Invesco

# Australian Smaller Companies:
## Fallen Angels, and Zombies and Glamours, oh my!

Invesco Australian Equities

### Overview

Active Australian smaller companies managers have historically generated very high levels of active returns for investors. The size of the active returns to the median Australian smaller companies manager may suggest that this cohort could be termed the "Wizards of Oz". In this paper, we take a look behind the curtain to see what is really driving these superior returns.

Smaller companies offer investors the potential for higher returns as these businesses are typically more dynamic, with higher growth and have greater operating leverage than their larger counterparts. However, in Australian equities simply allocating to a smaller companies index has provided investors with mixed results. To understand why passively investing in smaller companies might not be the best approach we have a look at some of the structural design concepts of capitalisation weighted indices and why they may work better for exposure to larger companies than smaller companies.

First, let's look at Large Capitalisation, or Broad Capitalisation, indices which give the most weight to the largest, and implicitly, the most successful companies of the day. Effectively, Large Capitalisation indices provide exposure to the best performing companies and reduce exposure to those companies that have a lower likelihood of future success. The more successful a company is, the more exposure you get and vice versa. It is they key component of why people would advocate for passive investing.

Capitalisation weighted Small Cap indices on the other hand don't offer the same structural advantage for investors and don't offer as robust an exposure. Due to capitalisation weighting of Small Cap indices, it is the largest Small Caps that get the majority of the exposure. There are typically two types of companies that feature as being large in Small Cap indices, they are either large companies that are now small (Fallen Angels) or companies that are trading on very high valuations based on extremely high growth expectations (Glamours). So where Large Capitalisation indices are weighted towards success, Small Cap indices tend to be weighted towards failure (Fallen Angels) and hope (Glamours). In addition, Small Cap indices have a greater representation to companies that barely earn enough revenue to meet their current interest payments, these companies are typically referred to as Zombies.

**Fallen Angels:** Are companies that were previously too large for small cap indices but have fallen from grace and now reside in small cap indices.

**Zombies:** Are companies that are unable, or barely able, to cover their operating and interest expenses. These companies typically have high levels of debt and low levels of profitability.

**Glamours:** Are companies that are trading on extremely high valuations with the expectation that future earnings significantly exceed current or historical earnings.

In this paper we will explore each of these concepts in detail specifically for Australian smaller companies. Our analysis highlights that it is very difficult for Fallen Angels, Zombies and Glamours to generate superior long-term returns for investors. The good news is that through utilisation of proven return drivers (Momentum, Quality and Value) investors can avoid these performance traps and stay on the yellow brick road that smaller companies offer. Importantly, you don't need to be paying relatively high fees to get access to the high active returns available in Australian smaller companies.

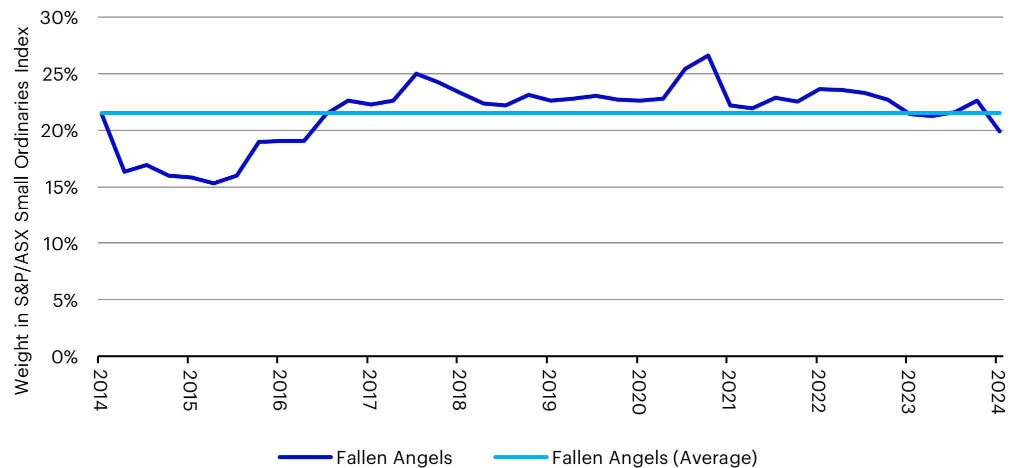
# Australian Smaller Companies:
## Fallen Angels, and Zombies and Glamours, oh my!

