Do you own enough global small caps?

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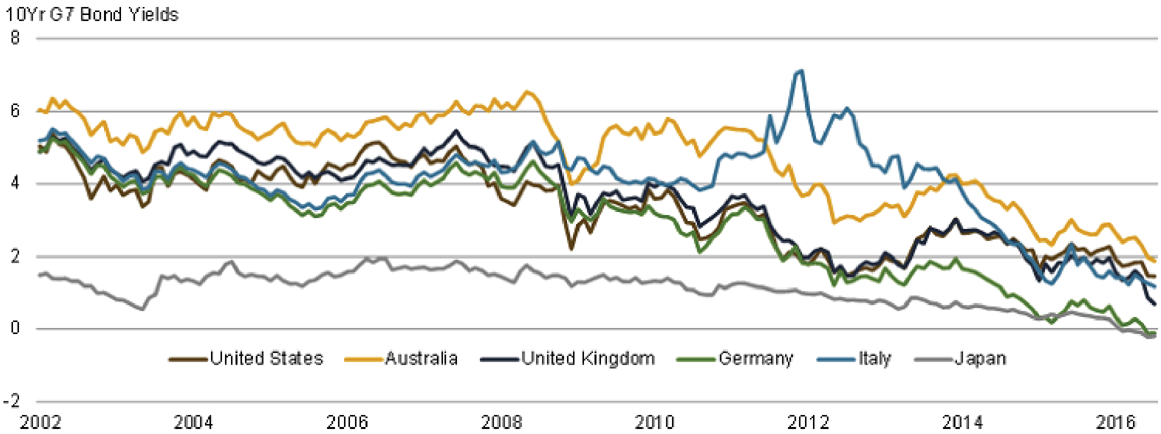
Investors are faced with something of a quandary at the moment. Global bonds are offering close to a zero yield (Figure 1), and equity markets have hit multi-year highs in some markets. Developed economies appear fragile and political uncertainty continues to shake confidence.

Figure 1: Where Will Returns Come From?
(Feb 2001 – 31 Mar 2016)



Sources: Lazard, Bloomberg. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard.

With fixed income and bank deposits not providing any meaningful return, investors need an asset class that offers potential upside, adequate diversification – and it should add to the overall risk/reward of the portfolio.

This is particularly true for Australian investors, who have a significant home equity bias, particularly given that more than 80% of Australian equities are financials and 60% are banks. Furthermore, 70% of Australian investors' net worth is in residential real estate.[1] Clearly, this is far from diversified.

portfolio construction forum

ONE SOLUTION – GLOBAL SMALL CAPS

To generate returns that can approximate historical norms and meet long-term liabilities, investors need three things: a larger equity allocation; a stream of less correlated returns; and, returns that outperform broader markets.

Clearly, pursuing this approach could also come at the expense of greater risk. This is why correlations is important. If increasing equities exposure in order to generate higher returns, from a risk management perspective, it is arguably better if the equities added are uncorrelated with what is already owned.

Historically, global small caps equities have had very low correlations with the Australian equity market (Figure 2).

Figure 2: Global small cap equities can be a strong diversifier
Equity market correlations (1990 – 31 Dec 2015)

	MSCI World Small Cap	ASX 200	AU-10 Yr Bonds	MSCI World Small Cap ex-AU	MSCI World ex-AU	ASX Small Ords
MSCI World Small Cap	1.00	0.56	0.12	0.78	0.91	0.49
ASX 200	0.56	1.00	0.17	0.77	0.48	0.83
AU 10 yr Bonds	0.12	0.17	1.00	0.30	0.09	0.18
MSCI World Small Cap ex-AU	0.78	0.77	0.30	1.00	0.53	0.76
MSCI World ex-AU	0.91	0.48	0.09	0.53	1.00	0.41
ASX Small Ords	0.49	0.83	0.18	0.76	0.41	1.00

Source: Bloomberg, MSCI. Diversification does not guarantee profit or protect against loss in declining markets.

The reason for these low correlations is that global smalls have much less exposure to industries such as banking and mining and this cyclical exposure is replaced with a higher weight in industrials which include pockets of niche businesses that are not overly cyclical (Figure 3).

