Contact Asset Management

INSIGHTS

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The case for *Quality* Small Caps in a Diversified Portfolio

Small-cap stocks offer a compelling investment opportunity for those willing to embrace a higher degree of risk in exchange for the potential for superior long-term returns. By incorporating small-cap stocks into a diversified portfolio, investors can enhance their risk-adjusted returns and gain exposure to companies with high growth potential.

However, we argue that a simple "buy the index" strategy is flawed. The S&P/ASX Small Ordinaries Index has lagged the broader All Ordinaries Index. We believe this is a result of low-quality, loss-making companies dragging down the segment. Successful small cap investing is best executed by stock pickers. After a period of sustained underperformance, we see an opportunity to increase exposure to Quality small caps to a well-rounded portfolio.

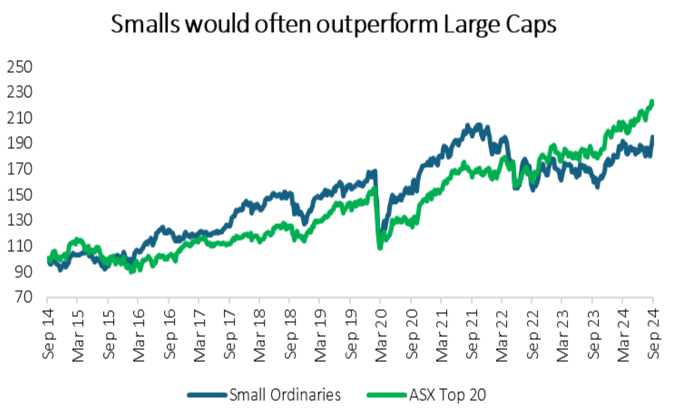
History suggests that Small Caps are supposed to outperform larger peers

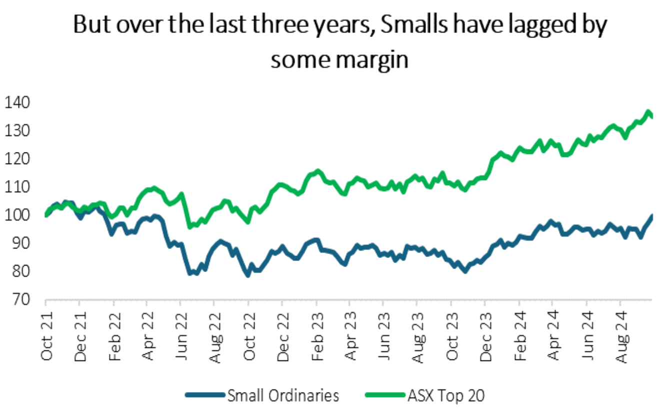
One of the most compelling reasons to invest in small-cap stocks is the so-called "small-cap premium." This concept, popularized by Eugene Fama and Kenneth French's seminal research on the Fama-French three-factor model, highlights how small-cap stocks have historically outperformed large-cap stocks over extended periods. The reason for this premium is rooted in the nature of smaller companies: they tend to be younger, nimbler, and more innovative, often growing at faster rates than their larger counterparts.

This is further supported by Dimensional Fund Advisors in their essay "The Case for Small-Cap Stocks". Data shows that from 1926 to 2020, small-cap stocks in the U.S. generated an average annual return of around 11.9%, compared to 10.3% for large-cap stocks. Although the premium has fluctuated over different market cycles, the long-term historical outperformance of small caps remains intact.

This outperformance is largely attributed to the growth opportunities inherent in smaller companies. Unlike large-cap firms, which may have already reached their peak, small-cap companies are often in the early stages of their growth trajectory, offering substantial upside potential. Additionally, market inefficiencies in the small-cap space can be exploited by astute investors, further enhancing returns.

However, the more recent performance of Australian small caps has gone against the empirical evidence. Quite drastically in fact. As depicted in the following charts, the S&P/ASX Small Ordinaries has lagged the S&P/ASX Top 20 and S&P/ASX Midcap 50 Indices by some margin.





Source: FactSet, Contact Asset Management

Active Portfolio Management is Key to Successful Small Cap Investing

We believe that there are several factors at play which help explain the recent disparity in performance between the S&P/ASX Top 20 and the S&P/ASX Small Ordinaries Index. Two in particular are the flow of passive funds to large caps and the search for quality.

