Invesco

Smaller Companies, Bigger Opportunities in 2024

Invesco Australian Equities

Executive summary

Investing in smaller Australian companies offers investors a broader opportunity set and more diverse growth opportunities compared to larger companies. The S&P/ASX 300 Index, representing the broader Australian equity market, is heavily concentrated in a few companies and industries, while smaller companies, as represented by the S&P/ASX Small Ordinaries Index, provide less concentration and access to secular growth opportunities. Moreover, smaller companies offer higher potential for active management to add value over a naïve capitalisation-weighted benchmark due to their dynamic business models and industry exposures.

Recent performance of smaller companies has been challenged by monetary headwinds, including aggressive monetary tightening by the Reserve Bank of Australia (RBA). However, as we approach the end of this tightening cycle and enter a period of greater economic stability, the outlook for smaller companies is improving. The global macro environment is also highly supportive of small company exposure, with value spreads remaining elevated, creating a constructive environment for active management.

This paper highlights the key value proposition of a quantitative approach to investing in smaller companies, exploring the fundamental opportunities offered by this diverse asset class and what market cycles tell us about possible future performance.

Overview

In Australia, investing in smaller companies provides investors with a range of potential opportunities to improve returns and reduce risk. The broader Australian equity market (as represented by the S&P/ASX 300 Index) is extremely concentrated, with a small number of companies and industries driving both the risk and return outcome for investors. In contrast, smaller companies within Australia (as represented by the S&P/ASX Small Ordinaries Index) offer far less company, and industry, concentration whilst also providing investors with the opportunity to participate in secular growth opportunities that are difficult to access in more established business models.

In addition to the greater exposure to more dynamic industries and business models, smaller companies have typically offered investors significantly higher active return opportunities than traditional broad market exposure. The median active smaller companies manager has persistently outperformed the S&P/ASX Small Ordinaries index over time. The opportunity for active management is greater because of the ability to access diverse business models and the ability to avoid investing in poor performers such as highly speculative companies. Our analysis shows that by avoiding the most speculative growth companies, investors may have historically earned an additional 3% per year above a naïve S&P/ASX Small Ordinaries index.

It is well documented that company fundamentals play a key role in differentiating expected returns amongst companies. Our analysis confirms that traditional return drivers such as Value, Momentum and Quality have displayed just as much efficacy in Australian smaller companies as they do in other market segments. Fundamental return drivers have been extremely well rewarded in smaller companies over the recent past and the longer term. When we evaluate the current opportunities within the small cap universe, we see relatively high levels of dispersion in market pricing which we believe will continue to be supportive for active management, and particularly those strategies that are focussed on proven return drivers such as Value, Momentum and Quality.

We acknowledge that the performance of smaller companies in Australia has been challenged over the past two years. This period of underperformance has been the highest we have seen in the past decade and coincides with a period of relatively high inflation and consequently aggressive monetary tightening by the RBA. Over the two years ending 31 December 2023, the RBA has raised interest rates 13 times, and this has put increasing pressure on smaller companies relative to their larger counterparts. Smaller companies are typically more sensitive to the domestic economy and typically have more debt than larger companies. At the end of 2023, we have a much more stable economic environment with falling inflation and more dovish policy settings from central banks globally. Looking at the business cycle in more detail, our own proprietary models suggest that globally we are entering the “recovery phase” of the business cycle. Historically, the recovery phase has been incredibly supportive for companies with cyclical exposure, high operating leverage, and higher sensitivity to a rebound in growth expectations. These characteristics are typically found in smaller companies as opposed to larger companies.

Australian smaller companies present significant opportunities for investors in 2024. Their greater diversity, exposure to dynamic industries, and potential for active management make them an attractive investment choice. Despite recent performance challenges, the evolving economic landscape and supportive global macro environment indicate a promising outlook for smaller companies.