Figure 3: Sector profile of global small cap equities
(30 Jun 2016)

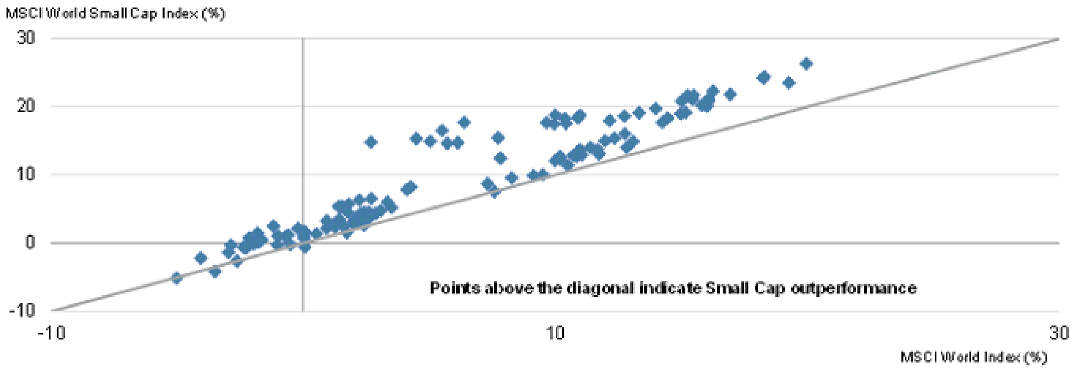
Sector	S&P/ASX Small Ords	MSCI World Small Cap
Consumer Discretionary	22.3	14.1
Consumer staples	8.0	5.0
Energy	3.9	4.3
Financials	20.0	24.7
Health Care	7.1	9.9
Industrials	10.6	17.3
Information Technology	7.5	13.2
Materials	18.5	7.6
Telecommunication Services	1.4	0.8
Utility services	0.7	3.2

Source: Bloomberg, MSCI. Data shown is relative to the MSCI World Small Cap Index

THE SMALL CAP PREMIUM

Historically, small cap companies have outperformed large cap companies. Over the last 15 years, small caps have outperformed large caps consistently. Figure 4 shows that on a rolling five-year annualised basis, small cap equities have outperformed large cap equities 95%of the time over the last 15 years.

Figure 4: Small cap equity premium - MSCI World Small Cap Vs MSCI World (Feb 2001 - 31 Dec 2015)



Months	Months of Small Cap outperformance	% of Months
120	114	95.0

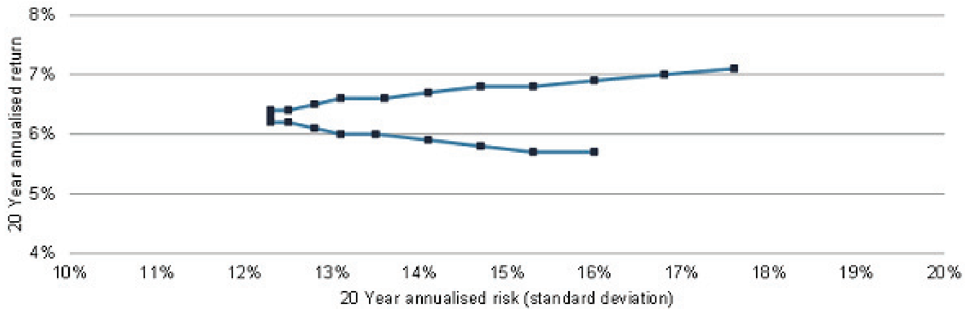
Source: MSCI. All data is in USD based on total return (net) indices, monthly frequency. The performance quoted represents past performance. Past performance does not guarantee future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. An investment cannot be made directly in an index. Indices are unmanaged and have no fees.

This outperformance is consistent with the findings of longer-term academic studies.

In their seminal paper[2], Fama and French (1992) concluded that the outperformance of small cap equities over large cap equities was due to an element of risk unique to small cap equities (that is, investors are compensated for undertaking additional risk).

Conventional wisdom suggests that small caps are more volatile than large cap equities. Figure 5 shows that an allocation of around 40% small cap equities to 60% large cap equities would have provided the most favourable risk/reward over the 20 years examined.

Figure 5: A more efficient portfolio – efficient frontier of large cap vs small cap equities
(20 years to 30 Jun 2016)



Large Cap allocation (%)	Small Cap allocation (%)	Return (%pa)	Risk (%pa)
0	100	7.05	17.58
10	90	6.92	16.03
20	80	6.78	14.66
30	70	6.64	13.55
40	60	6.50	12.76
50	50	6.37	12.34
60	40	6.23	12.34
70	30	6.09	12.75
80	20	5.95	13.55
90	10	5.81	14.65
100	0	5.68	16.02

Sources: Lazard, MSCI. Return = 20-year annualised total return. Risk = 20-year annualised standard deviation. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. An investment cannot be made directly in an index. Indices are unmanaged and have no fees.

