Systematically Small

The advantages of a systematic, broad market investing approach to small-cap equities

Invesco Australian Equities

Introduction

Small-cap equities can be an emotional space. Pundits ‘fall in love’ with one stock and ‘out of love’ with another. ‘Hot stock alerts’, ‘disruptors’, and ‘next big things’ are declared… with the occasional ‘blow-up’ that tempers enthusiasm. Large-cap equities tend to be a less emotional space due to the maturity of the companies involved and broad-market investment approaches. But broad-market investing approaches - such as systematic investing - can be applied just as effectively to the small-caps space. In fact, it offers benefits that can be otherwise hard to find.

The following paper explores key benefits that systematic investing can bring to small-cap investing.

1. Openness to macroeconomic change,
2. Superior diversification and liquidity from high breadth,
3. Consistent alpha from targeted risk taking,
4. True to label and low cost.

What is Systematic Investing?

Systematic investors employ quantitative models based on research from academia and from investment practitioners. Systematic investors employ large data sets of ‘signals’, grouped into ‘factors’, to invest in the broad market. They overweight attractive stocks and underweight unattractive stocks within tolerances that keep the fund from straying too far from the benchmark.

Alternatively, fundamental investors engage onsite with firms’ management and their suppliers and customers in a time-demanding process and must necessarily manage only a concentrated portfolio of high-conviction stocks. Both approaches, however, look for the same characteristics in a small-cap investment.

‘Momentum’ in fundamentals and sentiment

‘Quality’ management teams and financial statements

‘Value’ in the price of the stock

While both approaches broadly agree on what to look for in a good small-cap investment, the main difference ends up being about portfolio construction, with the systematic approach bringing some attractive differentiators.

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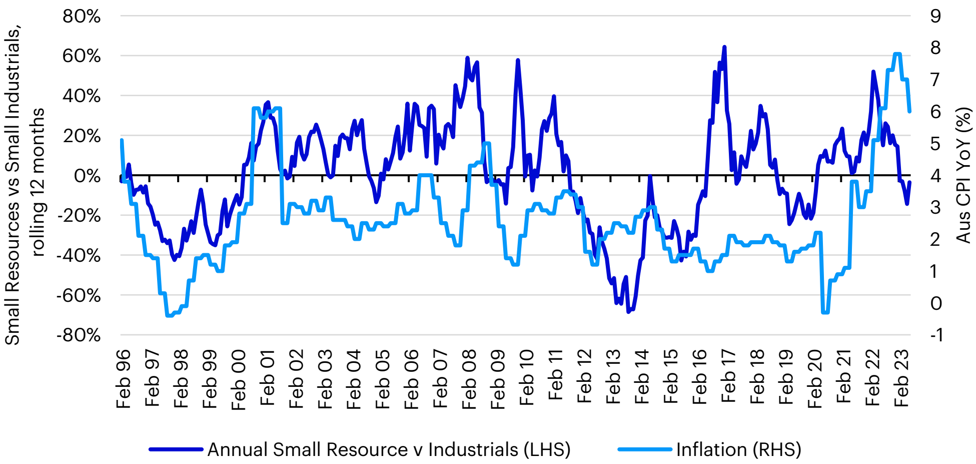
1. Openness to macroeconomic change

The broad-market approach of systematic investing opens up exposure to sectors such as energy and resources - sectors fundamental small-cap managers tend to eschew (focussing instead on industrial stocks). Resource stocks tend to outperform in periods of high inflation (see Figure 1), whether because strong economic growth drives inflation and resource demand (as in 2006) or because resource supply issues raise commodity prices which drive inflation (as in 2022). A broad-market approach to small-caps provides exposure to macroeconomic regime shifts such as these, enabling performance to be generated in different economic conditions.

Figure 1. Small-cap Resource stocks vs Industrials, vs inflation



Source: Invesco Australian Equities; Small Ords Resources Accumulation index vs Small Ords Industrials Accumulation index, vs Australian Consumer Price Index. 29 February 1996 – 30 June 2023.