### Fallen Angels (Anti-Momentum)

Unlike traditional broad capitalisation indices where companies can only be promoted to the index, for small cap indices companies can be both promoted to the index and relegated to the index. For example, a large company that has had a material event occur and a resulting significant decline in its share price can fall out of a large cap index and into a small cap index. Typically, when this occurs the new entrant will have poor share price and fundamental momentum. Despite the company's negative momentum it may still receive a relatively large weight in the small cap index as it is still a relatively large company.

To get a sense of the exposure to Fallen Angels within the S&P/ASX Small Ordinaries Index, in Figure 1 we plot on a quarterly basis the exposure to Fallen Angels; to satisfy our definition of Fallen Angels a company had to have previously been in the S&P/ASX100.

**Figure 1: Exposure to Fallen Angels**




Source: Invesco, Standard and Poors'. Fallen Angels refers to constituents of the S&P/ASX Small Ordinaries Index that have previously been a constituent of the S&P/ASX 100 Index.

As highlighted in Figure 1 over the past 10 years Fallen Angels, on average, have represented close to 20% of the total weight in the S&P/ASX Small Ordinaries Index. This high representation of poor momentum companies in the underlying index has significant implications for investor outcomes.

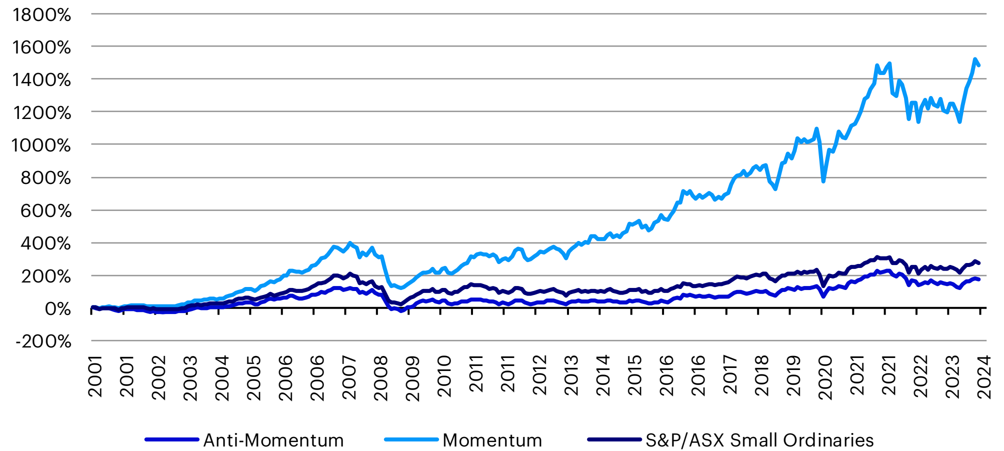
**Fallen Angels** have poor price and fundamental momentum and can be classified as "Anti-Momentum"

A key driver of equity performance is the concept of Momentum. First observed by Jegadesh and Titman[1] the momentum effect refers to the phenomenon that winning stocks outperform losing stocks over the short to medium term. Momentum has been a powerful driver of returns across all equity markets globally and is especially prevalent in smaller companies.

Fallen Angels, by definition, have poor price and fundamental momentum and can be classified as "Anti-Momentum". By simply avoiding these Anti-Momentum companies and investing in the highest momentum companies investors could have added an extra 6.7% per annum over the S&P/ASX Small Ordinaries Index as detailed in Figure 3.

[1] Jegadeesh, N. and S. Titman (1993): Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency, Journal of Finance 48(1), 65-91

**Figure 2: Momentum - Cumulative Returns (Jan 2001 – May 2024)**




Source: Invesco, Standard and Poors'. Momentum represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Momentum factor. Anti-Momentum represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Momentum factor.

