A good time to invest in Global Small Caps

There are well known benefits to investing in Global Small Caps. Interestingly, although investors are comfortable investing in domestic smaller companies, most have their entire global equity exposure in MSCI World (Large Cap) stocks. Successfully timing an entry into Global Small Caps might seem challenging, but history suggests it's now a good time to consider an allocation to this sector.

The case for Global Small Caps

There are a number of reasons to consider an allocation to Global Small Caps:

- Over the long term, Small Caps have outperformed Large Caps
- The consistent trend that Small Caps outperform Large Caps for the 12 months following a significant market drawdown
- Using four valuation metrics, the Global Small Cap index is currently at a discount to both the S&P/ASX Small Ordinaries and S&P500
- Over the last decade, the price/earnings ratio of Global Small Caps (NTM) has nearly always been at higher levels than domestic Small Caps. This has now reversed.
- Current sector exposures of Global Small Caps and domestic Small Caps have several large differences:
    - Small Ords has 23% in Materials, compared to 6% weighting in Global Smalls
    - Small Ords is 5% overweight Global Smalls' Real Estate
    - Small Ords is 11.7% underweight Global Smalls' Industrials
    - Small Ords is 7.7% underweight Global Smalls' combined IT and Health Care sectors

The summary statistics for all three indexes over the period from 31/03/2000 to 31/07/2022 are provided in Figure one. All returns are in AUD.

Figure one: Index characteristics

Characteristic	Global Large Cap	Global Small Cap	Small Ords
Total return, annualised	5.04%	7.56%	5.80%
Volatility	11.84%	13.79%	17.83%
Return/risk	0.43	0.55	0.33
Return, excess (to Global Large)	-	2.52%	0.76%
Tracking error (to Global Large)	-	6.5%	16.2%
Information ratio	-	0.39	0.05
Beta	-	1.03	0.70

Source: FactSet, MSCI

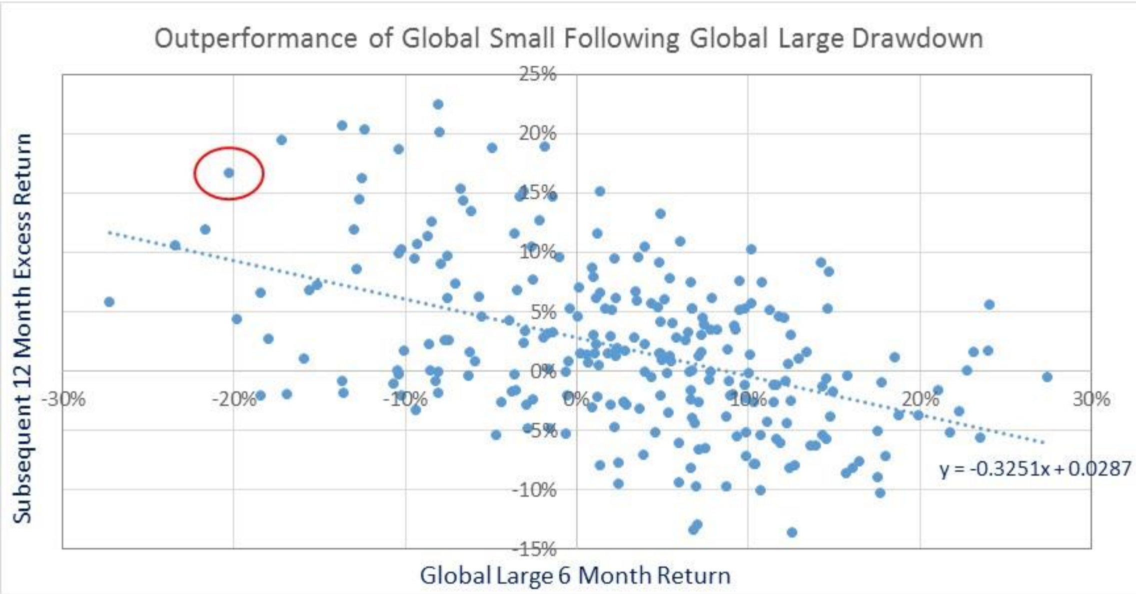
Following the market drawdown this year, it's timely to consider adding an exposure to Global Small Caps to an investment portfolio.

Timing the Small Cap Beta

Figure two shows the outperformance of MSCI World ex AU Small Caps (Global Smalls), given the recent performance of MSCI World ex AU (Global Large).

The X-axis represents the return for the last six months of Global Large, with the Y-axis the excess performance of Global Smalls for the 12 months following. The highlighted month is October 2002; Global Large's six-month return to that date was down 20.3%. From October 2002 until October 2003, Global Smalls then outperformed Global Large by 16.5%.

Figure two: Small Cap Beta



Source: FactSet, MSCI

We see a clear trend that after the broader market has fallen, Global Small Caps outperform. The trend is less clear if the recent six-month return of Global Large has been positive.

