-Caps by Coverage (# of Brokers) – # of Stocks

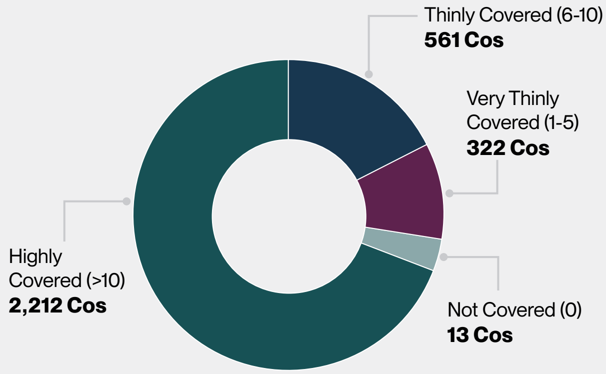


Figure 14: Global SMid-Caps by Coverage (# of Brokers) – % of Stocks

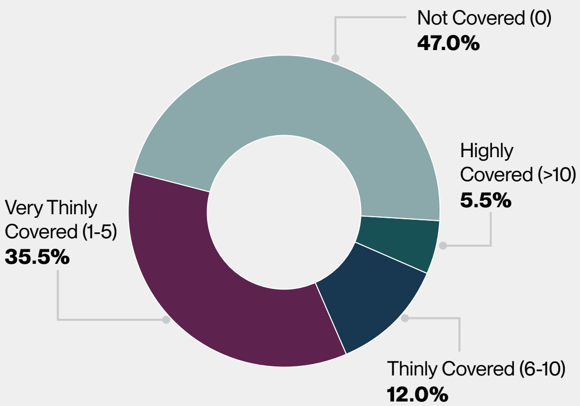


Figure 15: Global SMid-Caps by Coverage (# of Brokers) – # of Stocks

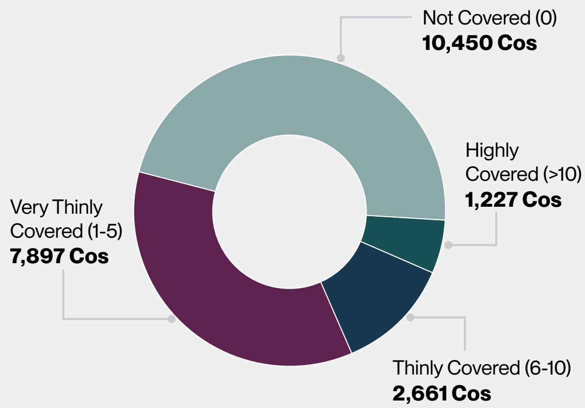


*Chart 3: Sell-Side Coverage – Global Large-Caps vs Global Small-Caps | Source: JP Morgan, 2022*

## Lack of Liquidity

Due to the smaller size, lower trading volume, and lack of research coverage, small-cap stocks often experience more pronounced and unpredictable price fluctuations, which may not always align with the company's underlying fundamentals. The reduced trading liquidity in small-cap stocks can result in price inefficiencies, where a single large investor's decision to sell can trigger a significant decline in the share price. This is in contrast to large-cap stocks, which generally have more stable trading patterns and are less susceptible to such abrupt movements. However, these share-price inefficiencies present an opportunity for investors to capitalize on undervalued small-cap stocks, potentially generating alpha for their portfolios.

## Reasons to Like Global Small-Caps

### More Choice

When it comes to selecting global stocks, investors have a wider range of options to choose from in the small-cap space compared to large-cap stocks. The larger number of investment options in the small-cap space increases the likelihood of finding attractive opportunities, which can lead to better investment performance. Specifically, there are over 22,000 global small-cap stocks compared to just over 3,000 global large-cap stocks. Additionally, the majority of small-cap stocks, over 18,000, are not sufficiently covered by sell-side analysts, whereas almost all large-cap stocks have decent coverage (as shown in Chart 4).

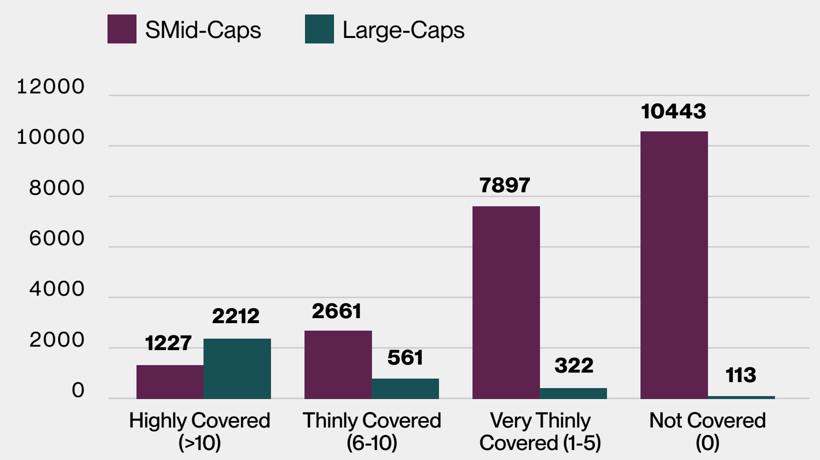


*Chart 4: Number of Small and Large-Cap Global Stocks & Level of Sell-Side Coverage | Source: JP Morgan, Bloomberg, FactSet, DataStream*