Structural opportunities: Revisiting the case for Australian Smaller Companies

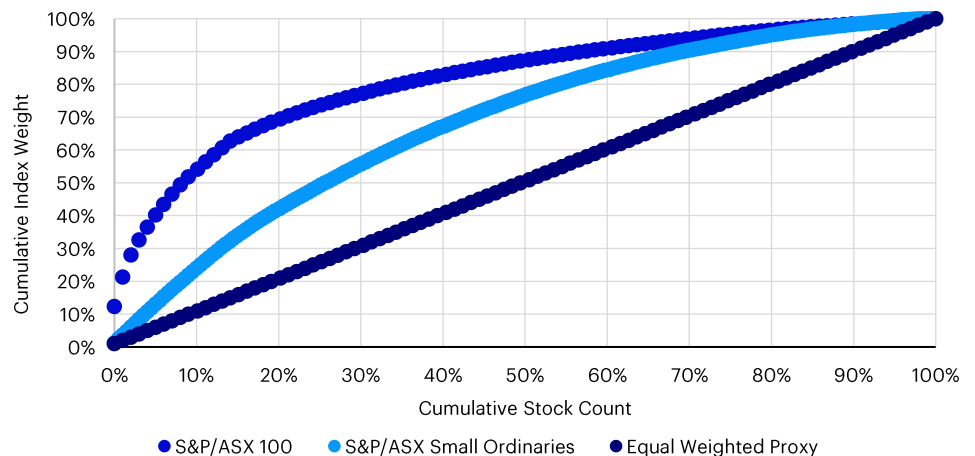
Greater opportunity set

One benefit of smaller companies is that, by definition, there are a greater number of smaller companies than there are larger companies, and this means that the underlying index representation for smaller companies is more diverse and less concentrated than larger companies (S&P/ASX 100 Index).

When we look at smaller companies using the S&P/ASX Small Ordinaries index we see that it is over five times more diversified than the larger companies exposure of the S&P/ASX 100 Index. The more diverse company exposure of smaller companies presents far greater levels of breadth for active investors to add value.

To get a visual sense of the concentration of larger companies in the Australian market, in Figure 1 we plot the cumulative index weight against the cumulative number of stocks held within an index.

Figure 1: Stock level concentration



Source: Invesco as at 31 December, 2023. Standard and Poors'

For the S&P/ASX 100 we can see that the top 10% of stocks make up just over 50% of the index weight. Whereas for the S&P/ASX Small Ordinaries, the top 10% of stocks make up 23% of the index weight. For illustrative purposes we have also included a fully diversified equal weighted portfolio as a proxy for the minimum concentration level.

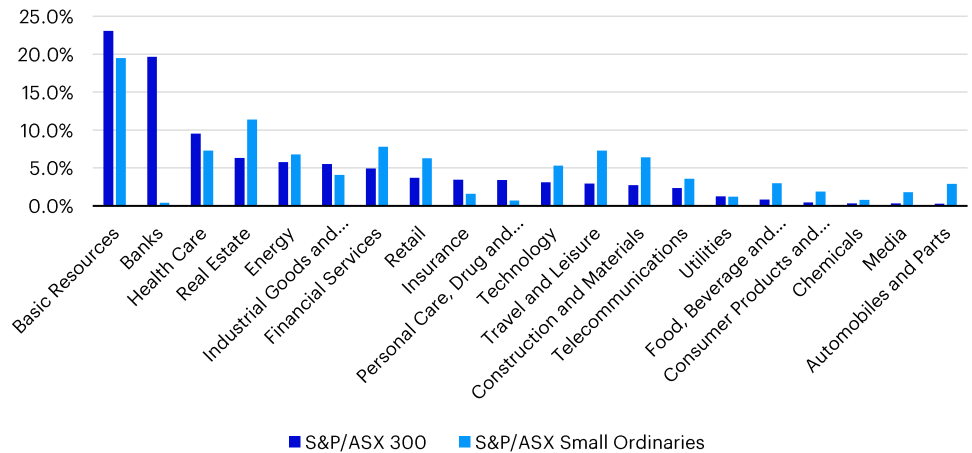
The extreme concentration within larger companies in the Australian equity market severely restricts the opportunity for active management and leaves investors with potentially under-diversified exposures.