**Figure 3: Momentum – Return Analysis (Jan 2001 – May 2024)**

| | Anti-Momentum | Momentum | S&P/ASX Small Ordinaries |
|---|---|---|---|
| Annualised Return | 4.4% | 12.6% | 5.8% |
| Annualised Volatility | 19.6% | 17.2% | 17.7% |
| Historical Beta | 1.05 | 0.93 | 1.00 |
| Excess Return | -1.5% | 6.7% | |
| Tracking Error | 5.8% | 5.5% | |
| Monthly Hit Rate | 46% | 66% | |
| Spread Return | 8.2% | | |

Source: Invesco, Standard and Poors'. Momentum represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Momentum factor. Anti-Momentum represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Momentum factor.

Not only do Anti-Momentum companies (**Fallen Angels**) experience lower returns than their high momentum counterparts, they also display higher levels of volatility as well.

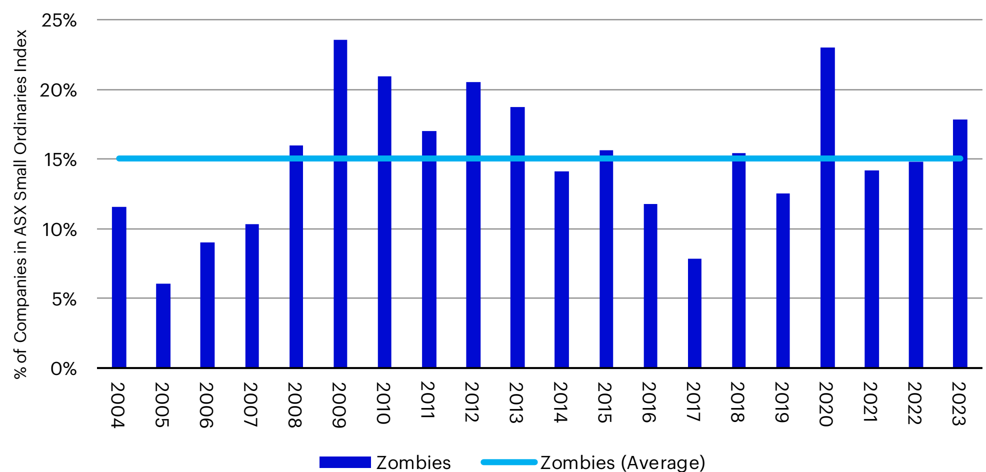
Not only do Anti-Momentum companies (Fallen Angels) experience lower returns than their high momentum counterparts, they also display higher levels of volatility as well. Investors have been well rewarded over time for avoiding Anti-Momentum companies in their portfolios.

### Zombies (Anti-Quality)

Zombie companies refer to those companies that are unable, or barely able, to generate enough revenue to cover their operating expenses and financing requirements. For these companies they may be Zombies temporarily due to either cyclical or one-off events (i.e. Covid) or permanently due to burgeoning interest expenses and/or declining revenues.

Zombie companies are much more prevalent within Small Cap indices than they are in Large Cap indices. In Figure 4 below we review the number of Zombie companies in the S&P/ASX Small Ordinaries Index over time. We see a significant exposure to Zombies within Australian small caps with on average 1 out of every 7 companies not making a profit in any given year. This is heightened in periods of economic stress such as the GFC (2008/2009) and COVID (2020).