### Better Growth Prospects

Small-cap companies often present better growth prospects than large-cap companies. This growth differential can be attributed to various factors, such as:

- Growth off of a much smaller revenue base.
- Every big company started as a small company before growing into large-cap status.
- Untapped products and markets can significantly impact growth for small companies.
- Small-cap companies are often more nimble and agile, enabling them to respond more quickly to changing market conditions and capitalize on new opportunities.
- Smaller companies can drive growth through bolt-on acquisitions.
- Large-cap companies may have a vast array of products, markets, and divisions, which can dilute their overall growth prospects.

### Small-Caps are Less Expensive

In my professional experience, I have discovered that in most cases, comparable small-cap stocks are available for purchase at a substantially lower valuation than large-cap stocks. While it takes time, judgement, and resources to find and analyze these companies; the ability to invest in a company that is similar but less expensive is a powerful catalyst for generating additional performance over the long-term.

It is a widely held misconception among investors that small-cap stocks generally have poor balance sheets and seldom pay dividends. While this may be true for the most speculative of small companies, it does not apply to the majority of publicly listed global small-caps. In fact, there are many small-cap stocks with sound balance sheets and impressive dividend payouts.

# Why Today?

## Relatively Cheap

Investors can take advantage of the currently low valuations of global small-cap stocks in comparison to large-cap stocks. Based on historical measures, small-cap equities are trading at their cheapest relative levels to large-caps in the past 50 years, as illustrated in Chart 5.

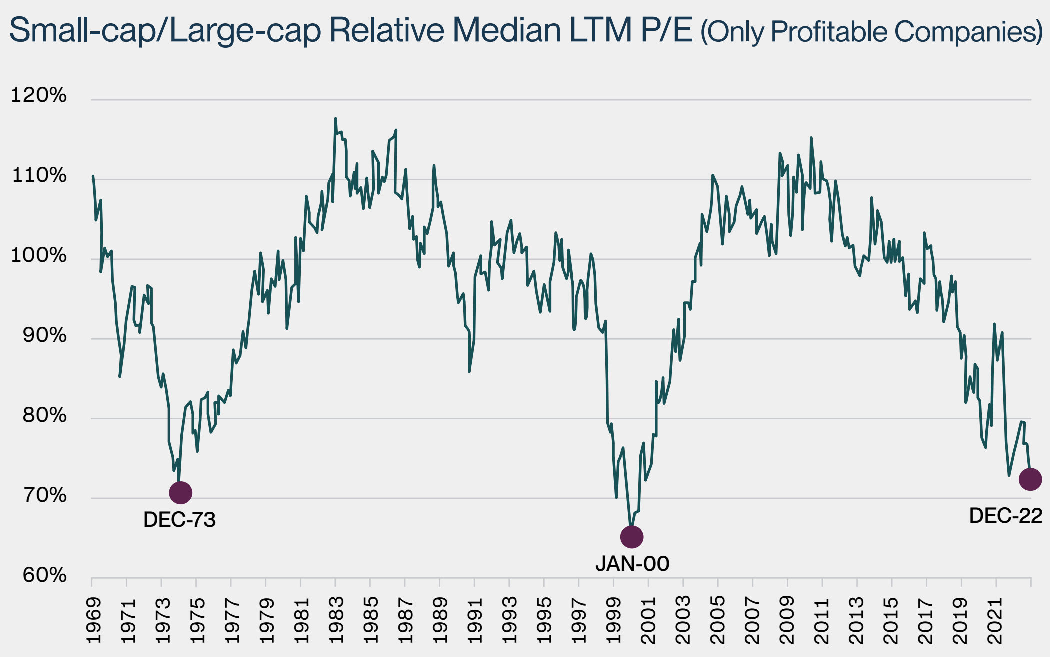


*Chart 5: Small-Cap vs Large-Cap Relative Valuations – 50 Years | Source: Furey Research Partners, US data only, 1970 to 2022*

## Better with Inflation

According to an article published in January 2022 by Franklin Templeton, small-cap equities were the only asset class to have outperformed inflation in each decade since the 1930s. Small-cap equities have demonstrated consistent outperformance against inflation in every decade since the 1930s, according to a recent study of US small-caps by Strategas. Additionally, an article published by J.P. Morgan in February 2023, suggests that small-cap equities are among the top-performing areas of the market during periods of rising inflation and interest rates. Given the possibility of an extended period of higher inflation, the potential for small-cap stocks to outperform inflation could offer significant benefits to investors.

