



WORLD VIEW:

Your Guide to Global Investing

Opportunities in small cap equities

By Peter Muldowney

Canadian pension plan sponsors have embraced a global approach to large cap non-domestic equity investing. In some cases, a global approach has replaced separate U.S. and non-North American mandates. In other cases, a global approach has been added to complement the separate regional mandates. Pension plans can benefit from extending this global shift to small cap equities, gaining enhanced portfolio diversification and better odds of beating the index benchmark.

There are different definitions of global small cap. According to the MSCI World Small Cap Index, *small cap* is stocks in

the US\$100 million to US\$5 billion range, with a median company size of US\$1.4 billion. Many of the stocks in the global small cap universe are household names in their local market; some even have a global brand, such as Abercrombie & Fitch (U.S.), Flight Centre (Australia) and Vitasoy (Hong Kong).

In a global context, though, small cap is not that small: there are more than 1,800 companies with a market capitalization greater than US\$1 billion to choose from in the index. (There are only 240 such companies in the S&P/TSX Composite Index and 111 companies in the S&P/TSX Small Cap Index.)

The largest individual stock in the global small cap index represents only 0.17% of the index. In contrast, the largest individual

stock in the S&P/TSX Composite Index represents 4.25% of its index, and the largest 15 stocks account for 43% of the index. To achieve a similar representation in a global small cap context, you would need to invest in 680 companies, which highlights the broad investment opportunity set of the global small cap universe.

The diversification benefits of global small cap go beyond individual stocks. While the major Canadian indexes are heavily skewed to the energy, materials and financials sectors (see Sector Comparison Across Indexes, page 48), the global small cap market provides representation across a much broader range of sectors, including higher exposure to healthcare and consumer discretionary (i.e., companies in the restaurant, luxury goods and travel industries). When Canadian plan sponsors have looked to improve diversification of their non-domestic equity investments, they have historically added a dedicated allocation to emerging market equities. The global small cap market provides similar diversification benefits relative to emerging equity markets.

The diversification benefits of global small cap go beyond individual stocks

SECTOR COMPARISON ACROSS INDEXES

GIC Sector	MSCI World Small Cap Index	MSCI Emerging Markets Index	S&P/TSX Composite Index	S&P/TSX Small Cap Index
Energy	7.6%	14.4%	26.6%	18.2%
Materials	10.5%	14.4%	24.1%	39.5%
Industrials	17.8%	7.3%	5.5%	10.2%
Consumer Discretionary	15.2%	7.1%	4.5%	7.6%
Consumer Staples	4.1%	6.7%	2.5%	3.5%
Healthcare	8.3%	1.0%	0.8%	1.7%
Financials	19.3%	24.2%	27.9%	14.0%
Information Technology	13.2%	13.3%	2.4%	2.4%
Telecommunication Services	0.8%	7.8%	4.0%	0.0%
Utilities	3.2%	3.8%	1.7%	2.9%

Source: MSCI and Datastream

Possible Rewards

While global small cap represents a different opportunity set, does “different” imply a good opportunity? Consider the following three potential benefits:

Growth opportunity - The most basic premise supporting an allocation to small cap equities is that large companies start small. If you can find the next generation of small companies that will grow faster and graduate into the large cap segment, the reward can be significant. It may be hard to believe, but as recently as November 2004, Apple Inc. graduated into the MSCI U.S. Large Cap Index. Global small cap companies tend to have a more focused line of business and higher insider ownership, resulting in greater alignment of interests between owners and shareholders.

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Sector opportunity - Plan sponsors can benefit from the higher consumer discretionary and healthcare sectors representation offered by the global small cap index relative to other major indexes. The spending patterns in developed and emerging markets should see the consumer discretionary sector perform well over the long term. The healthcare sector should also benefit from aging baby boomers in the developed world and from demands in emerging markets for better healthcare services.