**Figure 4: Companies with Negative Earnings**



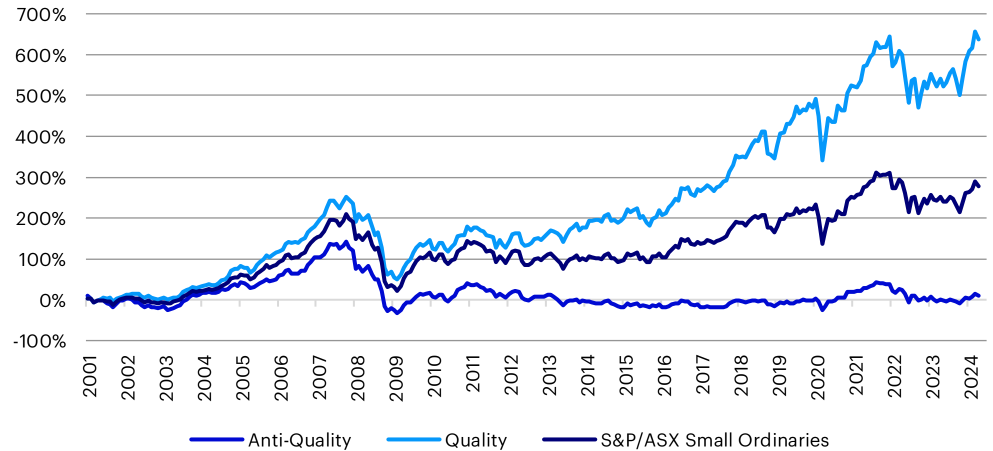

Source: Invesco, Standard and Poors'. Zombies refers to constituents of the S&P/ASX Small Ordinaries Index that had negative earnings in the respective financial year.

**Zombies**, best characterised as unprofitable companies, are "Anti-Quality"

Zombie companies are best characterised as unprofitable companies, or Anti-Quality and there is strongly compelling evidence that highlights a link between a company's profitability and the subsequent returns generated for investors[2]. If we look more broadly at the overall Quality of a company, we see that alongside profitability we can also assess a range of metrics to determine the financial health of the company as well as quality of the management. In Figure 6 we show the performance of best and worst companies using our proprietary Quality definition (which includes profitability).

[2] Novy-Marx, R. (2013): The other side of value: The gross profitability premium, Journal of Financial Economics 108(1), 1-28

**Figure 5: Quality - Cumulative Returns (Jan 2001 – May 2024)**




Source: Invesco, Standard and Poors'. Quality represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Quality factor. Anti-Quality represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Quality factor.

**Figure 6: Quality – Return Analysis (Jan 2001 – May 2024)**

| | Anti-Quality | Quality | S&P/ASX Small Ordinaries |
|---|---|---|---|
| Annualised Return | 0.4% | 8.9% | 5.8% |
| Annualised Volatility | 21.3% | 16.5% | 17.7% |
| Historical Beta | 1.15 | 0.91 | 1.00 |
| Excess Return | -5.4% | 3.1% | |
| Tracking Error | 6.4% | 4.3% | |
| Monthly Hit Rate | 42% | 60% | |
| Spread Return | 8.5% | | |

Source: Invesco, Standard and Poors'. Quality represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Quality factor. Anti-Quality represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Quality factor.

Avoidance of **Zombies** has improved the performance outcomes, reduced overall volatility and drawdowns experienced by investors

Anti-Quality (unprofitable) companies have a poor track record of success as we can see in Figure 6. Over the period Anti-Quality companies have trailed the broader S&P/ASX Small Ordinaries Index by -5.4% per annum. In addition, they have also displayed significantly higher levels of volatility. On the other hand, high Quality (profitable) companies have outperformed the S&P/ASX Small Ordinaries Index by +3.1% per annum, with lower volatility.