## Strong During Market Rebound

Small-cap stocks tend to experience greater pain during bear markets due to a flight to safety, however, all bear markets eventually reach a bottom, followed by a rebound and recovery.

Based on our analysis of the past three significant bear markets, we discovered that during the initial year of the rebound or recovery phase, global small-cap stocks had an average outperformance of 28% over large-cap stocks. This figure is a simple average of the outperformance observed in each of the three bear-market rebound/recovery scenarios we examined.

For instance, after one year from the bottom of the Dot-com bear market, global small-caps surged by 58%, while global large-caps increased by 38%. Similarly, after one year from the bottom of the Global Financial Crisis, global small-caps rose by 106%, compared to 78% for global large-caps. In the year following the bottom of the Covid-19 bear market, global small-caps soared by 115%, while global large-caps advanced by 78%. These figures suggest that when the recovery from the bottom commences, there is a high likelihood that global small-cap stocks will outperform significantly (refer to chart 6).

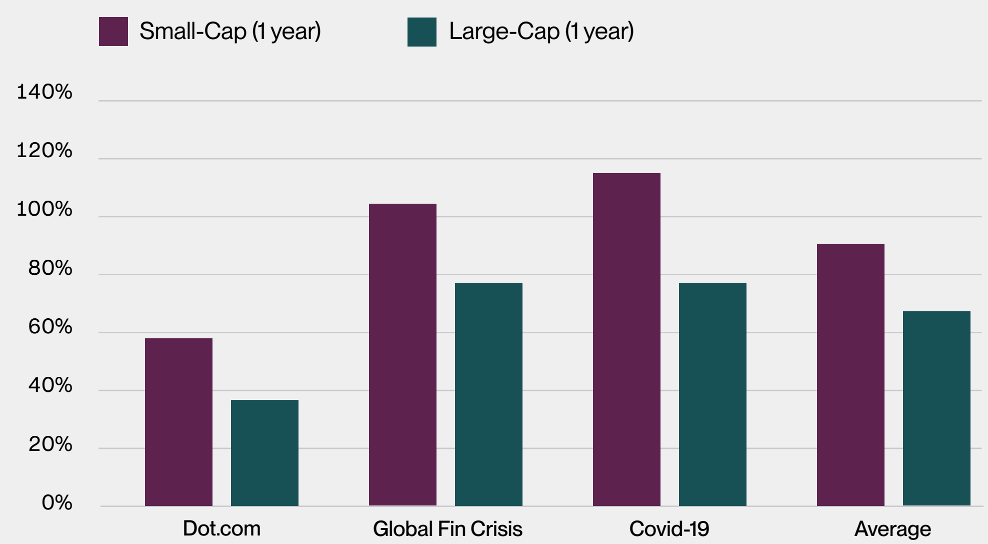


*Chart 6: Last Three Major Bear Markets – Recovery Returns over 1 Year – Small-Cap vs Large-Cap | Source: Bloomberg*

## But Aren't Small-Caps too Risky?

The asset class of global small-cap stocks is often considered too risky by many investors. This perception is primarily based on the commonly used measure of investment risk - volatility, which is typically defined as the standard deviation of returns. While it is true that small-cap stocks exhibit higher volatility compared to their large-cap counterparts, the difference is not significant. In fact, the standard deviation of monthly returns for the global small-cap and global large-cap indices over the past ten years is well within the same range. For instance, the MSCI ACWI Small Cap Index had a standard deviation of 16.8%, whereas the MSCI ACWI Index had a standard deviation of 14.5%. In my view, this difference is not substantial enough to dissuade long-term investors from pursuing higher returns.

## Conclusion

Although most investors allocate only a small portion of their portfolios to global small-cap public equities, this asset class has the potential to generate significantly higher future expected returns compared to large-cap public equities. This is because the inefficiencies of small-cap stocks, such as lack of sell-side coverage, liquidity, and investor interest, present opportunities for higher returns. In addition, many small-cap stocks have robust growth potential, sound balance sheets, attractive valuations, and provide diversification benefits due to the idiosyncratic nature of their returns. Furthermore, historical data suggests that global small-cap equities are inexpensive relative to other asset classes, perform well in inflationary environments, and deliver robust returns during market rebounds after bear-market bottoms. As a result, increasing allocations to global small-cap public equities could provide compelling benefits for investors.

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