Over the past decade the large Industry Superannuation funds have controlled a larger share of ownership and flows. Many prefer passive strategies and value liquidity. As a result, many are not going down the market as much which is impacting demand. Recent comments from the Future Fund have advocated increased small cap investing. However, to date this is immaterial against the wave of large cap passive flows. Experience has taught us that these flows of capital can reverse.

We also believe that the underperformance is a function of quality. While small-cap stocks can offer higher returns, it's crucial to avoid "junk" stocks, which are low-quality and high-risk[1]. The following table highlights the high proportion of ASX small caps that do not make money, do not pay a dividend and/or generate underwhelming returns. We believe that this is an excellent reason for Active investment management. As we have noted in the past, we don't want to own every stock in the index, we just want to own the best ones.

	No	Yes
Positive NPAT	35%	65%
Pay a Dividend	42%	58%
Generate ROE >10%	64%	36%
Satisfy all these criteria	**71%**	**29%**

Source: FactSet, Contact Asset Management

The active versus passive management issue is one of the most debated aspects of small cap investing. Given that small-cap stocks are often less researched and less covered by analysts than large-cap stocks, some argue that active management can add significant value in this segment of the market. Charles Schwab's research[2] suggests that the inefficiencies inherent in the small-cap market—such as fewer analysts covering these stocks and less publicly available information—can create opportunities for active managers to identify mispriced securities and generate alpha. Additionally, small-cap stocks often face liquidity constraints, making it more challenging for large institutional investors to take meaningful positions without moving the market. This, in turn, creates opportunities for smaller, nimble investors or active managers to capitalize on pricing inefficiencies.

Diversification Benefits

Small-cap stocks also offer unique diversification benefits, which is why they are often recommended as part of a well-rounded portfolio. According to Vanguard[3], small-cap stocks tend to have a lower correlation with large-cap stocks, making them a valuable asset class for reducing overall portfolio risk.

Vanguard's research demonstrates that by adding small-cap stocks to a predominantly large-cap portfolio, investors can enhance the portfolio's risk-adjusted returns. The reason is that small-cap stocks often perform well in different market conditions compared to large caps. For instance, during periods of economic recovery, smaller companies are typically more agile and better positioned to capitalize on new opportunities, driving superior performance relative to large-cap peers.

Vanguard also highlights that small-cap stocks are more influenced by domestic factors than global ones. This can provide an additional hedge against global economic uncertainties, making small-cap stocks particularly appealing to investors looking to balance their exposure between global macroeconomic trends and domestic growth opportunities.

Our approach – complement Active Small Cap Investing with Mid-caps and Founder-led businesses

Through the Contact Australian Ex-50 Fund, we invest using a set of investment principles that has been honed for generations. We believe that small caps play an important role in a diversified portfolio. We seek to complement a portfolio of quality small caps with mid-cap stocks (i.e. those that are ranked #51-100 on ASX Index weighting). Companies in the mid-cap segment are often at a point in the business life cycle whereby they are generating strong growth and profitability and commonly offer a growing dividend stream while still reinvesting in the business. As depicted in the following chart, the S&P/ASX Midcap 50 Index has delivered excellent results.

[1] "Size Matters, If You Control Your Junk" by Clifford Asness, Andrea Frazzini, and Lasse Pedersen
[2] "Small-Cap Stock Investing" by Charles Schwab
[3] "The Role of Small-Cap Stocks in Asset Allocation" by Vanguard

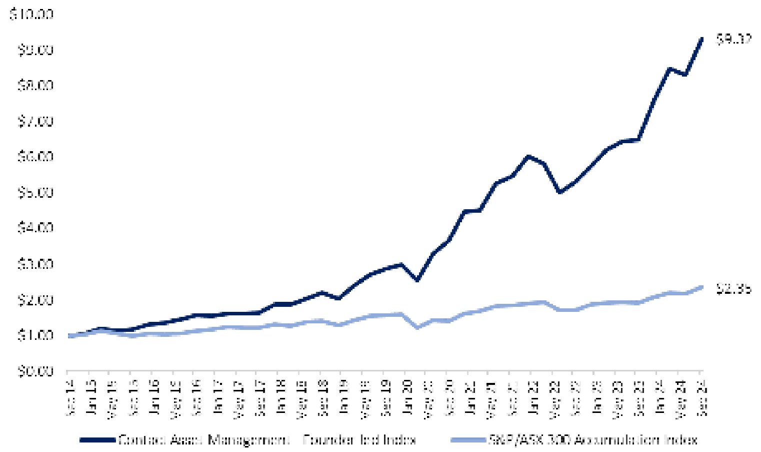
We believe that a SMID (small and mid) Cap portfolio can combine to generate strong results yet overcome some of the criticisms of small cap investing such as liquidity constraints. Mid-caps have generated strong returns over the past decade

Source: FactSet, Contact Asset Management

We are also huge advocates of investing in Founder-led businesses. For small-cap companies, which are typically more vulnerable to economic downturns and market volatility, strong leadership is critical. Founders, with their deep commitment to the success of their business, often have a better understanding of how to navigate challenges and sustain growth over the long term. This leadership-driven resilience can be particularly valuable in the small-cap space, where businesses are more likely to face cash flow constraints, competitive pressures and operational challenges.

The data supporting the outperformance of founder-led businesses is substantial. According to research by Anchor Capital Advisors in their report *"Founder-Led Companies,"* these companies have consistently outpaced non-founder-led firms in terms of both revenue growth and stock performance. Over the past decade, founder-led companies have delivered returns that are approximately three times higher than their counterparts. We have back tested this and created our own Contact Asset Management proprietary database of ASX listed Founder-led businesses. As detailed in the chart below, over the past decade, a portfolio of ASX Founder-led businesses has significantly outperformed the broader index.

Investing in Founder-led businesses is also proven to have delivered excellent returns



Source: FactSet, Contact Asset Management

This performance can be attributed to several key factors. First and foremost, founder-led businesses often exhibit a deep-rooted sense of purpose and long-term vision. Unlike professional CEOs who may be more focused on quarterly earnings and short-term stock performance, founders tend to prioritize the long-term health and sustainability of their companies. This focus on the future can lead to more strategic investments in innovation, research and development, all of which are crucial for driving growth in small-cap companies.

Moreover, founders are more likely to have a significant personal financial stake in their businesses, aligning their interests with those of shareholders. According to Bain & Company's article *"Founder-Led Companies Outperform the Rest — Here's Why,"* the founders of successful companies often hold large equity stakes, which incentivises them to focus on long-term value creation rather than short-term profits.

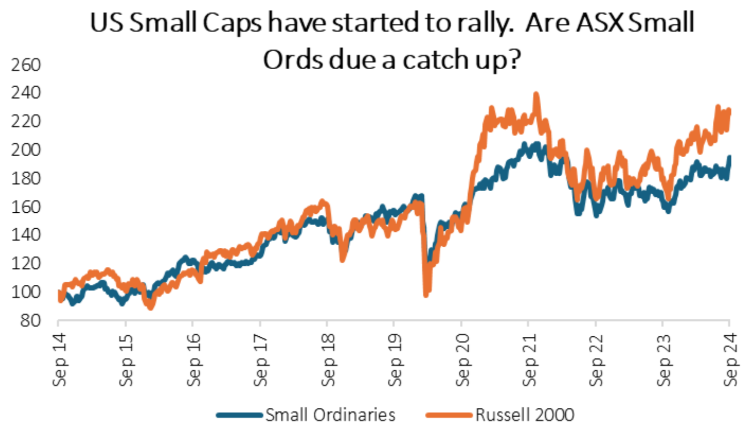
We believe that an investment process that focuses on Quality, Founder led and a SMID cap combination is best positioned for long-term success.

Conclusion

Small-cap stocks offer a compelling investment opportunity for those willing to embrace higher risk in exchange for the potential for superior long-term returns. By incorporating small-cap stocks into a diversified portfolio, investors can enhance their risk-adjusted returns and gain exposure to companies with high growth potential.

For investors looking to diversify their portfolios and capture high-growth opportunities, founder-led small-cap stocks represent a powerful combination of entrepreneurial spirit and market potential. By focusing on businesses where founders remain at the helm, investors can tap into the unique strengths of founder-led companies, including their commitment to innovation, alignment of interests with shareholders and ability to drive long-term value creation. While these businesses are not without risks, the historical outperformance of founder-led companies makes them a valuable addition to any investment strategy aimed at capturing the upside of small-cap investing.

We believe that we are at an interesting junction for Australian small-caps, particularly given the relative underperformance against the S&P/ASX Top 20 over the past three years. As economic conditions recover, buoyed by lower interest rates and more recently Chinese stimulus, we could see an improved performance in the segment. We are starting to see evidence of improved performance in US small caps and believe that our local counterparts could follow.



Source: FactSet, Contact Asset Management