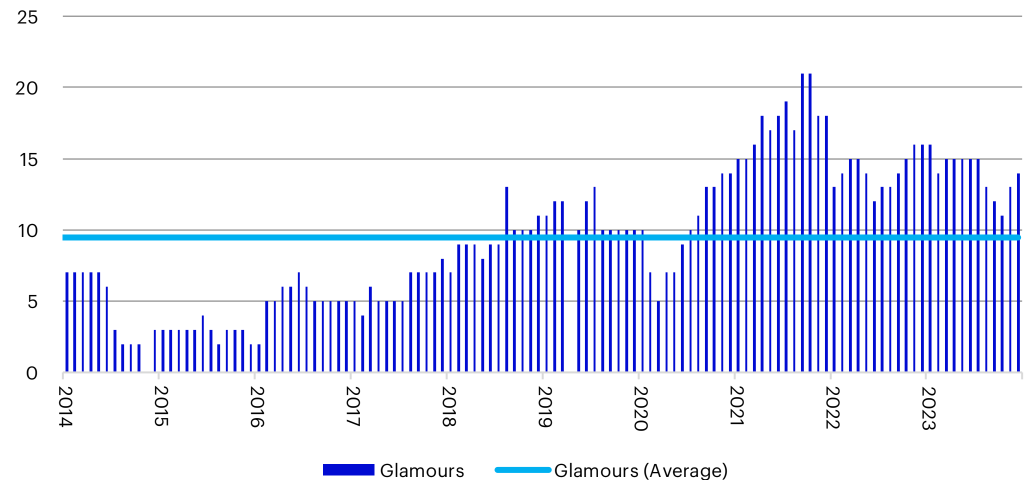
The avoidance of Zombies has not only improved the performance outcome for smaller companies but it has also reduced the overall volatility and also the drawdowns experienced by investors.

**Glamours (Anti-Value)**

Glamour companies are those companies that are trading on extremely high valuations with relatively high earnings growth expectations. These companies are often "hyped-up" by both the market and media. Glamour companies can be highly speculative and are often operating in new and unproven markets. In the short-term, empirical evidence shows that investors often pay too much for high growth and that more often than not high growth expectations do not fully materialise[3].

Historically, companies with high forecasted growth that is yet to materialise are often over-priced. One technique for screening such companies is to rank companies by their price-to-sales multiple and avoid investing in the most overpriced companies. The chart in Figure 7 shows the number of companies in the S&P/ASX Small Ordinaries Index over time that are trading on extremely high valuation multiples. For the purpose of this analysis, we define any company with a price to sales ratio higher than 30 as an extremely high valuation. To provide some context, it would take at least 30 years of current revenue of these companies to recover the initial investment.

**Figure 7: Companies with Extremely High Valuations (Jan 2014- Dec 2023)**



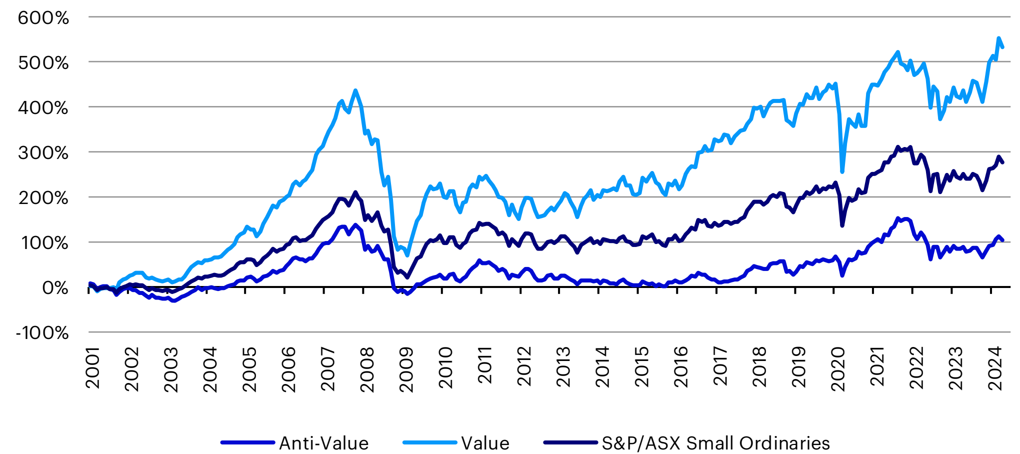

Source: Invesco Quantitative Strategies, Standard and Poors'. Glamours refers to constituents of the S&P/ASX Small Ordinaries Index that are trading on a Price/Sales ratio greater than 30. To provide some context, it would take at least 30 years of current revenue of these companies to recover the initial investment.