More diverse economic exposure

Not only are there effectively more stock picking opportunities for active investors in smaller companies, the S&P/ASX Small Ordinaries also offers a more balanced mix of industries than is effectively available when investing in the broader market.

The industry concentration of the S&P/ASX 300 and S&P/ASX Small Ordinaries is shown in Figure 2. The key differences arise from the dominant impact of the Australian banks, miners and healthcare (CSL), leaving the S&P/ASX 300 Index with half of its market capitalisation in these three industries. However, the S&P/ASX Small Ordinaries doesn't have the same level of industry concentration, representing a more diverse mix of economic exposures with meaningful impact. Specifically, the S&P/ASX Small Ordinaries Index has 10.7% allocation to secular growth sectors such as Technology, Media and Telecommunicatons (TMT) compared to just 5.8% for the broader S&P/ASX 300 index.

Figure 2: Industry Exposures



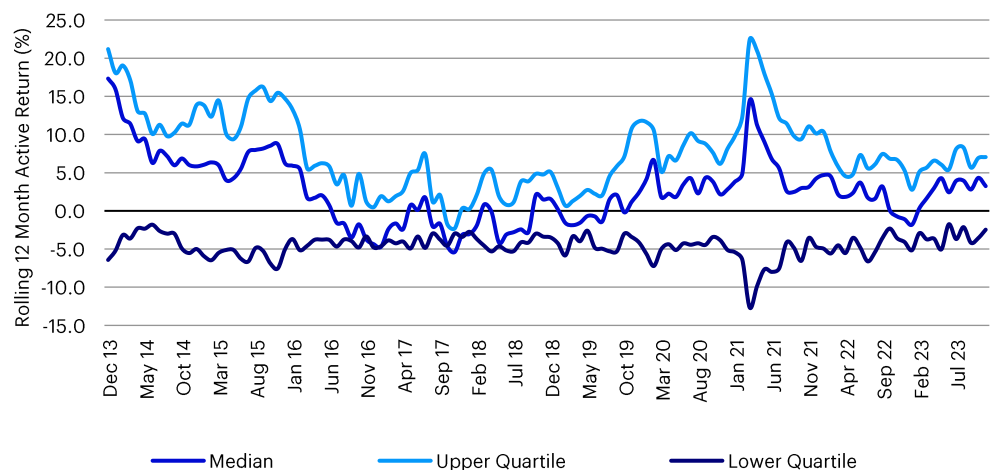
Source: Bloomberg, Invesco as at 31 December, 2023. Industries shown are the Industry Classification Benchmark (ICB) Super-sectors, as defined by FTSE and Dow Jones.

Having a more diverse mix of economic exposures presents active smaller companies investors with a greater ability to build portfolios with balanced risks and to benefit from a broad array of economic drivers.

Greater opportunity for active investors

Over time, active managers have displayed considerable and persistent skill in outperforming the S&P/ASX Small Ordinaries index. The persistent dominance of active managers in Australian smaller companies is unique and suggests that there are certain types of companies that active managers as a whole tend to persistently avoid.

Figure 3: Active manager returns (vs S&P/ASX Small Ordinaries Index)



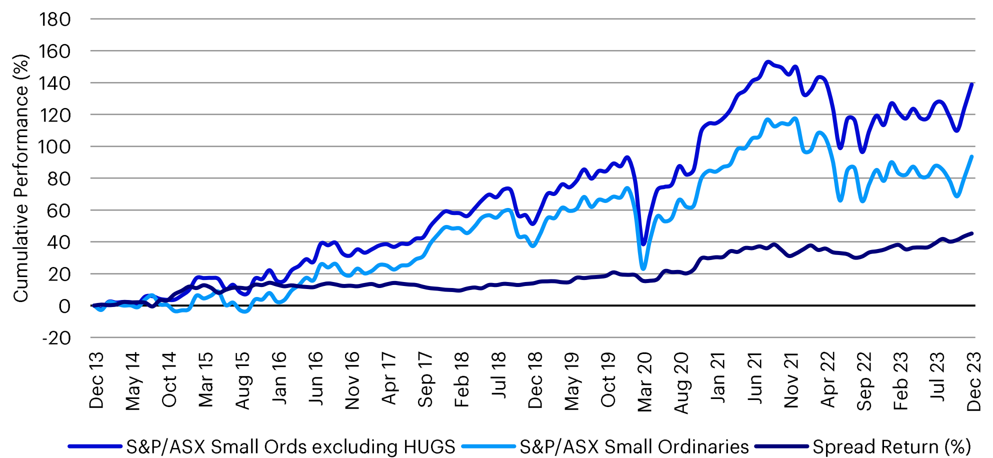
Source: Mercer, as at 30 November, 2023. Mercer Median Manager data is based on the Australian Small Cap universe. MercerInsight™: Information contained herein has been obtained from a range of third-party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

