Actively Managed Small Caps are a Core Portfolio Holding

In this paper, we review the performance of active managers in the Australian Small Cap sector. Historically, active management has consistently delivered outperformance as the opportunity set presented by the sector allows the fund manager to demonstrate both their stock selection and portfolio construction skill. An asset allocation decision on the viability of a small cap allocation based purely on analysis of the benchmark returns, ignores the demonstrated alpha opportunity available for investors over time.

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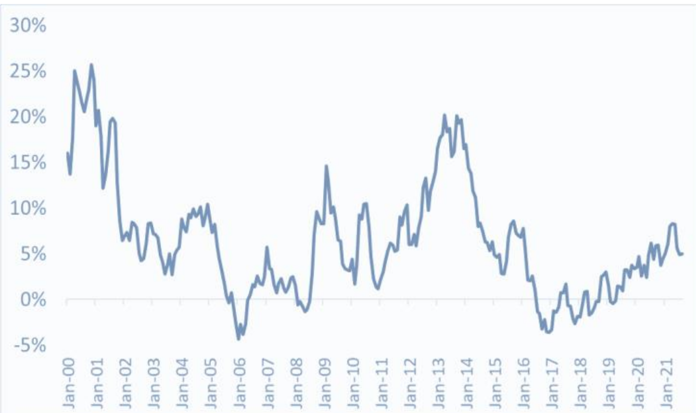
This article has been prepared by Flinders Investment Partners, the underlying investment manager for the Flinders Emerging Companies Fund which is distributed by Warakirri Asset Management..

We have chosen the 6-year anniversary of the Flinders Emerging Companies Fund to review the performance of active managers in the Australian Small Cap sector. It is important to note that historically, active management has consistently delivered outperformance against the S&P/ASX Small Ordinaries Index as illustrated in Chart 1, a time series of rolling 12-month outperformance* of the median small cap manager (Jan. 2000 to Aug. 2021).

Over the last 10 years, the median Small Caps manager has outperformed the benchmark (12.5% p.a. vs 6.7% p.a., see Table 1). Pleasingly for our investors, the Flinders Emerging Companies Fund has delivered solid outperformance with a return of 16.9% p.a. (Sept 2015 to Aug 2021). Importantly, the asset class continues to provide vast opportunity to deliver returns for investors.

Chart 1. Outperformance of the median small companies manager (rolling 12 months)



Source: Mercer, Flinders Investment Partners

When comparing across asset classes, while the Small Ordinaries Index has outperformed the S&P/ASX 200 benchmark index over all periods in the last five years, it has underperformed over the last 10 years (see Table 1).

Interestingly, the median small cap manager has outperformed both benchmarks, as well as the top quartile large cap (Australian Equities) manager over the 10-year period.

In fact, the median small cap manager exceeded the return of both indices over all periods, including the top quartile active manager in large caps.

Table 1. Australian Small Cap and Australian Large Cap Equity Manager Performance (to August 2021)

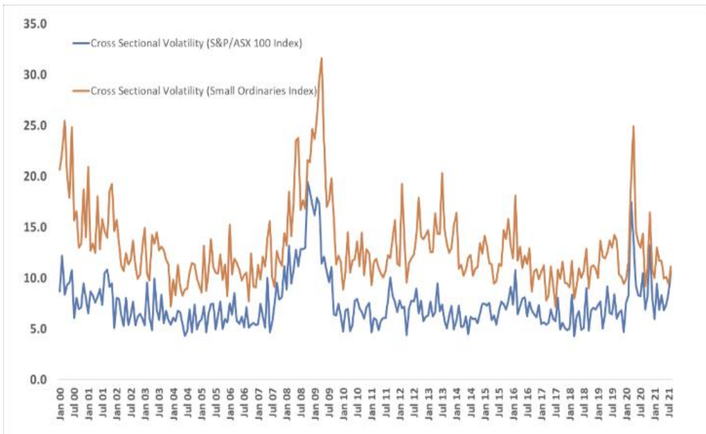
	1 yr (%)	2 yrs (% pa)	3 yrs (% pa)	5 yrs (% pa)	10 yrs (% pa)
Small Caps					
S&P/ASX Small Ordinaries	29.5	15.0	10.1	11.0	6.7
Upper Quartile	41.8	24.6	18.8	16.7	15.8
Median	33.6	21.3	14.0	13.3	12.5
Large Caps					
S&P/ASX 200	28.1	10.3	9.9	10.9	10.3
Upper Quartile	33.2	14.3	11.4	12.8	12.5
Median	30.1	11.3	10.0	11.2	11.2

Source: Mercer, Flinders Investment Partners

This outcome is not surprising - the cross-sectional volatility of the small companies sector is materially higher than the S&P/ASX 100 sector (which constitutes ~90% of the S&P/ASX 200 index - see Chart 2). The cross-sectional volatility represents (amongst other things) the opportunity set available to the investor. The higher the dispersion of returns, the higher the opportunity to add value. As the small cap asset class exhibits higher dispersion than large caps, there is the opportunity to provide higher returns.

The debate about the level of small company exposure in a portfolio has typically revolved around an assessment of their characteristics relative to large caps.

Chart 2. Cross-sectional volatility for the S&P/ASX 100 (large caps) and the S&P/ASX Small ordinaries (small caps) Indices



Source: Flinders Investment Partners

As demonstrated in Table 1, the average Australian Large Cap Equites manager has delivered returns close to the benchmark (and likely under the benchmark, after fees). This cannot be said of the small cap sector, where the median manger return has consistently and materially exceeded the benchmark.

An asset allocation decision on the viability of a small cap allocation based purely on analysis of the benchmark returns, ignores the demonstrated alpha opportunity available for investors over time. Hence, a small cap exposure is core to any portfolio allocation to equities.

A final point on valuation. Markets have rallied strongly since the trough on 23 March 2020. Suffice to say, equities have re-rated aggressively. From this perspective, it is prudent to assess the current valuation and growth characteristics of the market segments to determine suitability for continued investment.

Table 2 illustrates FY23 consensus expectations for large caps (S&P/ASX 100), mid caps (stock 51 to 100 within the S&P/ASX 100), small caps (S&P/ASX Small Ordinaries i.e. stocks 101 to 300) and finally the Flinders portfolio (based on FactSet consensus data). We consider FY23 fundamental data to normalise for the dislocation experienced in market post pandemic (FY21 and FY22).

The key outcome here is the attractiveness of the small cap sector from both a growth perspective (compared with large caps) and from a valuation perspective (compared with mid caps).

Table 2. Market Fundamental Attributes

FY23 Attributes				
	ASX 100	Mid Caps	Small Ords	Flinders Portfolio
EPS Growth	-4.8%	0.5%	9.4%	18.4%
Sales Growth	0.6%	3.1%	5.0%	2.4%
PE	18.0	20.5	18.4	15.4
Dividend Yield	3.9%	3.0%	3.0%	2.5%
Price to Cashflow	16.3	14.1	11.5	10.4
EV / EBITDA	8.7	11.4	9.4	7.7
ROE	13.7%	10.4%	10.1%	13.0%

Source: FactSet, Flinders Investment Partners

Importantly, the opportunity set presented by the small cap sector allows the fund manager to demonstrate both their stock selection and portfolio construction skill. Pleasingly, Table 2 also illustrates that a portfolio of high earnings growth companies can be identified with attractive valuation characteristics. This has been a feature of the Flinders Emerging Companies Fund since inception.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

* Performance data used in this report are before fees.