Table one: 12 month Returns of Global Small Caps following 6 month Global Large Return

6-Month Return, R	R < 0	R > 0	R < -10%	-10% < R < 0%	0 < R < 10%	> 10%
Number of Months	87	171	30	57	110	61
Small Excess	6.0%	-0.1%	7.2%	5.4%	1.0%	-2.1%

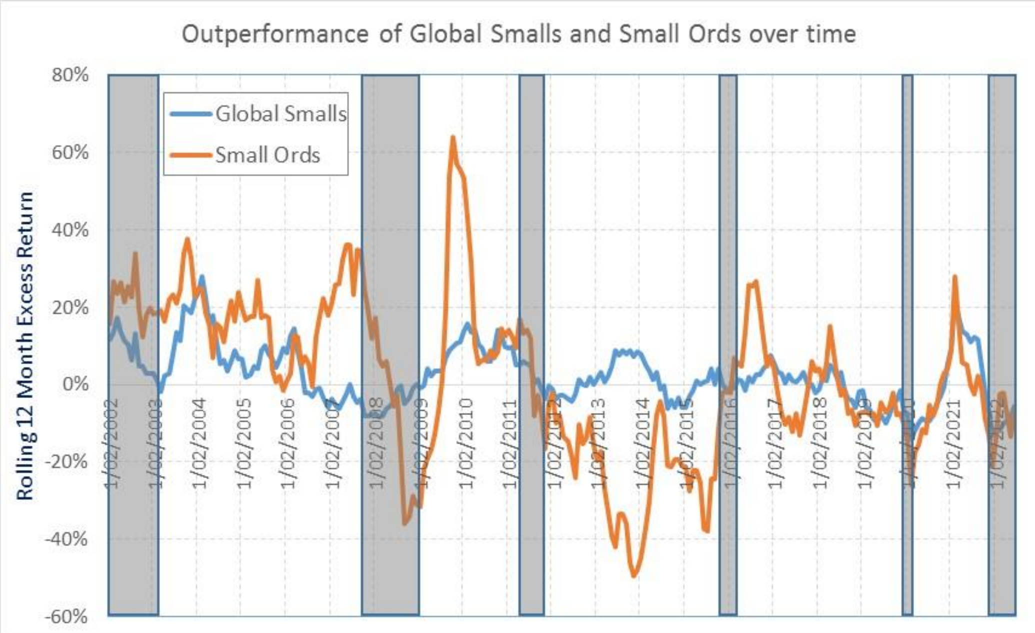
How do Australian Small Caps Compare?

Error! Reference source not found. Figure three shows the rolling 12-month excess returns of Global Smalls and the S&P/ASX Small Ordinaries Index (Small Ords). Significant drawdown periods of Global Large have been highlighted on the chart. Looking at the rolling outperformance data over time, we can see much of this outlier activity came around the GFC period (2008-2009), when relative returns for the Small Ords over MSCI Large moved from -60% to +60%.

Following the shorter drawdown in 2011, Global Smalls performed in line with Global Large, while Small Ords was very weak for several years. Small Ords performed strongly following the brief drawdown in

2016, with Global Smalls a small outperformer. Following the rapid drawdown and rebound in 2020, Global Smalls and Small Ords both outperformed strongly.

Figure three: Comparison of Global Smalls versus the Small Ords

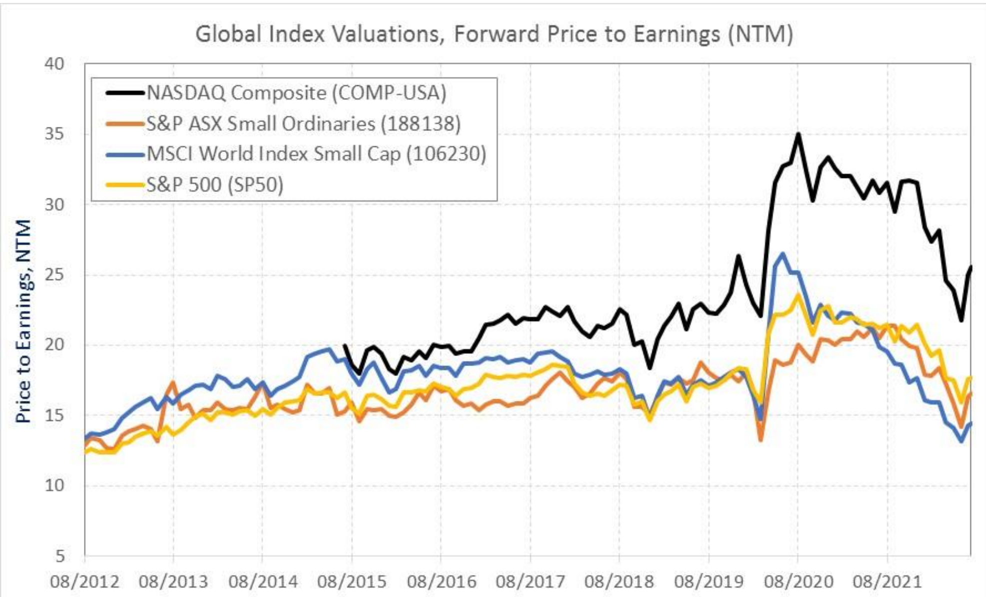


Source: FactSet, MSCI

Valuation of Small Caps

Figure four shows the relative P/E's of MSCI Smalls and the Small Ords, along with S&P500 and NASDAQ. The two small cap indices are trading at discounts to both their own long-term average valuations, and compared to US large cap indices. MSCI Smalls is also trading at a valuation discount to the Small Ords – the size of this discount is almost at it largest point seen over the past 10 years.

Figure four: Forward PE ratios of Global Indices over time



Source: FactSet

Conclusion

Although both Global Smalls and the Small Ords have historically outperformed overall following a drawdown in Global Large, the profile of their outperformance has been quite different. Small Ords saw huge relative volatility around the GFC and has had periods of underperformance following more recent drawdown events.

Astute investors balance the return and diversification benefits with the lower capacity, and slightly lower liquidity, offered by Small Caps. Global Smalls is currently trading at historically large discounts on a valuation basis to both Small Ords and Large Cap indexes and is at valuation levels not seen since 2012-2013, making it an ideal time to consider an allocation to this sector.