Our extensive analysis of Australian smaller companies shows that there are a number of common characteristics of underperforming small companies and that these characteristics can be exploited systematically. In the following section we provide an illustrative example of how investors can potentially avoid underperforming smaller companies.

Avoiding stocks with high uncertain growth expectations

Historically, companies with high forecasted growth that is yet to materialise are often over-priced. One technique for screening out such companies is to rank companies by their price-to-sales multiple and avoid investing in the highest-ranking companies. The chart in Figure 4 tracks the performance of a strategy avoiding the highest quintile (top 20%) of price-to-sales companies in the S&P/ASX Small Ordinaries Index. The chart demonstrates that simply avoiding the most expensive and speculative companies in the S&P/ASX Small Ordinaries Index you may be able to add considerable value over time.

Figure 4: Excluding high uncertain growth stocks (HUGS)



Source: Bloomberg. Backtest between Dec 2013 and Dec 2023, S&P/ASX Small Ordinaries portfolio benchmark. HUGS screen is Market Cap / Trailing Sales < 30. Screened portfolio is cap-weighted and rebalanced monthly. Past performance is not a guarantee of future performance.

Fundamental opportunities in Australian Small Companies

In addition to the relatively simple strategy of avoiding highly speculative and highly valued companies we also see a high amount of efficacy from traditional fundamental drivers of company performance, such as:

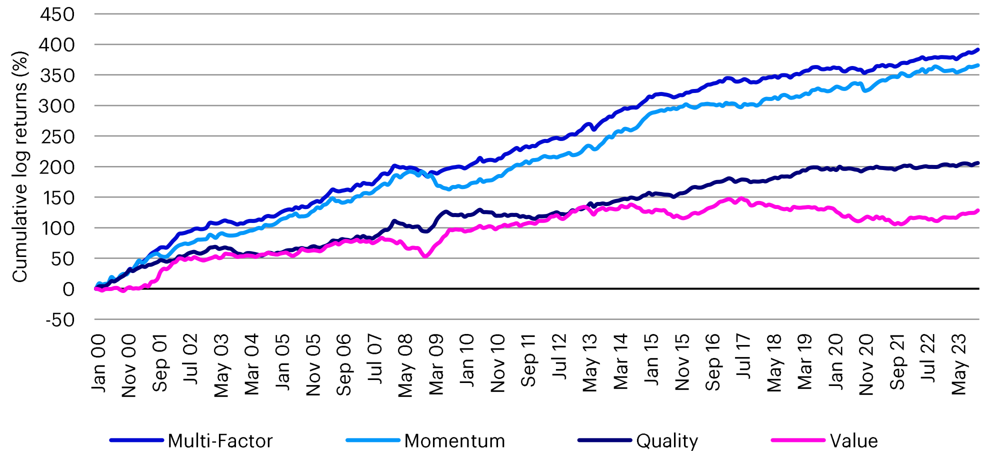
- **Momentum:** companies with growing fundamentals and improving market sentiment.
- **Quality:** companies with sustainable earnings, good management, and strong business franchises.
- **Value:** companies which are priced relatively attractively, with mispricing providing an opportunity for value to be captured.

Whilst these might sound like highly technical terms, they are merely taking advantage of what active investment managers have been doing for decades.

