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Research and Insights

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Global small caps: From unrecognised growth to future global titans

Small companies offer the potential for growth that can exceed their larger peers over the long term, an assertion supported by the data. Small Companies offer investors early stage entry into names destined to become future global titans. Ausbil's global small-cap team answer some key questions on how to access such unrecognised opportunities.

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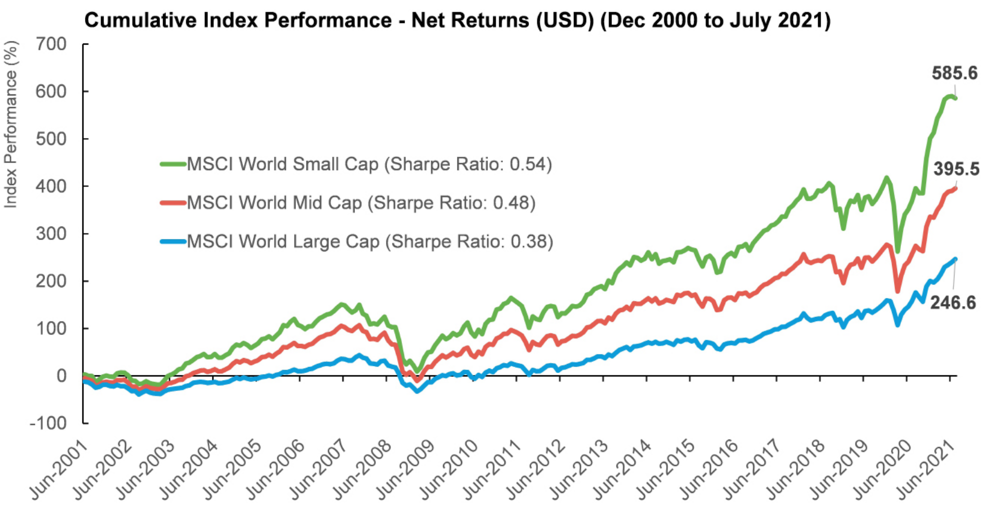
Q: Can you give us the elevator pitch for what you do?

TB: We find global companies that are early in their stages of development, are not actively covered yet by the market, and have latent, unrecognised growth prospects with the potential for major rerates and sustainable unrecognised earnings growth.

Finding uncovered 'gems', the names that offer what we call 'unrecognised growth' is where an active global investment manager like Ausbil can help investors take advantage of small-cap idiosyncrasies, while helping to reduce the typical level of risk that come with early-stage small-cap investing.

We like global small caps because over the long-term, smaller companies consistently show outperformance against their larger peers, as evidenced in Chart 1.