The benefit systematic investing offers in the small-caps space is having stock level coverage across the whole investment universe.

In 2022, an exposure to stocks in the resources sector – energy industry in particular - rewarded broad-market investors as commodity prices surged. Importantly, however, successful investing wasn't a one-way bet, as what started as supply-side driven support for commodity prices exaggerated by the Russia-Ukraine war, waned as the year drew to a close. Stock selection and diversification was key.

The benefit systematic investing offers in the small-caps space is having stock level coverage across the whole investment universe. Using Invesco's Wholesale Australian Smaller Companies Fund (the Fund) as an example, we can see this was demonstrated in the Energy sector in 2022, where a modest overweight in H1 was reduced to an underweight by the end of the year, but stock-selection did the heavy lifting. While the Fund benefitted from strong overweights in New Hope Corporation (NHC) and Whitehaven Coal (WHC) in Q1, the Fund diversified in the middle of the year to pare risk concentrations. Both names were reduced with WHC ultimately removed as it graduated into the ASX100. Viva Energy (VEA) was added, and Paladin (PDN) retained. Beach Petroleum (BPT) and Karoon Gas (KAR) were the largest underweights, helping to balance industry exposure. In all, the Energy sector contributed over 3% to relative returns, driven largely by stock selection (see the return attribution in Figure 2). Being open to opportunities presented by the macro-economic cycle but managing a risk-controlled industry exposure benefited investors in the Fund.

Figure 2: Invesco Wholesale Australian Smaller Companies Fund return attribution, 2022.

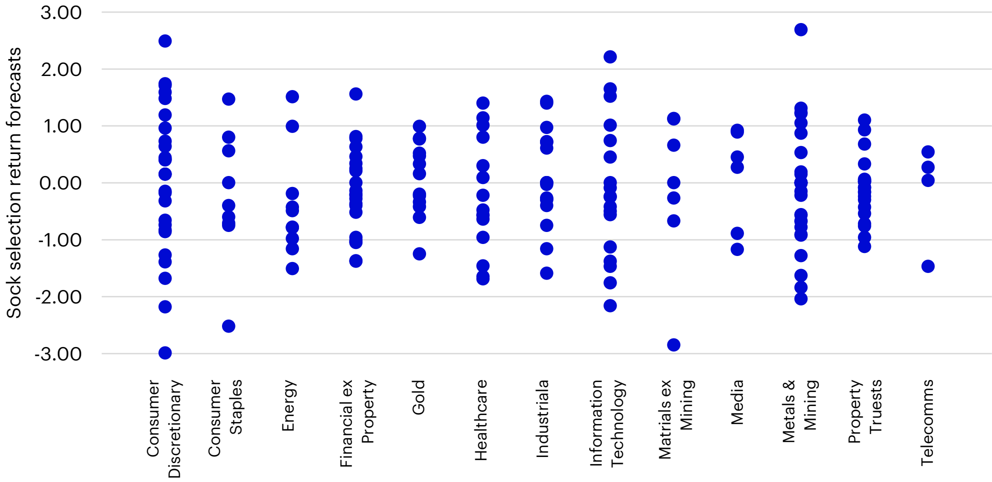
Industries	Portfolio Weight	Benchmark Weight	Active Weight	Portfolio Return	Benchmark Return	Industries Allocation Effect	Stock Selection Effect	Total Effect
Energy	**6.83%**	**5.58%**	**1.25%**	**107.45%**	**45.42%**	**0.88%**	**2.16%**	**3.04%**
Consumer Discretionary ex Media	15.46%	13.46%	2.00%	-17.13%	-27.03%	-0.17%	1.73%	1.56%
Information Technology	10.44%	8.66%	1.78%	-29.85%	-39.19%	-0.44%	1.21%	0.77%
Metals & Mining ex Gold	14.69%	12.85%	1.85%	-13.00%	-15.94%	-0.11%	0.59%	0.48%
Consumer Staples	3.80%	4.95%	-1.14%	-7.51%	-15.43%	-0.10%	0.34%	0.23%
Industrials	7.99%	8.30%	-0.31%	-0.81%	-4.65%	-0.07%	0.27%	0.21%
Health Care	6.71%	5.90%	0.81%	-22.01%	-23.84%	-0.09%	0.14%	0.05%
Media	1.69%	2.09%	-0.41%	-33.38%	-26.41%	-0.02%	-0.19%	-0.21%
Materials ex Metals & Mining	2.36%	3.89%	-1.53%	-20.53%	-12.47%	-0.10%	-0.13%	-0.24%
Telecommunication Services	1.53%	3.52%	-1.99%	8.93%	2.23%	-0.39%	0.11%	-0.28%
Property Trusts	12.81%	13.61%	-0.80%	-18.09%	-15.79%	-0.01%	-0.29%	-0.31%
Gold	6.12%	6.26%	-0.14%	-10.53%	-8.74%	-0.27%	-0.14%	-0.40%
Financials ex Property Trusts	9.56%	10.93%	-1.37%	-32.07%	-26.82%	0.18%	-0.60%	-0.42%
Total Portfolio				**-12.79**	**-18.38**			**5.59**