While the addition of small cap equities improved returns slightly, their most important benefit was the reduction in volatility. This may seem counterintuitive to the prevailing wisdom that small cap equities are highly volatile however it highlights the importance of diversification as a risk control measure – and, that used appropriately in portfolios, small cap equities may not actually be as risky as many investors think.

VOLATILITY AND TIMING

Most investors understand that global small equities can provide solid upside returns, but fear investing at the wrong time and losing on the downside volatility. However, Figure 6 shows that over the past 10 years (a period including the Global Financial Crisis), global small equities had the same standard deviation as the Australian S&P/ASX All Ords Index but for a much higher return. In addition, when compared to Australian small cap equities (as measured by the S&P/ASX Small Ords Index), global small cap equities had much lower volatility and much higher returns.

Figure 6: How volatile have small cap equities been?
(10 years to 30 Apr 2016)

	10 year return (% pa)	10 year std dev (%pa)
S&P/ASX Small Ords Index	1.10	19.53
S&P/ASX All Ords Index	4.93	14.58
MSCI World Small Cap Index	7.66	14.58
MSCI World Index	5.58	13.41

Source: Lazard, MSCI. All performance is in AUD. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. An investment cannot be made directly in an index. Indices are unmanaged and have no fees.

Another key concern for investors is timing. Investors are always looking for the ideal entry point into an asset class like global smalls. But market timing is extremely difficult. Investors should take a long-term view to their portfolio allocations. The key is maintaining an allocation to global small cap equities rather than trying to time them. Figure 7 shows that missing the five best trading days for the global small cap equities market each year over the past 10 years years would have had a big impact on return.

Figure 7: A matter of timing
(30 Jun 2016)

Year	MSCI World Small Cap Index Return (%)	Return Excluding 5 Best Days (%)
2016^	6.0	-5.1
2015	-0.3	-8.3
2014	1.9	-6.0
2013	32.4	21.9
2012	17.5	5.4
2011	-9.1	-25.1
2010	26.1	7.0
2009	44.1	15.1
2008	-41.9	-55.5
2007	0.8	-8.0
2006	17.2	4.9

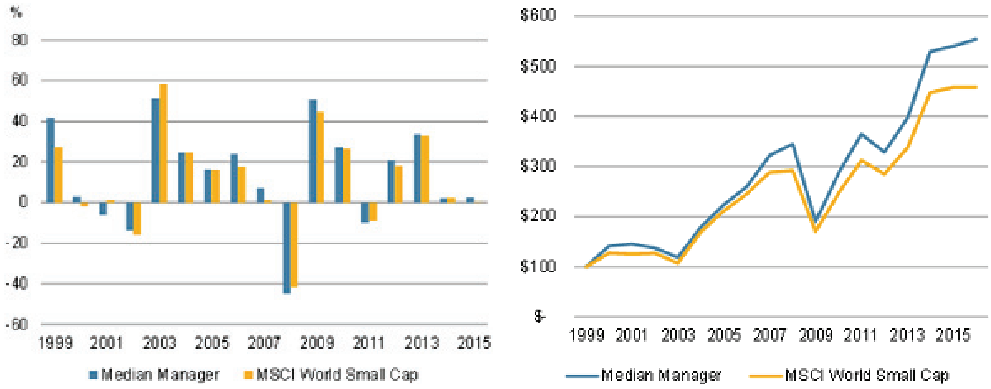
^ Year to date 2016. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. An investment cannot be made directly in an index. Indices are unmanaged and have no fees. Source: Lazard, MSCI.

GO ACTIVE

Small-cap equity performance can be enhanced by an active stock selection approach. Figure 8 shows that small-cap equity active managers have outperformed the index benchmark over time.