As demonstrated in Figure 5, these fundamental factors have been persistent drivers of returns in Australian smaller companies and across both the broader market.

Momentum has shown to be a particularly influential factor in the Australian market, reflecting the unique characteristics of the local economy and investor preferences for high growth opportunities. Combining Momentum with other key return drivers, such as value and/or quality, can help to provide a well-rounded investment approach.

Figure 5: Long-term factor returns in Australian smaller companies (S&P/ASX Small Ordinaries)



Source: Invesco. Model portfolio returns between Feb 2000 and Dec 2023. Past performance is not a guarantee of future performance. S&P/ASX Small Ordinaries Universe.

Focusing in on smaller companies, we note the key drivers of return are consistent across the broader market and smaller companies. Therefore, systematically using factors to drive stock selection is a reliable strategy for long-term outperformance of the ASX Small Ordinaries index.

Figure 6: Long-term factor returns in Australian equities

S&P/ASX Small Ordinaries Universe

February 2000 – December 2023	Multi-Factor	Momentum	Quality	Value
Annualised Active Return	6.9%	6.6%	4.8%	3.5%
Annualised Tracking Error	4.1%	4.9%	4.1%	5.7%
Information Ratio	1. 7	1.4	1.2	0.6

S&P/ASX 300 Universe

February 2000 – December 2023	Multi-Factor	Momentum	Quality	Value
Annualised Active Return	6.7%	6.4%	5.1%	3.6%
Annualised Tracking Error	4.2%	4.7%	4.3%	5.3%
Information Ratio	1.6	1.4	1.2	0.7

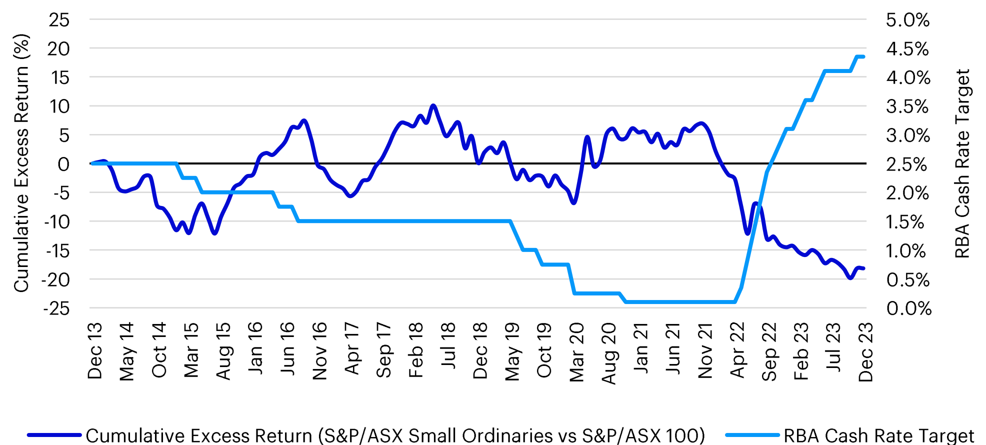
For more information on how a systematic approach can outperform traditional smaller companies investing methods, read our paper, "Systematically Small".

Current opportunities: Increasing economic stability provides strong tailwinds for 2024.

Comparing the performance of Australian Smaller Companies versus the S&P/ASX 100 – their larger compatriots on the Australian Securities Exchange (ASX) – we note a stark underperformance of the smaller cohort in recent years. The chart in Figure 7 plots the ratio of the last ten years of the S&P/ASX Small Ordinaries index to the S&P/ASX 100 index overlayed with the RBA cash rate. When the ratio is 0 then the cumulative performance of the S&P/ASX Small Ordinaries index and the S&P/ASX 100 index is the same, if the line is above 0 then the cumulative returns for the S&P/ASX Small Ordinaries index is higher than the S&P/ASX 100 index and vice versa.