Chart 1: Small is beautiful: The compelling performance of smaller companies



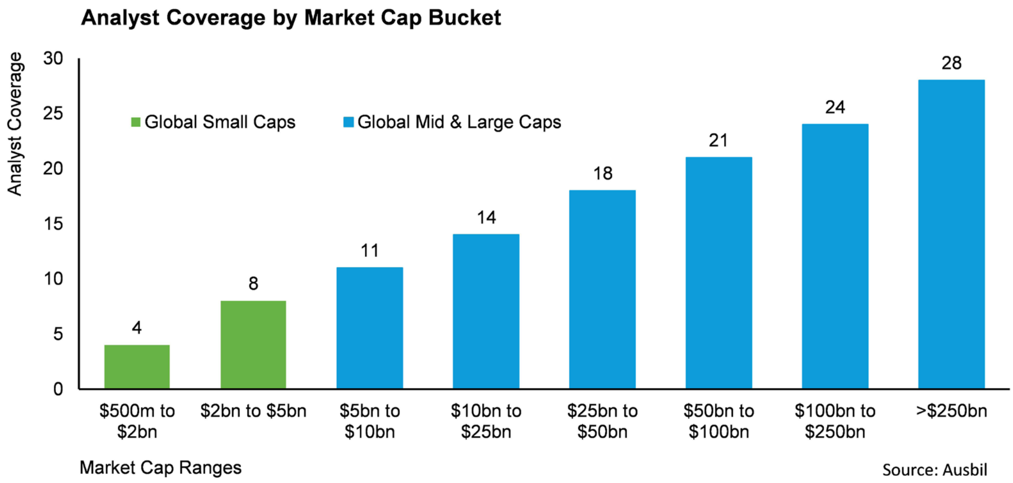
Source: Ausbil, FactSet

From Chart 1, since the inception of the MSCI indices in 2000, small companies have compounded well in advance of mid and large-cap peers. Over this twenty-plus years, small caps have risen by a factor of almost 6-times, mid caps buy almost 4-times, and large caps by the best part of 2.5-times. The outperformance of small companies has been shown consistently in the in the empirical long-term evidence provided by esteemed researchers such as Siegel (2015). Banz (1981) and Fama and French (1992), and in the market data.

Q: Can you explain the term, 'unrecognised growth'?

SW: Unrecognised growth is where a company exhibits the signs and potential for future earnings growth that is conceptually ahead of peers or the market in general, but for which there is no consensus as the company is not yet covered by a bevvy of institutional analysts. The company is 'unrecognised' because, due to size, it is yet to become large enough to warrant broad institutional coverage. Chart 2 illustrates how analyst coverage changes as companies become bigger. Global small caps operate in a 'sweet spot' of opportunity that has yet to be noticed or acknowledged by the institutional equity research machine.

Chart 2: What 'unrecognised' looks like



Ausbil's global small-cap team seeks the opportunities in the 23[1] developed markets in which we invest before any reliable institutional consensus has been established. In the case of some companies, there might be a consensus based on the views of a handful of analysts, as illustrated in Chart 1, but there is typically a significant divergence in views on valuation, opportunity and risk. The essential idea is that we focus on companies where growth will surprise, in companies that are attractively valued, and which we believe demonstrate relatively less risk in proportion to the opportunity. Combined with a lack of analyst coverage, forward surprise potential at attractive valuations reveals companies with unrecognised growth, which ultimately drives share prices.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 30 June 2021, Ausbil manage over $15.8 billion in funds under management.

1. MSCI World Small Cap, the global developed market index for small companies that covers 23 markets with around 4,400 constituent companies.

Q: Why do these companies go 'unrecognised' for a period of time?

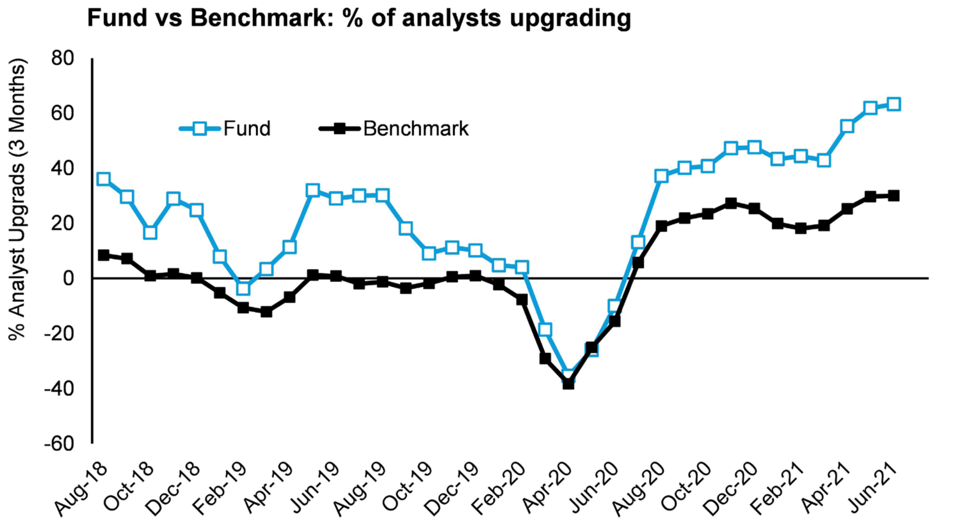
TB: Fast growing smaller companies are proving their business models, their sales and earnings can be volatile, and their businesses can be undiversified in terms of steady-state earnings. Institutions, like insurance companies which are not specialist small-cap investors, typically look for larger-cap equities with steady historical earnings, and more mature business models. However, large super and pension funds often carry significant allocations to small cap equities for the superior long-term returns they can offer in equity portfolios. Small companies, when the fundamentals are sound, the management is strong, and the business model is relatively unassailable, can offer upside potential for investors who are comfortable with riding-out shorter term bursts of volatility.

From the sell-side perspective, small companies are often supported by specialist financiers, angel investors, cornerstone investors, large insider holdings and small broking houses in their early years, before they graduate into the bigger leagues and into larger capital raisings with larger investment banks. This creates significantly more opportunity for astute small-cap investors to participate in funding rounds for businesses that are on a trajectory for major growth, ownership transition events and other ongoing capital raisings and block trades that offer the potential to steadily build positions in companies with the potential to become the next global titans.

Q: In your experience, what are the features of a good unrecognised opportunity?

SW: Our fundamental and quantitative research seeks to unearth the unrecognised winners that have a high probability of earnings upgrades. Chart 3 illustrates how, to date, we have been able to consistently track ahead of the market on capturing earnings upgrades.

Chart 3: Beating the consensus on identifying quality and upgrades



Source: Ausbil, FactSet

There is no exact template for finding companies with significant unrecognised growth that are also in the process of exceeding market expectations on earnings growth, however there are some key elements that appear in the excellent examples we have found in the past.

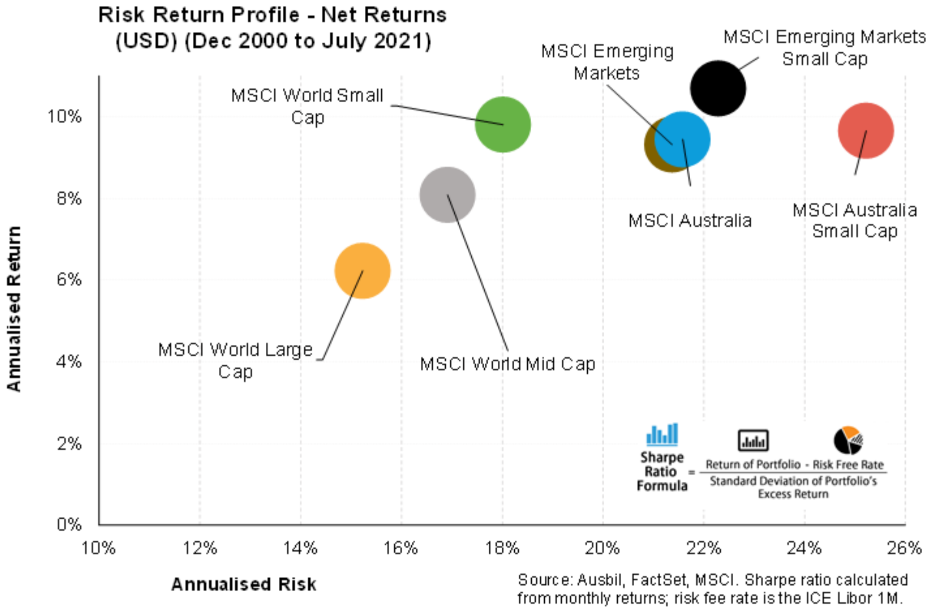
A great, unrecognised growth company often starts as a niche leader, that has global ambitions and products that are capable of contesting position in the global market place. Unrecognised growth companies often invest capital into their own expansion, as opposed to paying higher dividends, as they are able to earn a greater return on capital for investors through reinvestment. Quality unrecognised growth companies seek expansion, but not at the expense of strong ESG characteristics, which ensure critical elements are in place for successful expansion: strong corporate governance; and low environmental and social risks. An attractive company that exhibits unrecognised growth offers the potential for earnings surprise in future years, which ultimately draws the attention of the institutional market and eventually catalyses significant re-ratings.

It may be an oft-repeated cliché, but what holds all together, from the development of great strategy to the execution of a successful local and global business strategy, is the quality of leadership. Great unrecognised growth companies invariably boast great management. People matter in successful companies, and as active investors, we are well positioned to meet with, review, question and assess management as part of our due-diligence process.

Q: What about risk? Aren't small caps riskier investments than larger companies?

SW: In theory, small caps should be riskier than larger companies when compared on crude measures of diversified income and size, however, when adjusted for risk, small caps can be surprisingly rewarding. As illustrated in Charts 1 and 4, using the Sharpe Ratio measure of risk adjusted returns, global small caps typically demonstrate a superior risk-adjusted returns (higher Sharpe ratios), than both mid and large-cap stocks. Moreover, an active investment approach can increase this Sharpe ratio through concentration in high-quality unrecognised growth companies, and the active avoidance of low quality small caps that do not match the criteria we apply.

Chart 4: The risk-return profile of small caps in perspective



MSCI Index	Sharpe Ratio
MSCI World Small Cap	0.54
MSCI EM Small Cap	0.52
MSCI Australia	0.48
MSCI World Mid Cap	0.48
MSCI Emerging Markets	0.47
MSCI Australia Small Cap	0.46
MSCI World Large Cap	0.38

In taking a wider range of risks into consideration with the application of additional ESG risk filters, it is possible to further improve the risk-return outcome for small caps. ESG considerations can help reduce many tangible and intangible, un-quantifiable risks that help select winners and deselect losers in the risk-return equation.

Finally, liquidity management is key to success in global small-cap investing. Unlike mid and large-cap stocks that typically have deep order books in the marketplace, global small caps can display shallower order books, to the point of illiquidity. A company needs market trade flow in order for the execution of a clean investment thesis through the clean entry and exit of positions. In an illiquid stock, news can hamper the ability of investors to trade or exit. Ausbil manages exposure to liquidity risk very closely, and we will not enter positions that we cannot exit at any time, and within a reasonable timeframe. Relative to all small caps, this further improves the risk-reward positioning of our approach, and can also materially improve our Sharpe ratio.

In today's volatile markets, large companies are not a guaranteed mitigation for risk. The market has rapidly sold down many large caps regardless of size, and institutional share registers can be brutal to large caps, as much as they can to smaller companies.

Q: So can you give us some examples of what a great, unrecognised growth story looks like?

TB: Australia is only 2% of the world market. There is a lot of potential on offer in the other 98% of markets, and a lot of companies and sectors that are just not available in Australia. Moreover, small caps in larger markets have a natural advantage in being 'small fish in very large ponds'. One such company is theTradeDesk (TTD). The Global SmallCap Fund invested in TTD in June 2018. At the time, TTD was marketing online banner ads and content that rivalled Google Ads, but protected the identity of advertisers. TTD was a small fish in a very large pond, but it offered a compelling challenger solution to the dominant player in one of the world's most profitable spaces.

TTD displayed many of the crucial characteristics we look for as a sign of quality, unrecognised growth. It was a niche leader in digital advertising, with global expansion ambitions for developed and emerging markets. It offered new and unique products, especially in universal IDs that was not being offered by Google. The management team were already proven, and reinvesting a growing earnings stream back into expansion of the business. With strong ESG credentials and a focus on improved data privacy, a competitive edge in the market, TTD was able to build and expand, and generate earnings surprises that were not recognised by the market. The result is that from the $87 entry price in June 2018, earnings surprises drove the stock price to $900 by January 2021, at which time the Fund exited, with TTD graduating 'with honours' as an emerging global titan, moving from the Fund's benchmark into the mid-cap benchmarks.

Another example from the Fund's portfolio is Generac, a world leader in generators, based in the United States. Generac (GNRC) is another company that demonstrates the features of an emerging global titan, similar to our experience with TTD. Generac started as a niche leader in generators and smart energy. Growth ambition has since seen it expand globally, into South America and Europe. GNRC has expanded its product offering into inverters and smart grid tech, further investing through accretive mergers and acquisitions that expand both its capabilities and its footprint. GNRC has strong ESG credentials, especially with its link to future sustainable energy demand, and like TTD, it has a highly regarded management team. The Fund has seen its investment to date rise to over $280, from an entry point of $50 in May 2018, with the stock a key holding for future earnings surprise.

Q: Can you summarise the benefits of adding global small caps to a portfolio?

SW: We think the proposition for investors is simple. Global small caps offers a superior risk-adjusted return from a global opportunity set of companies, many of which are not represented in Australian equity sectors. The opportunity to invest early in the next theTradeDesk, Google or even Tesla are waiting to be discovered in these 23 developed markets. They are not common, but with the criteria we apply in selecting companies demonstrating superior unrecognised growth potential, we believe the odds are significantly shortened for investors capturing the growth of future global titans.

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