Figure 8: Active manager outperformance
(31 Dec 2015)

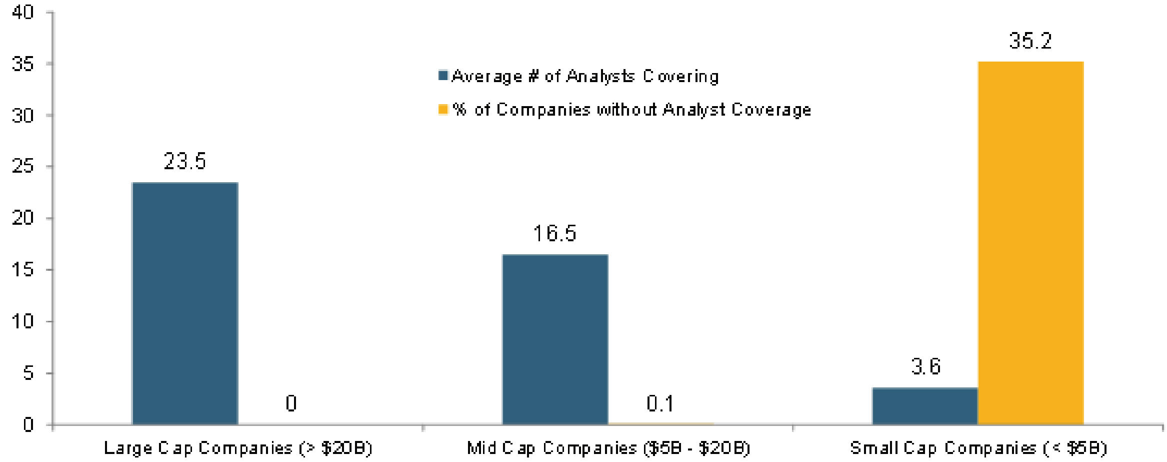
Median manager outperforms in 12 of 17 yrs | Growth of $100 (Net)



Sources: Lazard, MSCI, Evestment. Information is based on E-Vestment's Global Small Cap Universe. Past performance is not a reliable indicator of future results. This information is for illustrative purposes only and does not represent any product or strategy managed by Lazard. An investment cannot be made directly in an index. Indices are unmanaged and have no fees.

This outperformance is in part because the market for small cap equities is not as efficient as the large-cap equity market. Globally, much of the small-cap equity opportunity set is thinly covered by sell-side research analysts. Currently, around 35% of small-cap stocks in the MSCI Small Cap Index have no sell-side research coverage (Figure 9).

Figure 9: Small caps equities are not well covered by sell side research (30 Jun 2016)



Sources: MSCI, Factset. Universe is MSCI World All Cap (Large/Mid + Small Cap + Micro Cap) and may include more than one share class for certain companies. Market cap is float-adjusted MSCI value. Estimates reflect count of analysts offering EPS estimates for nearest unreported fiscal year-end as of 30 June 2015.

Small cap equity valuations are not cheap relative to history in most developed regions. However the US stands out as very expensive (Figure 10). Active managers can underweight the US small cap equity market and select cheaper starting points for investment.

Figure 10: Small cap equity relative value (30 Jun 2016)

	Forward P/E	Forward ROE (%)	Dividend Yield (%)
Continental Europe	15.8	9.6	2.5
United Kingdom	14.7	12.6	2.9
EAFE	15.0	9.3	2.6
US	22.5	9.2	1.7
Asia ex-Japan	15.6	8.8	3.7
Japan	14.2	7.8	2.2
Emerging Markets	13.0	9.6	2.3

Source: Lazard, MSCI. Forward Price/Earnings and Return on Equity are defined using the next twelve months. The figures above represent expected returns. Expected returns do not

represent a promise or guarantee of future results and are subject to change.
Investment characteristics are based upon a portfolio that represents the proposed investment for a fully discretionary account.

SUMMARY

2016 has been an uncertain year for markets – yet, markets are almost always uncertain. Logically, equity markets actually need uncertainty so that stocks are able to beat expectations and deliver returns to investors.

Global equities, both large and small, have had a strong run of performance since the Global Financial Crisis. There are two ways to move equity prices – either move the valuation multiple or grow earnings. The valuation lever has been a significant driver of global equity prices over the past six years. Valuations have risen approximately 40% to 60% (depending on the region). Going forward, it is more likely that equity prices will need to be driven by earnings growth. Global small cap equities is one of the best areas to seek companies that can compound high returns and generate faster earnings growth. Regardless of perceived volatility, there are numerous opportunities in the small cap equities sector on which active management with strong fundamental research can capitalise. The key, of course, is to find active small cap equity managers that can produce strong long-term returns.

ENDNOTES

1. Source: Average Australian HH balance, ABS

2. Fama, Eugene F. and Kenneth R. French. "The Cross-Section of Expected Stock Returns." *The Journal of Finance*, June 1992)

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