When we look at the relative returns, we can see that from the end of 2013 through to the beginning of 2022 the absolute return outcomes for both larger companies and smaller companies were similar. However, we do note that over that cycle there were short term periods of both underperformance and outperformance. More recently, we have seen a sustained underperformance of smaller companies relative to larger companies. On closer inspection we can see that the recent underperformance of smaller companies has coincided with consistent and persistent rises in interest rates. The persistent monetary tightening impacted the risk appetite of investors, and the market has also penalised companies with longer duration (higher expected growth) profiles and higher levels of debt.

Figure 7: Cumulative Relative performance of S&P ASX Small Ordinaries to S&P/ASX 100



Source: Bloomberg, Invesco, for date period December 2013 to December 2023. The performance ratio places ASX Small Ordinaries return index in the numerator, dividing by the ASX100 return index. A falling (rising) ratio indicates under (out) performance of the ASX Small Ordinaries relative to the ASX100.

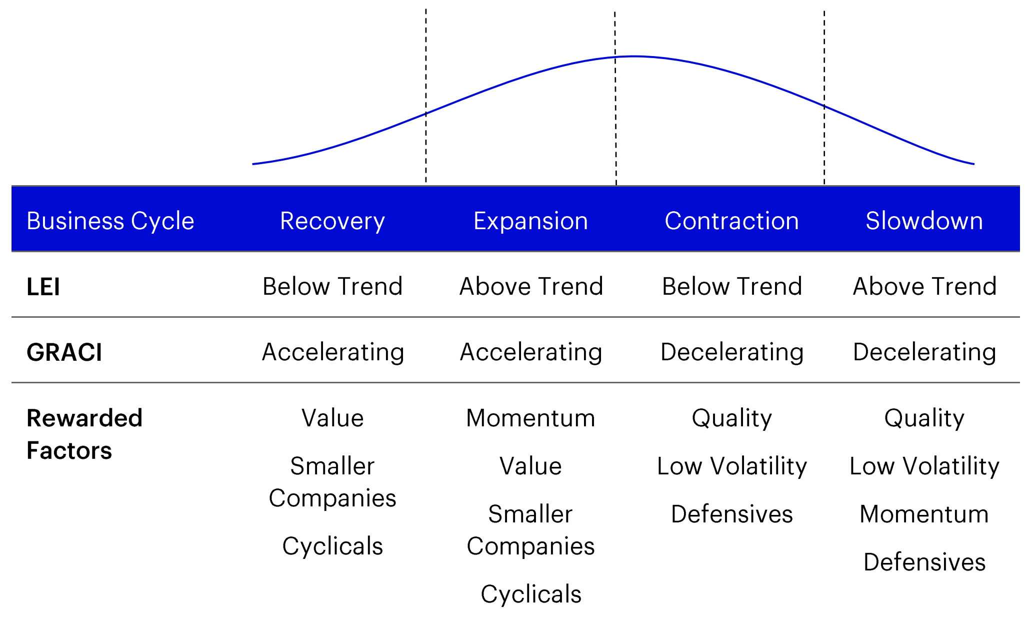
The current economic environment at the end of 2023 is much more stable than what we were experiencing at the beginning of 2022. With declining inflation and a more stable economic backdrop, the market is anticipating an increasingly dovish interest rate policy over the medium-term. We have seen this more dovish sentiment being reflected in asset markets in the fourth quarter of 2023. For the fourth quarter of 2023 the performance of both the S&P/ASX 300 and the S&P/ASX Small Ordinaries was strong, returning 8.4% and 8.5% respectively.

The economic cycle is supportive of smaller companies' outperformance

In addition to the current interest rate cycle, we examine the characteristics of economic regimes and how they relate to the outlook for factor performance. To this end, we measure regimes using a combination of global risk appetite and leading indicators of economic growth. Our composite macro regime framework combines our proprietary U.S. leading economic indicator (LEI) and global risk appetite (GRACI) to forecast the four stages of the business cycle.

The Global Leading Economic Indicator (LEI) is a proprietary, forward-looking measure of the growth in the economy. A reading above (below) 100 on the Global LEI signals growth above (below) a long-term average. The Global Risk Appetite Cyclical Indicator (GRACI) is a proprietary measure of the market's risk sentiment. A reading above (below) zero signals a positive (negative) compensation for risk-taking in global capital markets in the recent past.