**Glamours**, trading on materially higher valuations than the overall market, are "Anti-Value"

Glamour companies by definition are Anti-Value as they are trading on materially higher valuations than the overall market. Historically Anti-Value companies have disappointed investors as the implied growth represented in the relatively high valuations hasn't materialised. On the other hand, historically those companies that are trading on a relatively low valuation have outperformed.

[3] Lakonishok, J., Shleifer, A. and S. Titman (1994): Contrarian Investment, Extrapolation, and Risk, The Journal of Finance 49(5), 1541-1578

**Figure 8: Value - Cumulative Returns (Jan 2001 – May 2024)**




Source: Invesco, Standard and Poors'. Value represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Value factor. Anti-Value represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Value factor.

**Figure 9: Value – Return Analysis (Jan 2001 – May 2024)**

| Return Analysis | Anti-Value | Value | S&P/ASX Small Ordinaries |
|---|---|---|---|
| Annualised Return | 3.1% | 8.2% | 5.8% |
| Annualised Volatility | 19.9% | 20.0% | 17.7% |
| Historical Beta | 1.06 | 1.07 | 1.00 |
| Excess Return | -2.7% | 2.4% | |
| Tracking Error | 6.6% | 6.2% | |
| Monthly Hit Rate | 46% | 59% | |
| Spread Return | 5.1% | | |

Source: Invesco, Standard and Poors'. Value represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Value factor. Anti-Value represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary Value factor.

Anti-Value (**Glamour**) companies have underperformed the broader S&P/ASX Small Ordinaries Index by -2.7% per annum and have done so with significantly higher levels of volatility.

In Figure 9 we can see that over the period Anti-Value (Glamour) companies have underperformed the broader S&P/ASX Small Ordinaries Index by -2.7% per annum and have done so with significantly higher levels of volatility. When we compare this to Value companies we see that although they display a similar level of volatility to Anti-Value companies they have delivered 5.1% per annum more in return.

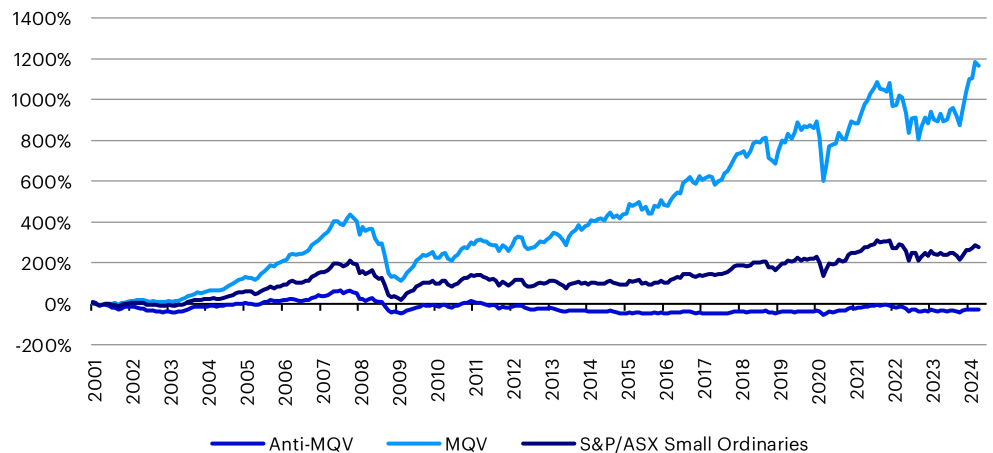
**Generating Alpha in Small Caps: Momentum, Quality and Value (MQV)**

It has long been observed that active managers in Australian smaller companies have provided strong performance relative to the S&P/ASX Small Ordinaries Index. In fact, over the past 20 years the median smaller companies active manager has generated an active return that is 5.9% per annum (before fees) above the S&P/ASX Small Ordinaries Index. This is truly an exceptional outcome for investors and is a reason why the median Australian smaller companies manager charges 1.8% in management fees (inclusive of performance fees).