Source: Invesco, Axioma as at 31-Dec-2022. Brinson return attribution.

While the Energy sector presented accretive opportunities in 2022, a more traditional hunting ground – small-cap industrials – delivered poor returns over the year. The pathway to overall outperformance again needed to be stock selection and risk control. As highlighted in Figure 2, the consumer discretionary industry benchmark return was -27%. Clearly, with tightening interest rates designed to curb discretionary spending and rein in inflation, headwinds were present for small-cap investors. Following a systematic investing process allowed for effective stock selection however, and the portfolio was able to outperform while having a net overweight industry position. Lovisa (LOV) was a standout, where the Fund built a large overweight in the middle of the year in time for strong outperformance – many other contributors came from underweights. Other overweights in names like Super Retail Group (SUL), Premier Investments (PMV) and AP Eagers (APE) were risk controlled such that challenging performance of these consumer stocks were not damaging overall, especially with the underweights to less favoured names like City Chic (CCX) and Points Bet (PBH) being particularly accretive. The fund earned 1.73% of relative performance from the Consumer Discretionary industry from good stock selection, with only a modest -0.17% of "industry allocation effect". In a year when the macro-economic kitchen sink was thrown at small-cap investors, being open to macro-economic change and having an adaptive approach to stock selection and risk control was the key to the Fund generating 5.6% outperformance in 2022.

Opportunities can be captured across the entire Australian small-cap universe through systematically covering every stock, every day. Figure 3 shows how the Fund achieves full coverage, with all industries included and return forecasts for every stock.

Figure 3: Invesco Australian Smaller Companies Strategy alpha scores for all ASX Industries



Source: Invesco as at 30 June 2023

There are no pet stocks, hot themes, or sweet-spot industries to risk obscuring opportunities from areas out of focus.

This ensures bias does not creep in… there are no pet stocks, hot themes, or sweet-spot industries to risk obscuring opportunities from areas out of focus. Systematic investing is open to access alpha from all areas.