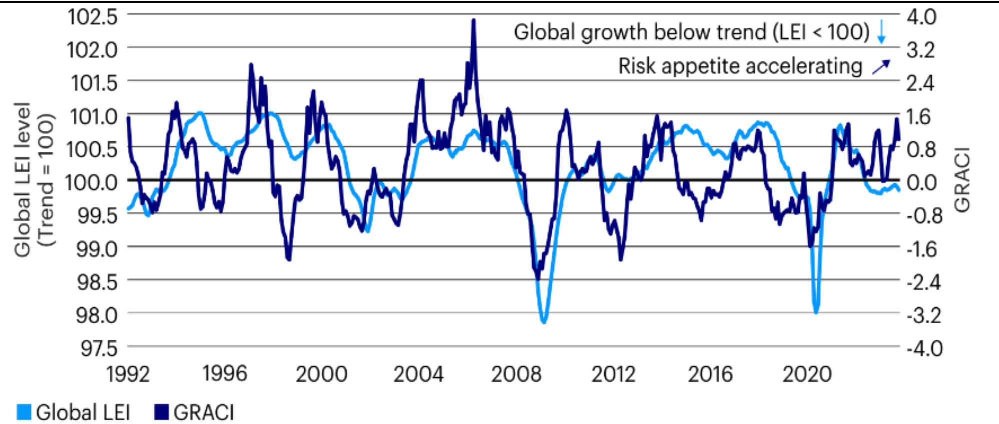
Figure 8: Business cycles and Factor Regimes



Business Cycle	Recovery	Expansion	Contraction	Slowdown
LEI	Below Trend	Above Trend	Below Trend	Above Trend
GRACI	Accelerating	Accelerating	Decelerating	Decelerating
Rewarded Factors	Value Smaller Companies Cyclicals	Momentum Value Smaller Companies Cyclicals	Quality Low Volatility Defensives	Quality Low Volatility Momentum Defensives

Global risk appetite is stabilising at levels consistent with prior peaks in the post-GFC period. Unless global growth begins to accelerate meaningfully in the near term, validating market expectations and fuelling additional momentum in risky assets, we believe markets have otherwise largely priced in a normalised inflation environment and more accommodating policy backdrop, with some risk of profit taking in case of negative surprises. Overall, our framework suggests the global economy remains in a recovery regime. Normally, in this context, the environment supports cyclical exposure with high operating leverage and higher sensitivity to a rebound in growth expectations. Smaller capitalisation companies are well positioned for the current phase of the business cycle.

Figure 9: GRACI and Global LEI



Source: Bloomberg, MSCI, FTSE, Barclay, JPMorgan Invesco Solutions research and calculations, from January 1, 1992 to December 31, 2023. The Global Leading Economic Indicator (LEI) is a proprietary, forward-looking measure of the growth in the economy. A reading above (below) 100 on the Global LEI signals growth above (below) a long-term average. The Global Risk Appetite Cyclical Indicator (GRACI) is a proprietary measure of the market's risk sentiment. A reading above (below) zero signals a positive (negative) compensation for risk-taking in global capital markets in the recent past. Past performance does not guarantee future results.

Smaller companies offering bigger potential in 2024

Australian smaller companies present significant opportunities for investors in 2024. Their greater diversity, exposure to dynamic industries, and potential for active management make them an attractive investment choice. Despite recent performance challenges, the evolving economic landscape and supportive global macro environment indicate a promising outlook for smaller companies.

Furthermore, fundamental factors have been persistent drivers of returns in Australian smaller companies and across the broader market. The combination of these fundamental factors (Momentum, Value and Quality) through a multi-factor framework has been shown to deliver excess returns and a higher information ratio when compared to an active strategy that relies on any single factor.

Given the above, investors should consider allocating to smaller companies for potential growth and diversification benefits through an active investment strategy that combines the three persistent drivers of returns, Momentum, Value and Quality.

Important information

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