At first glance, these returns would appear to be the result of amazing skill by the underlying active managers. However, as we have outlined in this paper there are some unique characteristics associated with Small Cap indices and when we avoid Fallen Angels, Zombies and Glamours investors can generate significantly higher returns than a naïve capitalisation weighted benchmark. While we have explored these concepts independently we will now look at how they can be used collectively to generate excess returns that are consistent with the median active smaller companies manager.

To take these concepts and turn them into a reliable alpha driver we combine all three drivers (Momentum, Quality and Value) into an aggregate alpha score and build a portfolio of the top 20% of companies based on those aggregate alpha scores. We call this portfolio the MQV portfolio and it is only exposed to the highest ranking companies. We also create a portfolio of the lowest 20% of companies based on an aggregate score of the underlying Momentum, Quality and Value exposures, we call this portfolio the Anti-MQV portfolio. The Anti-MQV portfolio has the highest exposure to Fallen Angels, Zombies and Glamours.

**Figure 10: MQV - Cumulative Returns (Jan 2001 – May 2024)**




Source: Invesco, Standard and Poors'. MQV represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor. Anti-MQV represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor.

**Figure 11: MQV – Return Analysis (Jan 2001 – May 2024)**

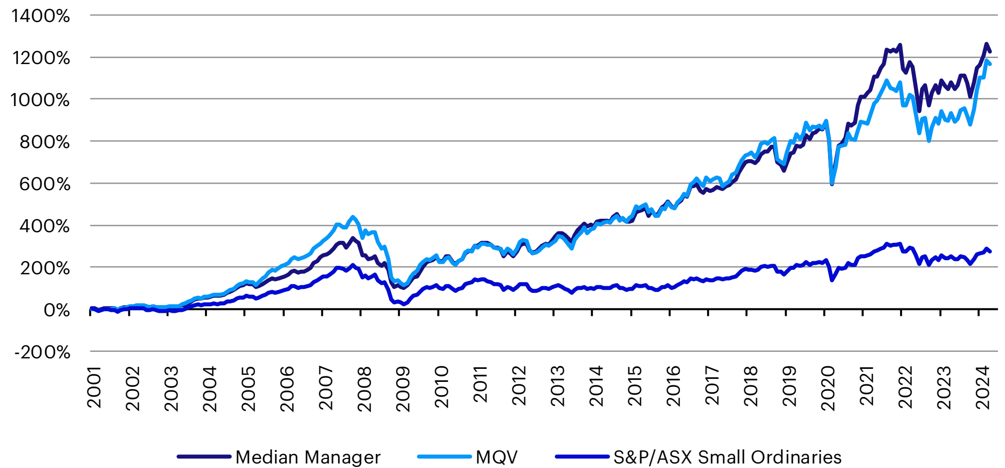
| Return Analysis | Anti-MQV | MQV | S&P/ASX Small Ordinaries |
|---|---|---|---|
| Annualised Return | -1.5% | 11.5% | 5.8% |
| Annualised Volatility | 21.6% | 17.2% | 17.7% |
| Historical Beta | 1.15 | 0.93 | 1.00 |
| Excess Return | -7.3% | 5.7% | |
| Tracking Error | 7.0% | 5.2% | |
| Monthly Hit Rate | 41% | 61% | |
| Spread Return | 13.0% | | |

Source: Invesco, Standard and Poors'. MQV represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor. Anti-MQV represents the bottom 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor.

We can see in Figure 11 that by combining all three return drivers the MQV portfolio outperforms the broader S&P/ASX Small Ordinaries Index by +5.7% per annum. Further, the Anti-MQV portfolio underperforms the same index by -7.3% per annum. This creates a 13% per annum spread between the best and worst companies using an aggregated MQV score.

The strong +5.7% excess return that we see for the MQV portfolio represents a significant opportunity for active smaller companies investors. In fact, it is very consistent with the returns we observe before fees from the median active smaller companies manager (+5.9%) over the same period.

**Figure 12: Median Manager - Cumulative Returns (Jan 2001 – May 2024)**




Source: Invesco, Standard and Poors'. MQV represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor. Mercer Median Manager data is based on the Australian Small Companies Universe, gross of fees.