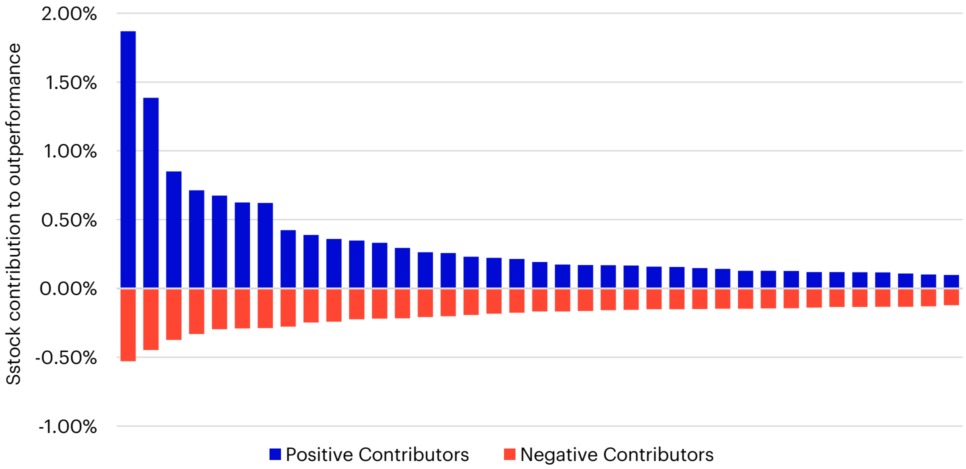
2. Superior diversification & liquidity from high breadth

The performance of concentrated portfolios can be significantly impacted by a small number of problematic stocks, due to large individual positions. In macroeconomic regime shifts, such as we experienced in 2022, swathes of stocks and sectors are impacted simultaneously. Concentrated portfolios are at risk of severe underperformance in these periods, and once the new regime sets in it can be very difficult to trade out of problematic positions in a small-cap portfolio - due to restricted liquidity. This can be further exacerbated by client withdrawals triggered by the poor performance (forcing sales at the 'bottom').

2022 saw considerable rotation in the market with outperformance for resource stocks and a sharp sell down of expensive growth companies. Some small-cap managers were significantly impacted by this market environment; the average performance of small-cap managers in the bottom quartile in the Mercer survey was -7.7% relative to index for the calendar year 2022.

Invesco Australian Equities' process focuses on high diversification, seeking performance across all sectors, allowing performance capture regardless of market cycle and macroeconomic regime. The +5.6% outperformance of the Fund in 2022, for instance, was driven by contributions from a wide range of individual stock positions (Figure 4).

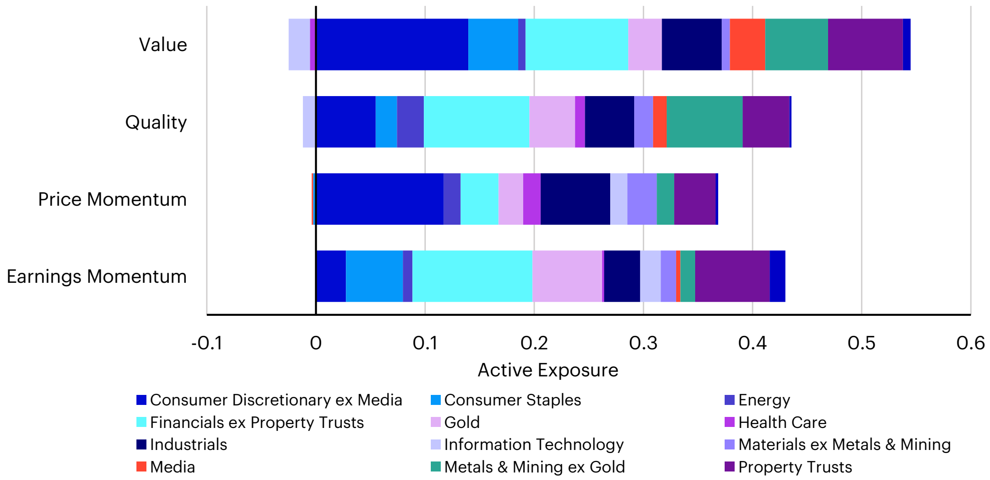
Figure 4: Invesco Wholesale Australian Smaller Companies Fund stock contributions, 2022.



Source: Invesco– 1 Jan 2022 – 31 December 2022.

In addition to stock diversification, systematic investing processes also help to achieve diversification across industries and styles. Figure 5 shows the Fund's active exposures being positive across all style factors and being achieved across all industries.

Figure 5: Diversification across stocks, industries and styles avoids concentration risks



Source: Invesco Wholesale Australian Smaller Companies Fund, as at 30 June 2023

High breadth also helps solve the challenge of liquidity risk. Figure 6 describes the liquidity challenge in Australian small-caps and shows that the ability to build large active positions with modest liquidity risk (5-days average trading value) is very limited beyond the largest 50 names. Systematic investing processes typically spread active share across a large set of names, avoiding being trapped in names that may take weeks to liquidate.

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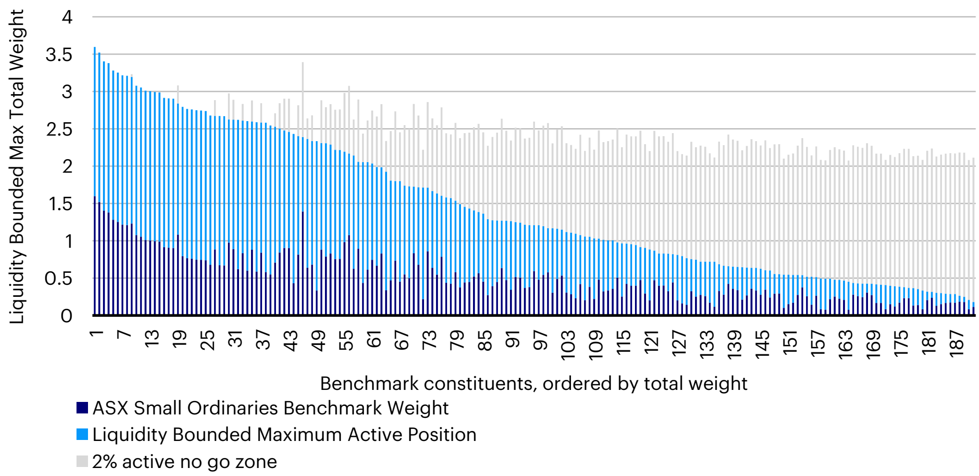
Figure 6: Australian Smaller companies benchmark weight, with liquidity bounded active weights



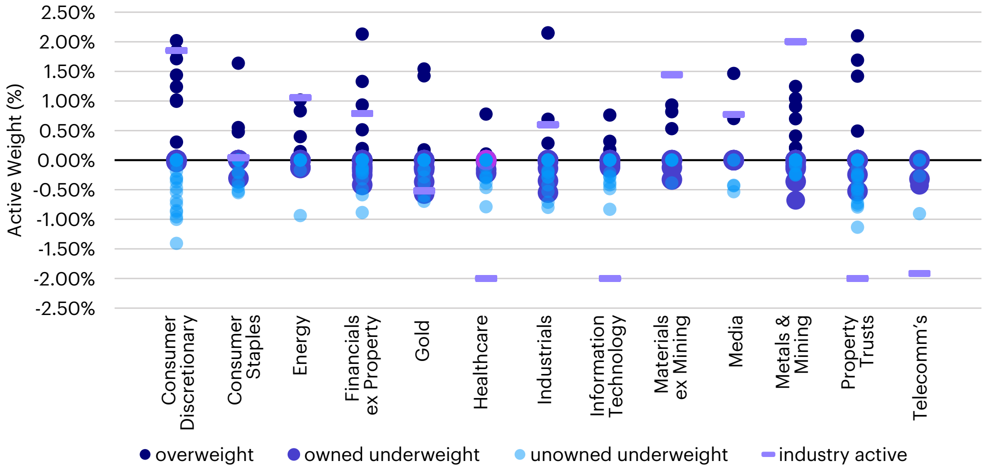
Source: Invesco. Benchmark weights are a snapshot in time, as are the average daily value measured, over a 62-day trailing window.

3. Consistent alpha from targeted risk taking

Systematic investing approaches, such as Invesco Australian Equities' approach, provide exposure to the broad market - overweight or underweight relative to the benchmark on an individual stock level based on the attractiveness of the stock's 'signals'. If the model thinks a stock has a high potential for out-performance it will be overweight (although the language used would be 'strong positive signals across all three factors – Momentum, Quality and Value'). But the exposures that come along with this stock selection; industry, size, etc; will be balanced with other positions taken in the portfolio to ensure the focus of active risk remains on intended stock selection rather than incidental macro-thematic tilts.

As an example, the Fund controls extraneous exposures to ensure a balanced exposure to the economic environment through the cycle while benefiting from a large number of individual stock selection opportunities. Figure 7 displays how the breadth of position taking occurs within controlled stock and industry limits relative to benchmark.

Figure 7: Position sizing targeted to meet alpha and tracking error objectives



Source, Invesco Wholesale Australian Smaller Companies Fund, as at 30 June 2023. Return & risk objectives are achieved by strict stock and industry constraints: Stock active +/- 2%, Industry active +/- 2%

The model is disciplined and highly diversified, and Value and Quality, for instance, maintain guardrails on Momentum – which is where the strong out-performance comes from. Systematic investing benefits from these guardrails by not holding strong Momentum stocks too long. Unbridled, Momentum investing can be prone to drawdowns when sensible valuations and business quality go unchecked. The complementary nature of Momentum, Quality and Value lowers Tracking Error and enhances the risk-return trade-off, a clear benefit of diversification.

4. True to label and low cost

From a portfolio management perspective, small-cap managers are offering 'Satellite' diversification from investor's 'Core' ASX100 holdings. A problem arises however when small-cap managers hold growth stocks into the ASX100 and beyond (think Wisetech and Xero). Investors with an existing large/broad cap 'Core' allocation then find themselves, perhaps inadvertently, with an increased portfolio concentration in names they already hold.

As an example, Invesco Australian Equities maintain their ASX300 ex-ASX100 scope, retaining a true-to-label small-cap focus and avoiding the ASX100 overlap. Afterall, there are always attractive growth companies emerging into the ASX300 from below which are brought into our investment model's scope.

In addition, systematic investing is simultaneously broad and disciplined because it's a rules-based investing approach. The time saved with efficient quantitative information gathering and analysis is passed on to the investor in the form of low fees, and the research costs and findings are shared by Invesco's global team of systematic investment professionals.

Conclusion

Systematic investing offers significant benefits for small-cap equities, making it a compelling and practical approach for investors. By examining the key advantages presented in this paper, we can see how systematic investing can outperform traditional methods in the small-cap space on a risk-adjusted and after-fees basis.

Firstly, the openness to macroeconomic change allows systematic investors to capitalise on shifts in economic conditions and industries that fundamental managers might overlook. By covering the entire investment universe and diversifying across all sectors, systematic investors can generate performance in different economic scenarios.

Secondly, superior diversification and liquidity from high breadth are essential for managing risk and avoiding severe underperformance during market shifts. The wide range of individual stock positions and diversified exposure to industries and styles enable systematic investors to reduce concentration risks and trade out of positions with limited liquidity risk efficiently.

Thirdly, consistent alpha is achieved through targeted risk-taking. The disciplined approach of systematic investing ensures that exposures to individual stocks are balanced, preventing excessive reliance on macro-thematic tilts and enhancing the risk-return trade-off.

Moreover, remaining true to the small-cap label ensures that systematic approaches provide investors with a distinct and complementary allocation to their core ASX100 holdings without unintended overlaps.

Finally, the low cost of systematic investing is a significant advantage. With the efficiency of rules-based approaches and shared research costs, systematic managers can offer investors lower fees while maintaining strong performance potential.

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Important information