Active opportunity - Small cap companies also tend to be less externally researched by the analyst community. As a result, active managers have a greater opportunity to outperform their index benchmark by identifying companies whose share price does not fully reflect their intrinsic value or growth prospects. For example, according to eVestment Alliance, active managers over the five years ending Dec. 31, 2010, have delivered, on average, 1.7% per annum added value over the MSCI World Small Cap Index.

Not Without Risk

Global small cap equities are not without their challenges, however. While active managers can mitigate some of the risks through research and careful selection of individual stocks, investors should consider the following:

Liquidity risk - It can take longer to trade small cap stocks than large cap stocks. Small cap stocks also tend to be more sensitive to changes in market sentiment (such as a change from a bullish to a bearish outlook for a particular sector), which can contribute to greater volatility.

Limited information flow - While higher insider ownership aligns with the interests of investors, it can also lead to a lack of transparency and flow of information, which is commonly found with large cap investments.

Threats from large competitors - Due to their size, small companies do not have the same access to credit markets as larger companies. This may limit a small company from realizing its potential, to the benefit of a larger competitor.

One Small Step for Investors

For plan sponsors wishing to pursue a global small cap equity investment, the

CAPS OFF: A CASE STUDY

A Canadian pension plan sponsor with a 60% equity/40% bond portfolio was interested in options for diversifying its global large cap equity portfolio. Following a review of the merits of emerging market (EM) and global small cap equity, it looked at alternative asset mixes. The objective was to maintain the plan's 40% long bond allocation and assess the merits of diversifying the 60% equity component.

The plan's equity component was 45% global large cap equity and 15% Canadian equity. In each of the following three proposed scenarios, there was no change to the 15% Canadian equity allocation, the global large cap equity allocation was reduced to 35%, and the remaining 10% was invested as follows:

Scenario 1: 10% EM equity

Scenario 2: 10% global small cap equity

Scenario 3: 5% EM and 5% global small cap equity

The table below shows the total portfolio risk and return analysis for the three scenarios for the five- and 10-year periods ending Dec. 31, 2010. The total portfolio returns are based on the relevant market index returns and asset class allocation for the different asset mixes. An allocation to EM, global small cap equity or a combination of the two resulted in a higher total portfolio return relative to the current portfolio mix, albeit with slightly higher volatility. The analysis did not take into account added value or lower volatility potential from active management.

HISTORICAL TOTAL PORTFOLIO ANALYSIS (as of Dec. 31, 2010)

Scenario	5 years		10 years	
	Return	Volatility	Return	Volatility
1 - EM equity	4.4%	9.5%	5.1%	8.8%
2 - Global small cap equity	3.6%	9.3%	4.4%	8.5%
3 - Equal combination	4.0%	9.4%	4.7%	8.7%
Current mix	3.3%	9.0%	3.7%	8.4%


Source: Connor, Clark & Lunn Financial Group and Datastream

For both the five- and 10-year periods, a 10% allocation to EM equities (and 35% global large cap equity allocation) was expected to deliver the highest return. However, when analyzing the quarterly relative returns over the 10-year period, the 5% allocation to both EM and global small cap (Scenario 3) offered the most consistent added value frequency in both up and down markets.

Many factors go into the asset mix decision. Recognizing the uncertainty associated with investing in equity markets, the proposed approach was to diversify the sources of return through exposure to both global small cap and EM equities.

process is the same as for other asset classes. The consulting community maintains databases on global small cap managers in Canada and abroad, and it adopts the same due diligence approach for researching global small cap managers as for other mandates. An important consideration, however, is to understand a portfolio team's specific tenure with global small cap investing.

The need for growth while being ever-mindful of total portfolio risk is still at the forefront of the minds of

institutional investors. Recently, they have shifted to a global focus for large cap non-domestic equity portfolios. By extending this global focus to small cap equities, they may benefit from a broader opportunity set and enhanced portfolio diversification—not to mention improved odds of beating the index benchmark. 

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