**Figure 13: Median Manager – Return Analysis (Jan 2001 – May 2024)**

| Return Analysis | MQV | Median Manager | S&P/ASX Small Ordinaries |
|---|---|---|---|
| Annualised Return | 11.5% | 11.7% | 5.8% |
| Annualised Volatility | 17.2% | 15.7% | 17.7% |
| Historical Beta | 0.93 | 0.87 | 1.00 |
| Excess Return | 5.7% | 5.9% | |
| Tracking Error | 5.2% | 4.3% | |
| Monthly Hit Rate | 61% | 65% | |
| Spread Return | 0.2% | | |

Source: Invesco, Standard and Poors'. MQV represents the top 20% of companies based on Invesco Quantitative Strategies (IQS) proprietary MQV factor. Mercer Median Manager data is based on the Australian Small Companies Universe, gross of fees.

In Figure 12 and Figure 13 we compare the performance of our relatively simple MQV portfolio and compare that with the median active smaller companies manager (before fees). We show that over time the MQV strategy has been effective at replicating much of the skill that is ascribed to active smaller companies managers. It also challenges the notion that you need to pay high fees to access smaller companies "alpha" and that much of the active management opportunities available can be explained by traditional return drivers: Momentum, Quality and Value.

**Positioning Smaller Companies portfolios for success**

Australian smaller companies can offer great investment opportunities, but navigating this sector requires a thoughtful approach. Small Cap indices tend to be exposed to a significant proportion of companies that either have struggled in the past (Fallen Angels), are financially weak (Zombies), or are overhyped with high valuations (Glamours). This can lead to lower returns and higher risks for investors.

The evidence clearly shows that Australian Small Cap indices often allocate a disproportionate weight to companies with poor momentum, financial instability, or inflated valuations. Consequently, passive investment in small cap indices can lead to mixed results.

By focusing on proven investment factors—Momentum, Quality, and Value—investors can effectively sidestep these pitfalls and capture superior returns. We show that the MQV portfolio, which integrates these critical factors, not only aligns with the returns achieved by active managers but also demonstrates that exceptional returns can be obtained without incurring high fees.

Our analysis underscores that employing a systematic, factor-based, approach enables investors to harness the true growth potential of smaller companies while avoiding the traps of traditional indices. By adopting this method, investors can achieve high active returns net of fees and successfully navigate the complexities of small cap investing.

A systematic, factor-based, approach enables investors to harness the true growth potential of smaller companies while avoiding the traps of traditional indices.

## Important information

This document has been prepared by Invesco Australia Ltd (Invesco) ABN 48 001 693 232, Australian Financial Services Licence number 239916, who can be contacted on freecall 1800 813 500, by email to clientservices.au@invesco.com, or by writing to GPO Box 231, Melbourne, Victoria, 3001. You can also visit our website at www.invesco.com/au.

This document contains general information only and does not take into account your individual objectives, taxation position, financial situation or needs.

Invesco has taken all due care in the preparation of this document. To the maximum extent permitted by law, Invesco, its related bodies corporate, directors or employees are not liable and take no responsibility for the accuracy or completeness of this document and disclaim all liability for any loss or damage of any kind (whether foreseeable or not) that may arise from any person acting on any statements contained in this document.

While any Invesco fund referred to in this document may consider Environmental, Social and Governance (ESG) aspects to better manage risks and improve returns, it is not bound by any specific ESG criteria. The fund may invest across the ESG spectrum and will not necessarily exclude companies with controversial business areas – such as those with significant revenues from coal, fossil fuel, nuclear power, weapons and tobacco – from the investable universe. Information used to evaluate ESG factors may not be readily available, complete or accurate. ESG factors may vary across types of investments and issuers, and not every ESG factor may be identified or evaluated. There is no guarantee that the evaluation of ESG considerations will be additive to the fund's performance. This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else.

© Copyright of this document is owned by Invesco. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco.